

# The Quest for Regulation of Uncollateralized Digital Lending in Ethiopia

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## Abstract

The availability and accessibility of credit is instrumental to startups that are in need of ‘seed money’ to raise investment capital. The availability of a credit system that is easy to secure is very critical. The current digital revolution has changed the traditional hurdles for accessing loan. Nowadays, technology has changed the modality and conditionality of accessing loan. Ethiopian banks and non-bank economic sectors, like Ethio-Telecom have started offering uncollateralized digital lending. The Ethio-Telecom, took the first initiative in offering easy and uncollateralized digital credit system in Ethiopia. However, the regulatory landscape is not ready to effectively to govern the increasing uncollateralized digital lending. This short article attempts to highlight the need for setting a regulatory framework that specifically suits to uncollateralized digital lending in Ethiopia by applying doctrinal research methodology.

**Key Words** Uncollateralized digital lending, Micro Small and Medium-sized Enterprises, Digital Credit Providers

## 1. Introduction

Credit is the wheel of commerce and entrepreneurship. It not only facilitates business activity, but also serves as a vital instrument in the realization of creative business thought into the reality. Very enthusiastic startups generate critical business imaginations that can be turned into influential entity if ‘seed money’ is obtained from financiers of ideas. No startup can realize a growing venture, unless provided with finance.<sup>1</sup> In this regard the availability and accessibility of credit facility is very critical. Traditionally, in the developing

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<sup>1</sup> Big global companies, like Google, Apple, Microsoft, Amazon, Alibaba, Uber, even emerging Ethiopian companies, like RIDE, Feres, etc. are fruits of creative minds. Unless financed, these influential companies would not have been dominated the global socio-economic relationship.

nations credit facility is not available to everyone. Lenders often assess the possibility of getting the loaned money back. As theoretical assessment and business plan may not necessarily guarantee the possibility of getting money back, a real guarantee (collateral) often demanded. Startups lack real guarantee. Consequently, creative ideas were shelved or trashed. Thus, there was no incentive to enthusiastic innovators. This may be one of the causes that had undermined development. Though exceptionally may be demanded, collateralization of loan is not a necessary condition in developed economies. In developing economies, like Ethiopia, traditionally, collateralization appeared a rule, and uncollateralized loan may be rarely offered. Currently this attitude of loan providers in Ethiopia appears changing.

In Ethiopia, the practice of offering loan, as ‘seed money’ to startups was introduced by micro finance institutions that have been using a group surety system, which is different from real guarantee (collateral).<sup>2</sup> Nowadays, however, the advancement of digital technology has been changing the modality and the traditional conditionality of accessing loan.<sup>3</sup> It appears that a bright day is popping up to the authors of creative thought that can be translated into a useful venture, as financial constraint could be easily tackled. Today, it is not uncommon to notice advertisement for offering loan without a conditionality of collateral or other form of guarantee. Recently, multiple financial service providers have started digital lending through mobile application thereby easing accessibility of loan for the underserved and unserved micro, small and medium enterprises (herein

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<sup>2</sup> Due to its nexus and sponsorship of political actors in most micro finance institutions, credit facility offered by micro finance institutions could not change the huge need for investment capital. Further, it was tainted with embezzlement. Though the significance of micro-finance institutions cannot be denied, it could not effectively address the unbalanced demand for credit facility. Given the high demand for loan, micro finance could not meet be accessible to all and in all times.

<sup>3</sup> U.S. Department of the Treasury, Opportunities and Challenges in Online Market place Lending, (16 May,2016), p..3.

after MSMEs). In Ethiopia, institutions that provide finance to individuals and enterprises appear racing to win the hearts of credit seekers and elevate their market share through digital platforms by offering collateral free credit. In old days finance was a critical barrier to startups. Would that be a horrible past history? We have a good memory that before the introduction of digital lending system MSMEs relied on bank loan, which was not easy to access on account of bureaucratic hurdles and lack of assurance system for repayment. Today non-bank credit providers have been aligning with banks. Due to stiff competition for market share banks and non-bank financial service providers have adopted digital credit platforms that are not only accessible, but also collateral free.

