CDC-SPTF FINTECH WEBINAR SERIES FOR INVESTORS

Brief 1. FinTech Investments: Evaluating Risks and Value to Clients

Many investors want to better understand opportunities in the FinTech space but do not have a roadmap for how to evaluate such investments for their risks and benefits to clients. Industry-wide standards exist for evaluating the consumer protection and social performance management (SPM) practices of *traditional* financial service providers and can be a starting point for FinTech providers as standards and guidelines are being adapted. In the meantime, investors are seeking answers to the questions: *During due diligence and monitoring of FinTech investments, how do we evaluate client protection risks*? *How do we assess the value for the end consumer?*

SPTF and CDC Group have designed a webinar series for investors to help answer these critical questions. SPTF is coordinating with experts including the Smart Campaign, MicroSave, and others to develop content for the series.

This brief presents key lessons from the introductory webinar. During the webinar, Alex Rizzi of the Smart Campaign outlined some specific client protection risks posed by FinTech, and Pim Engels of FMO discussed how his organization is adapting its due diligence process for FinTech investments. Future webinars will delve further into specific topics, such as “pay as you go” models and data privacy, and what they mean for due diligence and ongoing monitoring.

Listen to the full recording here. To sign up for the webinar mailing list, contact Leticia Emme.

Part 1: Key client protection risks posed by FinTech

While FinTech models can provide benefits to clients – such as meeting short-term liquidity needs – there are several client-borne risks of mobile credit. During the webinar, Alex Rizzi highlighted the main risks that Smart Campaign has identified during its research. While the risks were largely derived from mobile credit providers, they can apply to other models:

1. Credit capacity decisions based on digital data can put clients at risk for overindebtedness.
   While the use of alternative data (transaction amounts, airtime usage, ratio of talk to text, etc.) makes credit decisions faster and easier, the traditional debt-to-income client evaluation is often skipped as providers do not have the information. Many of these models are looking only for client *willingness* to repay and use imprecise proxies for *capacity* to repay. Furthermore, the algorithms used to identify desirable customers are often proprietary and not readily shared with investors.

2. Wall-to-wall digitization of all parts of the lending process may put clients at risk of irresponsible practices. In low- and no-touch models, clients have little human contact with their provider and may be unsure how to get help if they need it.

3. Rapid processing of loans and pop-up marketing can increase risk for overindebtedness and hasty credit choices**.** For example, a client transfers money into her mobile wallet, two minutes later, she receives an unsolicited SMS offering her a loan, she clicks “accept,” and three minutes later, she receives the loan into her wallet. A loan she may not have been looking for 10 minutes ago. Instant or near-instant loan approval and pop-up marketing such as unsolicited SMS, may lead people to take a loan they do not fully understand.

4. Responsibility for consumer protection is diffused along the value chain
   In many FinTech business models, responsibility for client welfare is dispersed along the value chain. Unlike traditional finance, where responsibility for clients typically falls on a single provider, FinTech often uses multiple firms to service a single customer—a marketing firm, an underwriter, an agent, a bank, etc. The Smart Campaign describes this as the consumer protection “hot potato,” where the responsibility for protecting consumers gets tossed from firm to firm and none are fully liable for client welfare.

5. The models assume some clients will lose in the experimental phase
   Initial rollouts of credit deployments are often made with imprecise algorithms that are meant to improve over time. The experience generated by these early loans is used to hone the algorithm, and a relatively large number of defaults might be expected at first. This process is considered by the provider to be a necessary part of the model’s development. However, this experimental phase can have real consequences for client “guinea pigs.” For example, millions of Kenyan borrowers have been blacklisted for defaulting on mobile loans of a few dollars. Refinement of the credit model should not be done at the expense of the consumer.

Other risks have been well-documented by the Smart Campaign (here), CGAP (here), and MicroSave (here).

Part II: What does this mean for responsible investors?

