CDC-SPTF FINTECH WEBINAR SERIES FOR INVESTORS

Brief 4. FinTech Investments: Pricing and pricing transparency in digital credit

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 fourth webinar. During the webinar, Rafe Mazer of FSD Kenya discussed the consumer risks related to pricing and pricing transparency in digital credit. Peace Osangir of Kopo Kopo and Eliud Mungai of Branch discussed how their organizations price their products and how they disclose those prices to consumers.

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

This session focused on pricing and pricing transparency specifically for digital credit. "When you look at the risks around issues in pricing for consumers, and when you look at the pace of scale vs other digital financial services, digital credit is the most pressing product line that we should be thinking about with pricing and pricing transparency," Rafe Mazer said.

He noted that some of the questions around digital credit echo debates from microfinance in the 1990s and early 2000s. For example, some questions include:

- *Why are the interest rates so high?* CGAP research shows wide variance and high APRs for digital products in Kenya. High-interest loans can lead to politicization of this issue.

- *Do customers understand what they're signing up for?* A survey of M-Shwari consumers showed that few clients understood the full cost of their loans. After a new rule enforcing pricing disclosures took effect, there were significant improvements in client understanding. "Transparency, when done right, can improve understanding, and that can perhaps lead to improved behavior and decision-making in borrowing," Rafe said.

- *Are these loans helping the lower-income populations or financially excluded?* A CGAP survey in 2017 showed that digital borrowers tend to be male, younger, urban and previously banked. "I'm not always sure we're reaching the fully excluded. We may just be offering diversity to the already banked," Rafe said. "We need to improve upon getting the digital credit models out to not just the low-hanging fruit consumers."

- *Who is monitoring these new providers and products?* Because digital financial services providers include a mix of regulated and unregulated banks and MNOs, financial regulators may not have the scope to issue pricing transparency rules to apply to all lenders equally. In Kenya, the Competition Authority issued the rule enforcing disclosure rules – not the Central Bank – because its rule applied to any firm operating in Kenya that offered the product, not just financial firms.

Part I: Opportunities for pricing and pricing transparency with digital credit

Despite these challenges, the delivery, collection channels, and new data sources with digital credit make more product and pricing innovations feasible. "We have some opportunities to do pricing and pricing transparency better and with more rigor because they're on digital channels."

- *Loan tenure can be more flexible.* Because of the creativity it enables, the digital delivery channel and automation allow lenders to do things that were not viable from a business perspective with traditional, in-person lending models. For example, Kopo Kopo offers merchant loans with no fixed tenure. The repayment is made as a percentage of each merchant payment transaction, meaning loan repayment happens on pace with business activity. Similar models could be developed to reflect seasonality in various sectors of the economy.

- *Loan terms can be adapted to include new repayment and penalty structures*. For example,
    - Jumo offers pay-as-you-use daily interest rates.
    - Branch does not charge penalty fees. "A fee is counterintuitive because they're already unable to repay what they owed," said Eliud Mungai. Branch works with clients to determine the reason behind late payments and try to get them to pay as quickly as possible. In lieu of penalty fees, late repayment negatively affects clients' ability to get larger loans.

- *Lenders can more easily test and measure efforts to improve consumer understanding because it's easier to collect data.* For example,
    - M-PAWA held an experiment in which it supplemented its digital credit and savings product with interactive, educational SMS about the product and how to effectively use it. Clients who used this feature increased savings balance and repaid loans an average of five days earlier than before.
    - In a separate experiment, separating finance charges from the principal reduced default rates from 29% to 20%.
    - In separate research, clients were given an active choice whether to view terms and conditions for a loan. By making it a choice, the number of consumers who viewed the terms and conditions increased from 10% to 24%. Delinquency rates for borrowers who chose to view them were 7% lower than those who did not view them.

- *We can find new ways to gather data and apply customer segmentation.* This will be important as we move digital credit from small consumer credit loans to loans for different sectors of the economies, Rafe said.

Part II: How can investors work with investees to lower pricing?

While pricing for digital credit – particularly short-term credit – can be high, the speakers shared several examples and ideas for lowering prices for consumers. For example, investors can make sure their investees:

- *Use the right types of alternative data.* While digital credit providers have started using various types of data to more efficiently assess consumers' ability to repay, some types of data have proven more effective than others.
    - Kopo Kopo has found that one proxy for income can be customers' use of their mobile phone, such as their usage of airtime, payments from their phones or use of other mobile credit facilities.
    - Digital data regarding the supply chain – such as purchase history or the movement of goods – is also helpful, Peace Osangir of Kopo Kopo noted.
    - Branch uses SMS logs to see clients' mobile money balances or it they're late with other lenders. Rafe emphasized that mobile money balances are very helpful indicators of repayment.
    - Data on how the customer interacts with the app can also be indicative. Branch has found that customers who read the FAQs tend to be good borrowers.
    - Social media data does <u>not</u> have a high correlation with ability to repay, Eliud and Rafe said.