Ethiopia's first experience with fully digitized form of collateral free lending was surfaced in 2018 with the launching of Ethio telecom's airtime credit scheme.<sup>4</sup> Since then, *Kifiya* Financial Technology has developed *Qena* platform to enable banks to offer lending service for MSMEs. *Michu* of Cooperative Bank of Oromia, *Dube alle* of Dashen Bank, *Telebirr* of Ethio-telecom as well as *Apollo* of Bank of Abyssinia are among the financial service providers adopted to effectuate digital credit without collateral. As offering credit is not solely confined to banks, non-bank financial institutions can engage in digital credit job. Despite widespread collateral free digital lending has been attracting enthusiastically entrepreneurs, the pace of regulatory framework is weak or not adequate enough to regulate the fast-moving technology and demands of the time. Submittedly, in the existing arrangement, there is no adequate regulatory framework that can address issues and side effects of digital lending that is not backed by collateral. Easy accessibility to all has made digital lending prone to fraud that can potentially backfire the emerging technology and

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<sup>4</sup> Kflip Uncollateralized and digital credit in Ethiopia: How far has it come and where is it heading? -K-flip knowledge Hub, :<<https://kflip.info/2022/12/21/uncollateralized-digital-credit-in-ethiopia>>

restrain innovative acumen.<sup>5</sup> To fill the apparent gap, financial services like *Qena* platform of *Kifya* Financial Technology have been partnering with banks, like Cooperative Bank of Oromia.

Since the heydays of digital lending scheme in Ethiopia, billions of birr credits were provided digitally. In the first nine months of 2023 budget year, banks in partnership with mobile money have provided more than 3.6 billion birr loan through digital lending.<sup>6</sup> Despite the apparent success of digital lending by providing quick solution to the critical need for money, supposedly, on account of weak regulatory system, service offered by digital lending channels are not only inadequate but also exposed borrowers to exorbitant interest rate, cost, and charges, lack of compliant mechanism for redress, non-or inadequate data protection rules,, absence of regulatory framework and guidelines for prevention of over-indebtedness or abusive debt collection mechanisms, transparency and disclosure, fraud prevention and no regulation to impose duty and responsibility on service providers like duty to notify change of contract that can overburden consumers. This explains why offering of loans through digital platforms is described by the World Bank both as a resounding success and, at the same time, a regulatory minefield.<sup>7</sup> These evils have surfaced and would bear more negative consequences in digital lending on account of

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<sup>5</sup> The author learned that fraud through telebirr credit system was claimed by several telebirr customers. Fraudulent persons get sim cards of another person either through forged IDs or sometimes in collaboration of TeleCom employees loaned money in false identity. Such side effects of technology may be expected but cannot substantially damage the service. The Ethiopian Telecom has also identified the kind of fraud that can affect digital financial service. Regarding the details and types, see <https://www.ethiotelecom.et/what-are-frequent-fraud-types/>,

<sup>6</sup> Capital News Paper, “Digital lending schemes boom in Ethiopia, quadruple in magnitude,” < <http://www.capitalethiopia.com/2023/05/08/digital-lending-schemes-boom-in-ethiopia-quadruple-in-magnitude/?amp=1> >

<sup>7</sup> Muli, A. K. *Digital lending in Kenya; the case for regulation* [Thesis, Strathmore University] (2020). p-2. <https://su-plus.strathmore.edu/handle/11071/9556>., See also Klein, Michael U. and Mayer, Colin, *Mobile Banking and Financial Inclusion: The Regulatory Lessons* (May 1, 2011). World Bank Policy Research Working Paper No. 5664, <https://ssrn.com/abstract=1846305>.

inadequate regulatory framework and weak remedial mechanism for aggrieved consumer.

Despite unexpected exigencies, digital lending has revolutionized the credit market landscape. It offered relief to enthusiastic entrepreneurs that wished to test their knowhow in productive ventures. The challenges could be easily remedied through legislative action. The lack of a regulatory framework permitting financial institutions that do not collect savings from depositors, as well as foreign financial services operators, to engage in digital lending services poses challenges for investors in this field. Exploitation of borrower by digital lenders is a concern, and the interest rate charged to the customers who take digital loans is exorbitant. Concerns also exist on the privacy of personal data collected from customers and how well the data is protected. There is a huge need to have a regulatory framework that can better guarantee protection to consumers, offer conducive and enabling environment to the public. The other issue that needs solution in digital lending is the legality of credit agreement in digital form and capacity of parties to the contract. The requirements in clinching enforceable lending agreement, verification of the fulfillment essential elements of contracts, like age and status of contractants as well as ability of the parties to make decision and to carry out what is provided in the agreement needs an adequate regulatory framework. In Ethiopia, today, lending is provided by financial services financed by customer, i.e. those that collect money from depositors only. However, in digital lending era, any financial service providers, even those that are not open to deposit can take part. Needless, to say, such actions could be sustainable if properly regulated.

