Financial Consumer Protection and Fintech: An Overview of New Manifestations of Consumer Risks and Emerging Regulatory Approaches (Consumer Protection note) by Gian Boeddu and Jennifer Chien

Fintech[57] is increasingly recognized as a key enabler worldwide for more efficient and competitive financial markets, and for expanding access to finance for traditionally underserved consumers. As noted in the Bali Fintech Agenda,[58] launched in October 2018 by the World Bank Group (WBG) and the International Monetary Fund (IMF), fintech can support economic growth and poverty reduction by strengthening financial development, inclusion, and efficiency. The critical challenge for policy makers is to harness the benefits and opportunities of fintech while managing its inherent risks.

Some of these risks are new. But many represent new manifestations of existing risks due to the technology that supports and enables fintech offerings, from new or changed business models, product features, and provider types, and from greater consumer accessibility to sometimes unfamiliar or more complex financial products.[59] For example, a rapid expansion of the peer-to-peer lending (P2PL) market in China in the first half of the 2010s was followed by significant platform collapses, incidents of fraud, and platform operator misconduct, which caused significant losses to consumers.[60] While digital microcredit has expanded access to credit in some developing economies, countries such as Tanzania and Kenya have seen large numbers of borrowers unable to repay loans due to irresponsible lending practices.[61] Similarly, while there was significant uptake of electronic money (e-money) in many developing markets, this has been accompanied by a rise in a variety of risks for consumers, including potential loss of funds due to fraud and unscrupulous fee-charging. Such negative experiences, in addition to causing direct harm to consumers, may also lead to greater mistrust of fintech and the financial sector, overall.

The COVID-19 pandemic has further accelerated the widespread transition of consumers to digital financial services and fintech, highlighting their significant benefits while also demonstrating how risks to consumers can increase in times of crisis and economic stress. For example, reports from Indonesia indicate that individual lenders/investors have been adversely affected by risky loans made through P2PL platforms, as have been borrowers who obtained such loans, and are now struggling to get lenders/investors to restructure them.[62] Significant numbers of low-income consumers have faced difficulty repaying existing debts due to the pandemic.[63] Small enterprises have been severely affected by widespread closures and safety measures to slow the spread of COVID-19, thus decreasing enterprises' profitability and impeding repayment obligations.[64] This in turn exposes their investors to increased risk of loss from their investments. In addition, significant increases in fraudulent app-based digital microcredit lenders have been observed during COVID-19 lockdowns.[65]

Authorities responsible for financial consumer protection (FCP) regulations are increasingly faced with the challenge of developing or adapting regulations that may be necessary to address risks to consumers generated by fintech. The task of regulators in developing countries is even more difficult if they tackle this new challenge while

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57. For the purposes of this note, *fintech* refers to advances in technology that have the potential to transform the provision of financial services, spurring the development of new business models, applications, processes, and products. See World Bank Group and International Monetary Fund, *Bali Fintech Agenda,* 12.
58. World Bank Group and International Monetary Fund, *Bali Fintech Agenda.*
59. For an overview of risks and benefits in a digital financial services context, see G20/OECD Task Force on Financial Consumer Protection, *"Financial Consumer Protection Policy Approaches."* 12–14.
60. See, for example, Duoguang, "Growing with Pain," 42; Owens, "Responsible Digital Credit," 8–9; Huang, "Online P2P Lending," 77; Hornby and Zhang, "China's Middle Class."
61. For example, a 2017 MicroSave study found that 2.7 million Kenyans were blacklisted in credit reference bureaus in the past three years; 400,000 of these for amounts of less than $2. See MicroSave, "Where Credit Is Due."
62. See, for example, Faridi, "P2P Fintech Lending Sector in Indonesia."
63. For example, 76 percent, 80 percent, and 89 percent of low-income survey respondents in Ghana, India, and Kenya, respectively, indicated they were late in making loan repayments since the pandemic began. See BFA Global, "Dipstick Surveys."
64. See, for example, Gibbens, "Helping Small Businesses."
65. https://www.centerforfinancialinclusion.org/combating-the-rise-in-fraudulent-fintech-apps.