- *Access and contribute to a centralized collection of data.* Right now, lenders often partner with data providers, which entails giving up a percentage of returns to the data provider. Any sort of centralized collection of data – in which all providers share good and bad credit information about consumers – would help lower this cost. "How can we create a centralized platform where all providers in this space could view a customers' position?" Peace said. Rafe added that such a platform should also reflect economic activity, such as wholesale purchases data or payments data.

- *Use innovative methods to lower customer acquisition costs.* For example, Branch is exploring using a customer referral model, in which it would provide an incentive to existing customers for referring friends. The reward would benefit existing customers and still cost significantly less than Branch would normally pay to acquire a customer.

- *Provide incentives for customers to repay early.* In some cases, Branch will waive a percentage of interest that was charged if the client pays earlier.

- *Introduce differentiated pricing.* Kopo Kopo offers improved pricing to customers that have been frequent borrowers and are lower risk customers in terms of repayment. "The longer a customer has been with us, the more we know about the customers' repayment behavior, then the better the terms of credit off them," Peace said. "We want to make sure the customer benefits from a good credit history."

- *Advocate for laws that level the playing field for competition.* "We have a lot of room for innovators to enter the markets, Rafe said. "Now we might want to look at leveling the playing field of competition." Such laws include:
    - Ensuring equal treatment of consumers, irrespective of the lender they happen to be engaged with at the time.
    - Preventing discriminatory pricing for accessing USSD channels. "We want to make sure one lender isn't paying 5-10x more than another for access."

Part III: How can investors improve pricing transparency?

The speakers also shared several ways digital credit providers can improve pricing transparency. Investors should make sure investees:

- *Contact customers to check for understanding of terms of service.* Digital channels do not entirely replace the need for human touch. Kopo Kopo calls applicants to ensure they understand the terms of credit and to check that the loan will be used for an economic purpose that adds value.

- *Use innovative tools to disclose pricing.* Kopo Kopo developed a digital slide ruler that allows customers to see the correlation between the amount they want to borrow, the fees that would entail and the percentage of their profit. "There's an element of consumer control," Peace said. "With the sliding scale, they're able to determine, 'If I take this much, and this is my fee, based on my profit margin, am I comfortable with what I'm paying back?'"

- *Employ opt-in settings for data privacy or sharing.* Default settings are powerful, and clients often do not read terms and conditions, Rafe said. First and foremost, requiring clients to opt-in to sharing their data gives them more control of their data. However, it can also make it clearer to them what pricing or product benefits would stem from sharing their data. These terms and conditions should include the types of data being collected, how they would be used, and the third party that data is being shared with. It should also include time and usage limitations regarding how the data will be used.

- *Use the best metrics for consumer understanding.* All three speakers noted that APR, while a useful tool to standardize costs in a market, can be difficult in consumer facing disclosures, particularly for short-term lending. Peace said that Kopo Kopo has found that APR creates more confusion than clarity for their customers; rather, they have found that communicating the absolute amount the customer will pay is the best way to communicate.

- *Understand the duty of care to customers.* Transparency des not take away the duty of care for lenders to prevent a customer from taking a loan if it is not in their best interest. Kopo Kopo sometimes talks clients *out* of taking a loan if it's clear the client doesn't understand the terms or if the loan will not add economic value. "It's a bit counterintuitive, but you want to make sure at the end of the day the customers' business is not negatively affected by the credit they're taking," Peace said. “We work with the customer throughout the journey to ensure that, at the end of the loan, they’re in a much better position. What we look for is a customer that can repeat business with us. We do our part to ensure the money goes to good use, the customer is aware of the service, and the customer is educated throughout the loan journey.”

Recommended reading

Stanford Social Innovation Review (SSIR), *FinTech for the Financially Excluded.*
https://ssir.org/articles/entry/fintech_for_the_financially_excluded

MasterCard Foundation, *Can Big Data Shape Financial Services in East Africa?*
http://www.financedigitalafrica.org/wp-content/uploads/2018/03/FiDA-Can-Big-Data-Shape-Financial-Services-in-East-Africa.pdf