This article explores issues involving regulatory oversight on uncollateralized digital lending as the basis for proposing a fitting regulatory framework for the digital financial providers. It aims at filling the apparent lacunae by benchmarking digital lending regulations in selected foreign nations that have undergone the process

of digital lending. The Kenyan digital lending practice and regulatory framework can best suit to the Ethiopian situation. Being neighboring nations, regulation in Kenya is implemented in an environment that bears similarities with the Ethiopia scenario. This makes it an ideal comparison to the Ethiopia's digital lending scheme. Similarly, though a bit developed, Indian regulatory environment can best instructive. The Indian fintech sector is reported to have over 1000 digital lenders with funding of more than USD 2.5 billion.<sup>8</sup> Further, the Ethiopian digital lending market can draw instructive lessons from Chinese digital lending scheme. The three nations are purposely selected. Similarity of lifestyle, and relatively better economic movement has attracted this author. Exploration of the norms, practice and institutional framework both in Kenya, India, and China is assumed very ideal to the emerging Ethiopian market. The analysis of data of stated nations is obtained from secondary sources and publicly available data. The article primarily follows doctrinal research methodology. It analyzes available data in light of the practice and possible challenges that would restrain the current pace of development of the Ethiopian digital lending market.

The article is organized into five sections. The first section covers the context of the problem, which consists of an overview of the situation. The second part focuses on digital lending in the global setting. In this part, the regulatory framework and experiences with uncollateralized digital lending in Kenya, India and the Chinese fintech sector are examined. The third section examines the practice of uncollateralized digital lending in Ethiopia. The possible *pros* and *cons* are briefly summarized. Finally, the fourth section explains how to effectuate issues with the uncollateralized digital lending in Ethiopia.

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<sup>8</sup> Manish Jain, *Fintech in India powering mobile payments*, (2019), p. 12.

## 2. Uncollateralized Digital Lending: Global Setting

The digital lending revolution is a global phenomenon. It has been reshaping borrowing experiences across the world. From North America to Asia, digital lending is changing the way individuals and businesses access credit. Nations around the world are experiencing a paradigm shift. The traditional lending model appears giving way to digital platforms, which is driven by several key factors. Among the factors, the widespread use of smartphones and the Internet has made it easier to access online financial services. This has enabled digital lenders to reach a wider audience. Digital loans offer a simplified and efficient application process. Borrowers can apply for loans from anywhere on the globe and get approval as quickly as face-to-face communication in disregard of barrier walls. Digital lending schemes have either avoided or reduced lending bureaucratic channels thereby making access to credit system more accessible to entrepreneurs who needed investment capital most and unbanked populations in developing nations. A number of have been experiencing a significant success in the uncollateralized digital lending framework.

Uncollateralized digital loan is a loan that does not require collateral. Instead of relying on the borrower's assets as collateral, lenders approve unsecured loans based on the borrower's creditworthiness.<sup>9</sup> Uncollateralized digital lending has been a multi-billion dollars industry across the globe. It was launched in 2010 by China's E-commerce platform Alibaba, in which uncollateralized digital lending provided a total of \$13.4 billion to about 3 million micro, small, and medium-sized enterprises (hereinafter called MSMEs).<sup>10</sup>

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<sup>9</sup> National Credit Union Administration. "Personal Loans: Secured vs. Unsecured," <https://mycreditunion.gov/life-events/consumer-loans/secured-unsecured>.

<sup>10</sup>Further Africa, "Ethiopia banks advised to start uncollateralized digital lending, (Februa27, 2022, <https://furtherafrica.com/2022/02/22/ethiopia-banks-advised-to-start-uncollateralized-digital-lending/>

In developed systems, credit rating models and the use of non-traditional data sources enable digital lenders to assess creditworthiness comprehensively, and digital lenders use big data analytics to tailor loan in line with the needs of borrowers. This personalized approach increases borrower satisfaction and meets financial goals.<sup>11</sup> Digital lending in developing economies differs significantly from personal loans provided by fintech lenders in developed economies, primarily in terms of regulation, loan size, duration, interest rates, borrower access to financial services, and borrower financial status. In developing nations, digital lenders operate with fewer regulations compared to fintech lenders in developed economies. The scope and scale of digital loans in less developed nations is typically smaller and offered for shorter durations. Additionally, digital loans in developing countries often come with significantly higher interest rates. Moreover, while borrowers in developing economies generally lack access to traditional financial services, in developed economies a larger proportion of borrowers have been obtaining credit from fintech lenders. Borrowers in the developing economies are typically poorer and experience greater income volatility.

Notably, digital lending platforms in Europe, for instance, are subject to different regulations, which are different from banks, primarily due to the absence of deposit-taking activities. Notably, digital lending platforms in Europe are subject to different regulations which are absent in traditional banks.<sup>12</sup> In the American digital lending landscape, regulatory activity has been minimal so far. However, as digital lending continues to gain prominence in the country, there is a

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<sup>11</sup>Shakhawat Hossain, "Global Impact: How Digital Lending is Revolutionizing Borrowing Experiences Worldwide", <https://www.linkedin.com/pulse/global-impact-how-digital-lending-revolutionizing-shakhawat-hossain/?trackingId=ftlzb9e3QxivzcPZmIvzA%3D%3D>.

