CDC-SPTF FINTECH WEBINAR SERIES FOR INVESTORS

Brief 2. FinTech Investments: Repayment capacity analysis, pricing, and predatory marketing

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 second webinar. During the webinar, Anup Singh of *MicroSave* discussed the consumer risks related to pricing and marketing strategies of FinTech companies, and Rafe Mazer, a consumer protection expert who has worked with digital credit providers, discussed how investors can address these risks. Future webinars will delve into other 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.

Anup Singh started the call by outlining four key design considerations for *sustainable* FinTech:

1. **User-centric design**. Products and services must meet the needs of the end user for it to work. Anup noted that FinTechs often create a solution for a problem that does not exist.
2. **Pricing**. Pricing must be easily understood and perceived affordable by end users.
3. **Marketing and customer acquisition**: Marketing must communicate the uses, benefits, and risks to end users.
4. **Responsibility**: Aspects of social performance and client protection must be embedded within the products and services delivery.

While all four considerations are important to achieve sustainability, this webinar focused on the middle two considerations: pricing and marketing.

Part 1: FinTech pricing

What are the risks to clients?

While product pricing in any sector can pose risks to consumers, the FinTech sector provides its own set of consumer protection risks around pricing. This is due to several factors:

- **Lack of supervision.** FinTechs are not subjected to rigorous supervision compared to traditional financial service providers. They have more freedom on pricing offerings.
- **Risk Pricing.** FinTechs mainly focus on client segments perceived to be risky due to their irregular incomes. They price their digital credits highly since such services are unsecured, and chances of recovering the money in case of default are low.
- **Use of alternative data to assess ability and willingness to repay.** FinTechs offering credit often assess their customers' ability and willingness to repay by developing algorithms to analyze available alternative data. Additionally, some digital lenders have access to complete data sets through exclusive partnerships with MNOs. Theoretically, analysis of such data – such as locations a client frequents, usage of data services, or social media activity – can be beneficial to the FinTech and the client:
    - Alternative data could lead to better client understanding and profiling, which could lower risk pricing.
    - Use of alternative data could help identify different marketing strategies, which could lead to discounted pricing.

  The assumption is that over time, FinTechs will use this data to lower overall costs and prices. *<u>However, there is little evidence to show that prices lower over time</u>.* End users are paying a higher price while FinTechs finetune their data algorithms, but they are not being rewarded down the line with lower costs.
- **Risks in pricing models.** Different pricing models can present risks to the sustainability of FinTechs, which in turn affects their end users.
    - Several pricing models – including pay-as-you-go, bundled, flat rate, and threshold pricing – can be open to fraud. For example, with a threshold pricing model in Kenya, university students have learned how to game the system. They borrow one loan, buy another SIM card to borrow another loan, and then use the second loan to pay the first one. With such loan juggling, students can increase their loan sizes to around 4-5x of their first loan in just three months, Anup said.
    - Additionally, with flat rate and threshold pricing, FinTechs may have lower risk coverage than the loan demands. "If you're not using alternative data, you're loaning on a hunch," he said.

  Such risks can handicap a FinTech. If it's not giving good loans, a FinTech is not able to build up a strong data set to analyze and refine its algorithms.

- **Short-term focus.** Many FinTechs operate in a high-risk, high-reward mindset with a short-term focus, Anup said. Their investors, who demand high returns in relatively shorter time frames, often reinforce this. "FinTechs often ask why they must care about responsible pricing because they are not NGOs. But if one FinTech gets pricing wrong and does something to harm the market in a significant way, there will be a huge clamp down with regulation," Anup said. "They're not thinking about the long-term future of the company."

What does this mean for responsible investors?

Given these pricing risks, investors that are focused on benefits to end clients will have to adapt due diligence and monitoring for FinTech investments. Investors should:

- **Ask: Do clients fully appreciate what they're paying for?** Investors should demand FinTech investees give a presentation on how they present pricing to consumers. A lot of borrowing in FinTech is discretional and consumption-based, which is not necessarily economically beneficial to consumers. Plus, the market is not price sensitive when it comes to low-value transactions. "The more we can weed out this kind of borrowing, the better," Rafe said. "This is where investors can leverage."
- **Analyze if there is a downward trajectory in price over time.** Clients should not pay for the FinTech's learning expenses – such as fine-tuning algorithms – over a long period of time.
- **Look for elements of responsible pricing models.** This includes:
  - Transparency on pricing, terms, and conditions
  - Market-based pricing, which is non-discriminatory pricing
  - Pre-payment penalties and transaction fees aren't excessive and are communicated to the customer
- **Evaluate the price**. Evaluate the market price range, analyze competitors' pricing, and check if the pricing of products and services is within the public domain. This can be done through websites or messages to the subscribers. Investors should also evaluate customer participation in pricing determination.
- **Evaluate risk mitigation mechanisms for pricing models.** For example, to combat cases of fraud, FinTechs can implement two-factor authentication. To combat reputation risks around pricing, FinTechs should monitor stakeholders and customers' perceptions.
- **Ensure compliance with laws that do exist.** While most FinTechs are not yet subjected to regulation, some are. For example, for more than three years, M-Shwari refused to report positive borrowers to the credit bureau, even though it was required by law, Rafe said. Commercial Bank of Africa is similarly not reporting positive borrowers to the credit bureaus in Tanzania and Uganda. Many lenders also do not disclose the cost of their loan to the consumer prior to entering the loan agreement, violating basic pricing transparency principles. Given this track record of poor consumer protection compliance by some digital lenders, investors should demand written confirmation from investees that they are

following the law before investing and include consequences for cases where non-compliance is detected.