Given these risks, investors that are focused on benefits to end clients will have to adapt due diligence and monitoring for FinTech investments. Pim Engels shared lessons learned from FMO’s efforts to do so:

1. Conduct in-depth interview with FinTech owners**.** While the traditional microfinance industry tends to consist of “known entities,” the FinTech industry consists of entrepreneurs and angel investors that are largely unknown to microfinance investors. Phase 1 of FMO’s risk

screening involves an in-depth interview with the FinTech's leadership and owners to better understand their motivations, as they can have a major impact on how clients are treated. As Pim noted, investors must "pay attention to whether the true nature or mission of the company is to deliver a product or service to the benefit of the end client, or whether the company is turning the end client into its product."

2. Adapt due diligence *questions*. It is essential to understand how FinTech providers differ from traditional providers, and to treat them accordingly during due diligence and monitoring. As it makes more FinTech investments, FMO is adapting its risk assessment questions accordingly:

    - *Business environment and model.* With FinTech companies, investors need to dig deeper to understand the potential market size. Investors should also carefully consider the proof of demand; product usage data, portfolio quality data, and repeat clients are useful metrics for this.
    - *Profitability and pricing*: Investors should keep the following questions in mind:
        - Many early-stage FinTechs are inefficient, loss-making, and subject to their investors' high return expectations. What are investor expectations, and how do these affect the client?
        - Clients at the start-up phase are not reaping the full benefit of the efficiency the technology is promising. How fair is that, and how long will the company build the model?
        - What is the justification for technology expenses?
    - *Regulatory environment*. FinTech companies typically are not regulated. Investors should ask if the regulators in the country are actively tolerating FinTech, and if they are supportive of the venture capital industry.
    - *Lending practice*. Potential questions for FinTechs include:
        - How much of the lending practice should be automated? When is client touch necessary?
        - Does the algorithm include any loan limits to prevent client overindebtedness?
        - How does the company perform data analytics?
        - How does the company balance the need to experiment with the need to prevent clients from harm?

3. Adapt due diligence *process*. FMO's standard risk screening involves two phases: (1) desktop research on ownership, business environment, profitability and the regulatory environment; and (2) on-site due diligence focused on lending practices. As it explores more FinTech opportunities, FMO is realizing that Phase 1 is not feasible solely as desktop

research; it has become increasingly important to discuss these issues on-site. Additionally, due diligence for FinTech requires new skillsets for investment officers, which involves additional training.

4. Know that it is ok to walk away. FMO does not have set requirements for many of its new due diligence questions for FinTech, but it feels it is imperative to ask them to better understand the company. FMO believes if an investor feels any discomfort with how a company talks about and treats clients, it is best to listen to that instinct and walk away. Just as it is acceptable to walk away if an investor does not like a company's business model, Pim noted that "it is perfectly fine to walk away if you don't feel comfortable with the level of responsible practices."

PART III: Join the conversation

Understanding the FinTech space and its effects on end clients is a moving target. The technology and delivery methods change rapidly, as do the players. It is essential that global learning is shared among investors. A good deal of learning has already taken place, and there are many initiatives aimed at self-regulation.

Those with investments in FinTech can share their expertise with the rest of the industry. The learning curve will be much shorter if investors compare notes, and potentially arrive at some *shared criteria for FinTech due diligence/monitoring* and potentially a client protection certification for FinTech providers. There are several avenues for investors to join this work:

- Participate in this CDC-SPTF webinar series, which is open to investors only. To sign up, please contact Leticia Emme.
- Join the SPTF Social Investor Working Group, which is open to all social investors.
- Participate in a working group to develop investor guidelines for responsible digital finance, hosted by IFC and Goodwell. The group aims to create practical and actionable guidelines for responsible digital finance that investors will self-subscribe to, (re)define, promote and implement. The group is only open to investors. To join, contact Lory Camba Opem.
- Join the Smart's Campaign's FinTech Community of Practice. The group is for FinTech companies only, but investors can nominate their FinTech portfolio partners, and the Smart Campaign will publish new tools and research that emerges over the next year. For more information, contact Alex Rizzi.