having to implement a baseline FCP regulatory framework.[66] In a recent survey, regulators identified their limited internal technical expertise as the foremost impediment to regulating and supervising "alternative finance" (such as P2PL and equity crowdfunding) effectively.[67]

This note provides (1) an overview of new manifestations of consumer risks that are significant and cross-cutting across four key fintech products: digital microcredit, P2PL, investment-based crowdfunding, and e-money;[68] and (2) examples of emerging regulatory approaches to target such risks. This note is based on a more detailed recently-published WBG Policy Research Paper titled *Consumer Risks in Fintech—New Manifestations of Consumer Risks and Emerging Regulatory Approaches.* The research paper delves more deeply into each of the four key fintech products and their associated risks. The appendix provides an overview of product-specific risks for which more information can be found in the research paper.

The primary focus and objective of this note, and the paper on which it is based, is to inform authorities' development of regulatory policy. The examples included here are intended to assist regulators considering potential FCP regulatory approaches to fintech. However, it is hoped that the discussion of manifestations of consumer risks in a fintech context can also assist authorities with related key areas, such as market conduct supervision.

The key consumer risks and corresponding regulatory approaches discussed in this note include the following:

- **Factors, such as the novelty and opaqueness of fintech business models, responsibilities of fintech entities' in the context of those business models, and a lack of consumer understanding of the new offerings can lead to heightened risks of fraud or misconduct by fintech entities or third parties.** Platform finance (P2PL and investment-based crowdfunding) poses risks to consumers; both lenders/investors and borrowers. Lenders/investors may face losses due to the conduct of platform operators or related parties, such as fraudulent lending or investment opportunities, misappropriation of funds, or facilitation of imprudent lending or investment to generate fee revenue for the operator to the detriment of consumers who will ultimately bear resulting losses. Consumers borrowing from such platforms may similarly suffer harm from the resulting imprudent lending. Holders of e-money face risks related to agent misconduct, including charging of unauthorized fees, splitting transactions to earn more commissions, and "skimming" into agent accounts. Regulatory approaches to addressing such risks include: vetting of fintech entities during the authorization stage; risk management and governance obligations for platform operators; imposing clear responsibility and liability on providers for the conduct of persons acting on their behalf; placing targeted obligations on platform operators to safeguard consumers' interests regardless of business model (such as requiring P2PL platform operators to undertake creditworthiness assessments even if they are not themselves the lender); warnings and provision of other key disclosures to consumers regarding the risks associated with fintech products; and segregation of client funds.

- **Certain characteristics of fintech business models can lead to conflicts of interests between consumers and fintech entities.** For example, business models heavily dependent on fees generated by new lending business can give rise to perverse incentives for fintech entities to act in a manner inconsistent with the interests of their consumers, such as P2PL platforms or digital microcredit providers focusing on loan quantity over quality to maximize fee-related returns. Such risks can be exacerbated in markets where fintech entities are attempting to grow their revenues and size quickly. Potentially harmful conflicts can also arise where fintech entities are empowered to take decisions affecting the risk of loss on loans, but where that risk is borne by consumers—such as a P2PL or crowdfunding platform operator assisting with loan or investment selections without performing adequate due diligence. Corresponding regulatory

66. For an overview of key elements of an FCP regulatory framework (being an element of a broader legal and supervisory framework for FCP), see, for example, World Bank Group, *Good Practices,* 14, 68, 102, and 140.
67. World Bank Group and CCAF, *Regulating Alternative Finance,* 63.
68. Selected as examples of fintech offerings that may address some of the most basic needs of first-time, and thus inexperienced, financial consumers—namely, making payments, borrowing, or saving or investing money—as well as representing different stages in the development of fintech product offerings and corresponding regulatory and policy frameworks that surround them. See section 2.2 for definitions of these terms as used in the paper.

approaches include placing positive obligations on fintech entities to manage and mitigate conflicts of interest, to act in accordance with the best interests of their consumers, to undertake adequate assessments regardless of business model, and to prohibit business arrangements that encourage conflicted behavior.