- **Focus on the medium- to long-term.** FinTechs have a very short-term focus, Anup said. “Right now, it’s ‘I have a solution, people are buying our products because they’re innovative and fancy, and we’re not reporting to anybody.’” Somebody must take a medium- and long-term focus on sustainability. Investors should play that role by imposing covenants to ensure design considerations for sustainable FinTech.

For a longer list of due diligence questions related to pricing and other topics, see the Annex.

Part 2: FinTech marketing

What are the risks to clients?

FinTechs are more likely to use “below the line” marketing than traditional financial service providers. While “above the line” marketing entails more traditional advertising – such as billboards or posters – “below the line” strategies focus on highly customized content: using keywords to target a market, targeting promotions on social media to individuals, or advertising at events their target market will likely attend. Many FinTechs have specifically focused these strategies to target the millennial generation.

Such strategies are not inherently harmful. However, stemming from FinTechs short-term focus – and the need to quickly increase the customer base and eliminate competition – such marketing can become predatory:

- **Reckless borrowing.** Prequalified loan offers and solicitation can lead to reckless borrowing. A *MicroSave* report on digital credit in Kenya shows that repeated push SMS messages drive loan uptake when borrowers do not have a need or intention to borrow. “The marketing is designed in a way that it feels like if you don’t get this loan right now, you’re missing a golden chance,” Anup said. Clients often use the loan for consumption instead of entrepreneurship, which can lead to defaults.

- **Unclear terms**. FinTech marketing often does not mention all fees, specify if an interest rate is flat or discounted, or tell a client where to find out more detailed information. MicroSave research in Kenya showed that many digital credit users did not understand the real cost of the interest payment until the day they had to repay.

- **Comparison marketing**. Marketing sometimes dilutes messages in a confusing fashion to distort the market. For example, when Uber entered a market in India, they said they offered the price at one-fifth of their competitors. However, that’s not the real price because it’s not a sustainable price.

- **Higher defaults**. Such reckless borrowing or unclear terms can lead to higher defaults. In Kenya, more than 400,000 borrowers are listed as nonpaying or delinquent in credit bureaus for defaulting on loans as small as $2. FinTech – designed to help bring low-income consumers into the financial system – is excluding them.

What does this mean for responsible investors?

Investors focused on benefits to end users should take steps to ensure their investees are using responsible marketing practices. Such steps include:

- **Invest in companies that offering meaningful loans**. "We'd like to see investors push the boundaries of digital credit for the real economy. There is an upper limit of the utility of these nano-credit loans for consumer and business owners. And the purely commercial money is going to chase that segment already," Rafe said. "I would like to see social investors' money go to really innovative ideas where you're starting to use more cash flow data or merchant data to offer meaningful loans that target certain segments, such as merchants or small-holder farmers. That's meaningful but requires more sweat."
- **Look for elements of responsible marketing design.** Responsible marketing should:
  - Be honest and transparent about social causes. Avoid aggressive marketing by being transparent and completely disclosing information.
  - Be aware of legal regulations specific to the industry. Ensure the message remains silent on pricing comparisons to avoid implications.
  - Be involved with the audience at a social level. Ensure visibility in social media and engage with its customers
- **Ensure investees disclose full cost in marketing**.
  - Marketing should disclose fees, specify the type of interest rate, and point users to where they can find out more details.
  - FinTechs should explore innovative ways to better educate consumers. CGAP conducted a pilot with an educational content provider, which developed user-guided SMS learning to supplement farmers when they enrolled through M-PAWA. Pilot participants had significant increases in savings balances and paid back loans earlier than they had previously. "There's a hybrid middle ground between education and marketing that might be a sweet spot to explore," Rafe said.
- **Talk to end users.** To help determine if predatory marketing is taking place, investors must assess how customers found out about the FinTech and its products. What were they told the benefits would be? What do customers think about the FinTech after using the products? Ideally, this would involve talking to randomly selected users. Investors should also analyze the investee's webpage and social media pages for reviews.

For a longer list of due diligence questions related to marketing and other topics, see the Annex.

ANNEX: Due diligence questions for sustainable FinTech

Overall sustainability:

1. Is the solution really addressing the needs of the end user?
2. What customer segments and channel penetration are used by the FinTech?
3. What is the value proposition to the FinTech, to the end user, and to the other stakeholders that are part of the business strategy?
4. What are the resources and partners of the FinTech?
5. What is the FinTech's marketing and communication strategy?
6. How are they managing their risks?
7. What are their revenue streams? What are the risks in leveraging those revenue streams?
8. Are they pricing their services appropriately? Do they have costs that are reasonable for the sector?
9. What is their vision for the next 5 years and 10 years?

User-centric design

1. What informed your product offering(s)?
2. Who is your target customer?
3. Do you consider your solutions to be market-led? How do you measure that?
4. How did you achieve user-centric design in the solutions you offer?

Pricing

1. What is your pricing model and what led to that model?
2. Is the model working for the target customers? If yes, why?
3. Do you intend to change the model in the next 3 years? If yes, why?

Marketing

1. Which marketing strategy are you using currently? Why?
2. How effective is the strategy? How do you measure its effectiveness?
3. Do you intend to change the strategy in the next 3-5 years?

Responsibility

1. How sustainable is your business model?
2. To what extent do you offer responsible financing? Focus on product itself, marketing, pricing.

Capacity to Repay

1. What informs your customers repayment ability?
2. Is this FinTech using any technology to understand the customers' ability to repay? If any, tell us more about the technology.
3. To what extent are you using alternative data? Please explain.
4. How accurate is this approach?
5. Any plans to enhance repayment capacity analysis?