The Future of Lending – Post Covid 19

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The COVID 19 pandemic disrupted economies worldwide - with frequent lockdowns, business closures and job losses. Small businesses which provide the bulk of employment were particularly devastated, with more than 80% in India estimated to have been significantly impacted in the initial phases.

A loan is sanctioned based on the lender's assessment of the probability of default (based on the available information about a borrower) and the anticipated loss in the event of a default (based on the value and enforceability of collateral). Traditionally, lenders had face to face contact with borrowers and risk was assessed by taking into consideration the potential borrower's credit history, income, purpose of loan and strength of collateral. For business loans, lenders also differentiated between sectors in terms of inventory norms, balance sheet ratios, etc, as these differed between industries. With the widespread losses to businesses and individual incomes, past data could no longer be a reliable predictor of the future. To compound matters, policy interventions like debt moratoria and deferment of NPL (non performing loan) classifications further reduced the usefulness of financial data for lenders. This led to lenders becoming conservative and a slowdown in fresh credit disbursals.

Necessity is the mother of invention. Faced with a situation of lockdowns, social distancing and difficulty in assessing a borrower's ability to repay based on traditional methods, lenders embraced digitalization with a vengeance - for business continuity and for some, their very survival. Financial service providers were compelled to digitalize internal operations – from account opening to loan underwriting, monitoring and collections. They also rolled out new digital channels and Apps.

In their journey to digitalize, lenders used a variety of tools, like:

- Alternative data (AD), ie., data not available from credit reports. An immense amount of data is available through mobile networks, financial service providers, on line platforms and Government databases. This, together with non-financial information scraped from social media and online behaviour, can provide information that is at least as predictive as the data of the credit bureaus. As per World Development Report 2022, a study has found that in Germany credit scoring models based on digital footprints were better at predicting credit worthiness than credit bureau scores. In India, a study of loan data from a large fintech lender showed that use of mobile and social footprints improved risk assessments. It also helped risk assessment of individuals who lacked a credit bureau record.
- Artificial Intelligence (AI) and Machine Learning (ML) tools. ML models can integrate real time data and adapt to changing economic conditions. Thus, the algorithms are more efficient in assessing credit risk remotely and can automate due diligence. Big data analytics helps in fraud detection. While AI is very useful for lenders, it is important that lenders are aware that biases in programming and data could introduce an element of discrimination in the lending process and guard against the same.
- Cloud integration. This enabled integration with credit bureaus, alternative data sources, etc., which helped them to automate the entire lending process.
- Mobile support and Apps for wide and speedy reach, particularly useful in a country like India with a high density of mobiles.
- The digital payment ecosystem which allowed seamless digital disbursals and collections.

Implementing AD, AI and ML in their models and processes was challenging for a number of lenders which had legacy systems which lacked flexibility. There was also a shortage of data analysts and software development engineers. This gave birth to multiple start ups with niche technology and products which offered Saas (Software-as-a-Service), subscription models and modular solutions.

This also resulted in a proliferation of nimble, tech savvy fintech companies offering niche products and serving consumers, both MSMEs and individuals, at various socio economic levels. The traditional lenders ie., the banks and NBFCs, increasingly tied up with fintech companies for co-lending, with the latter doing the originations as well as the collections and the former leveraging their capital base. A number of traditional lenders also acquired fintech companies. Even non-finance companies like Big Tech and retailers became active in this space.

Although currently loaning by fintech companies and Big Tech accounts for only 1-2% of overall credit to private sector, their growth is impressive. For example, Paytm has reported 8.5 million loan disbursals during the quarter ending June 30,2022, aggregating to Rs 5,554 crores, a 492% increase vis-à-vis the same period in 2021.

P2P and P2B platforms are also active, servicing the needs of small businesses and individuals.

Major e-commerce platforms are offering credit to merchants and consumers registered with them. They have access to the revenue/ purchase history and return history and use this data to underwrite the loans. Some other platforms tie up with banks and financial institutions and share the data (after data owners consent) based on which the latter provide credit via the platform.

It is evident that the digital push necessitated during the lockdowns, the enforced work from home norms and the social distancing disrupted the pre COVID models of lending, particularly to SMEs and individuals. Multiple kinds of players as also various models of financing by traditional players have emerged. While a number of these initiatives had been visible even prior to the pandemic, they suddenly got accelerated manifold and consumers also embraced them. According to a Mckinsey survey the pandemic accelerated digitalization by as much as 7 years. Microsoft CEO observed in the early days of the pandemic that he saw two years worth of digitalization in two months.

Digitalization raises two serious issues. That of:

- Cybersecurity. The susceptibility of digital financial services to cyberattacks and digital fraud requires lenders to make ongoing improvements to their IT infrastructure so as to keep pace with newer and newer technologies. It also calls for skilling and awareness on the part of staff, education of the consumers and supervisory control by the regulators.
- Privacy. As data is often owned and controlled by different entities/platforms, data usage and credit information sharing requires regulatory oversight. A digital finance provider or product may fall within the jurisdiction of telecommunications, consumer protection, competition, banking, etc. Regulators need a mechanism to collaborate to prevent anti-competitive or abusive practices. Further, as the proliferation of digital finance has outpaced the financial literacy of many consumers, fair lending norms need to be addressed.

Various platforms and players, both financial sector and non-financial sector, are present in the market for providing short term loans and loans to small businesses and individuals. High value credit and long term loans, however, are available primarily from commercial banks and development finance institutions.

The pandemic adversely effected the GDP, demand and supply of goods, jobs and small businesses. While the Indian economy is on the path of recovery (despite global headwinds, high fuel prices and higher than desired inflation), an investment cycle which can kick start a virtuous cycle of jobs, income and consumption is critical. In the face of disrupted supply chains globally, India is receiving some attention from international investors who wish to diversify and perceive India as a repository of talent. The demand for credit is also expected to go up as capacity utilization (currently around 75%) increases, as businesses will seek to expand capacity or invest in greenfield projects. Capex in metals, commercial real estate, construction and transportation is already visible.

During FY2022, 10,445 projects with aggregate investment of Rs19.27 lakh crores were announced, up sharply from the previous year, as per a survey of the investment monitoring firm Project Today. Breaking a trend, the manufacturing sector accounted for 40% of these, spread across both traditional and sunrise sectors like green energy, electric vehicles, lithium batteries, data centres and warehousing. Unless infrastructure development fails to keep pace with the demands of business, we should see large opportunities for bank credit. Banks are reasonably well positioned to take advantage of these opportunities and thereby also contribute to the critical agendas of ESG and climate change.