- **Consumers may face a heightened risk of adverse impacts due to platform or technology unreliability or vulnerability.** Consumers may be more vulnerable to cyber fraud when acquiring fintech products than when accessing financial products through more traditional channels as interaction with providers is largely or exclusively via digital and remote means. Platform or other technology malfunctions can have adverse impacts on consumers ranging from inconvenience and poor service to monetary loss and loss of data integrity, the risk of which may increase due to heavier reliance on automated transaction processing. Regulatory approaches to addressing such risks include specific obligations on fintech entities to address technology and systems-related risks and risks associated with outsourcing.

- **Some fintech entities may be at greater risk of business failure or insolvency than established financial service providers (FSPs), due to inexperience, untested businesses, and market factors affecting long-term viability.** This can mean that consumers, whose funds are held or administered by a fintech entity, face correspondingly greater risk of loss if the provider becomes insolvent or the business ceases to operate. Consumers may risk losing their committed loan principals and investment funds or repayments and earned investment returns that are being held or administered by a P2PL or crowdfunding platform that fails. Insolvency of e-money issuers or banks holding e-money floats similarly puts client funds at risk, especially where there is no deposit insurance. Regulatory approaches to address such risks include requirements for client funds to be segregated from other funds held by a fintech entity and requiring that fintech entities have in place business-continuity and resolution arrangements.

- **The digital environment poses inherent challenges for disclosure and transparency, amplified by the novelty of fintech product offerings and consumers' lack of experience with such products.** Information provided via digital channels may not be appropriately formatted to assist in understanding or retention by consumers. Poor design of user interfaces may hamper consumer comprehension or exploit behavioral biases by concealing or underplaying "negative" aspects such as risks and costs. Fintech can also give consumers access to products, such as P2PL or crowdfunding investment opportunities, to which they may previously have had limited or no exposure, thus making clear and understandable information even more essential for good decision-making. Approaches to address such issues include requirements to disclose key information in a consistent and clear format, on a timely basis, and in a manner that can be retained by consumers. Behavioral insights can also be utilized to disclose information via digital channels in a manner that aims to increase the likelihood of consumer comprehension.

- **Consumers face potentially heightened risks when acquiring fintech products due to their lack of sophistication or inexperience.** With the development of fintech, consumers increasingly have access to novel and complex financial products, but they may lack the knowledge or experience to assess or use these products properly. For example, platform finance enables more individuals to act as investors and lenders. This has positive implications for financial inclusion but can present enhanced risks for ordinary consumers new to assessing more complex opportunities. Potential regulatory approaches include setting limits on individual investments, such as overall caps on how much an individual may borrow through a P2PL platform or how much money a company can raise on a crowdfunding platform, or limitations on specific types of investors or exposures; targeted warnings to potential investors; requiring consumers to confirm that they understand the risks they are undertaking; and cooling-off periods. Risks may also arise with respect to digital microcredit products being offered to consumers that are unsuitable and unaffordable. Regulatory approaches include requiring effective creditworthiness assessments and applying product design and governance principles, particularly where automated credit scoring is utilized.

- **Use of algorithms for consumer-related decisions is becoming particularly prevalent in highly-automated fintech business models.** Consumers may face a range of risks as a result, such as discriminatory or biased outcomes. Emerging approaches in this context include applying fair treatment and anti-discrimination obligations to algorithmic processes; putting in place governance frameworks that require procedures, controls, and safeguards on the development, testing, and deployment of algorithms to ensure fairness; auditing requirements; and providing consumers with rights regarding how they or their information may be subjected to algorithmic decision-making.

It is not the intent of this note to suggest that all risk mitigants it discusses should be implemented. For any regulator contemplating implementing the kinds of regulatory measures discussed in this note, it will be important to prioritize and take a risk-based approach, to tailor regulatory approaches to country context, and to balance the need for consumer protection with the resulting impact on industry and market development and innovation. It would not necessarily be advisable for a country to implement all of the regulatory measures discussed in this note immediately or to transplant approaches from other jurisdictions without adjustment. This note also summarizes a range of key implementation matters for regulators to consider.