<sup>12</sup> Kern A, *Principles of banking regulation*, (2019), p.5.



growing need and rationale for regulation.<sup>13</sup> This Section deals with analysis of uncollateralized digital lending regulations in three jurisdictions. The analysis would help to comprehend the Ethiopian practice and assumed to offer lessons that can indicate possible measure legislative intervention in regulating uncollateralized digital regulation in Ethiopia.

## 2.1. Uncollateralized Digital Lending in Kenya

Financial inclusion is one of the primary issues in sub-Saharan Africa. In 2014, the region had 350 million unbanked individuals, accounting for 17% of the global total.<sup>14</sup> In Kenya, all banks provide digital lending service without collateral. More than 30 private banks provide uncollateralized digital loan to micro, small and medium level enterprises (MSMEs).<sup>15</sup> Kenya's initiative of uncollateralized digital lending was launched (M-PESA) by Safaricom and other banks in 2007.<sup>16</sup> Modern-day lending in Kenya has shifted away from traditional bank loans to digital lending. The Digital Credit Providers regulations address public concerns given the significant growth of digital lending, particularly through mobile phones. Kenya has been taking proactive measures to ensure responsible and regulated digital lending practices.

Since the last two decades, Kenya has become the epicenter for fintech innovation in sub-Saharan Africa<sup>17</sup> Over the last decade the

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<sup>13</sup> Wilson JD, *Creating strategic value through financial technology*, (John Wiley & Sons, New York, 2017), p.78.

<sup>14</sup> Asli Demirguc-kunt *et al*, Findex Notes #2014-2, The Global Findex Database 2014, "Brining the 2 Billion Unbanked into the Financial System," (April 2015), <https://www.worldbank.org/content/dam/Worldbank/Research/GlobalFindex/PDF/N2Unbanked.pdf>

<sup>15</sup> Further Africa, *supra* note 10.

<sup>16</sup> *Id*

<sup>17</sup> Otiato Guguyu, "Market leaders panic as 10 digital lenders cleared, *Business Dail*,

nation has achieved tremendous growth in digital lending. In 2018 more than 25% of the Kenyan adult population obtained at least one digital loan, whereas less than 5% borrowed from microfinance institutions.<sup>18</sup> In Kenya, digital credit services are being offered by multiple providers and target at persons who can benefit most – persons having no access to banking services, and disadvantaged, such as the poor, the disabled and other excluded populations.<sup>19</sup> It is to be noted that the traditional banking business is only accessible to the financially stable and to those who can afford collateral and able to repay the loans together with the interest and fees.<sup>20</sup>

Kenyans have taken significant steps to regulate digital lending within their borders. The Central Bank of Kenya (hereinafter called CBK) (Amendment) Act 2021 paved the way for the subsequent promulgation of the Digital Credit Providers Regulations 2022.<sup>21</sup> These regulations provide for the licensing and supervision of Digital Credit Providers (hereinafter called DCPs) not previously regulated by the CBK.<sup>22</sup> On March 18, 2022, the Central Bank of Kenya published the Digital Credit Providers Regulation 2022. The regulation enables the CBK to fully regulate and supervise digital lending providers that previously operated in the Kenyan market without regulation.<sup>23</sup> The regulation addresses issues related to licensing, administration, credit

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<https://www.businessdailyafrica.com/bd/markets/capital-markets/digital-lending-gets-more-competitive-as-10-cleared-3954370>

<sup>18</sup> Totolo, E. The digital credit revolution in Kenya: an assessment of market demand, 5 years on. Nairobi, Kenya: FSD Kenya, (2018), p.2.

<sup>19</sup> Kendall J, Nataliya M and Ponce, measuring financial access Around the World, (2010).

<sup>20</sup> Totolo (2018), *supra* n 18.p.2.

<sup>21</sup> Maxwell Muturi *et al*, “The Changing landscape of digital lending in Kenya” (2022), [The changing landscape of digital lending in Kenya - KPMG East Africa](#).

<sup>22</sup> *Id*

<sup>23</sup> Jackson Marchara Githu, “Legal & Regulatory Framework for Digital Financial Services in Kenya – Digital Financial Services in Kenya – A case for Urgent Reform” (2021), [Legal & regulatory framework for digital financial services in Kenya: A case for urgent reforms \(econstor.eu\)](#)

transactions, consumer protection, high interest rates, unethical debt collection practices, obligations regarding misuse of personal data, anti-money laundering (hereinafter called AML), and combating the financing of terrorism (hereinafter called CFT) for digital credit providers.<sup>24</sup> In accordance with the regulation a person may only participate in digital credit activities if he/she is authorized to do so by the CBK or by another relevant law. Participation in an unlicensed digital lending is a criminal offense. Thus, any person who acts without authorization will be punished with imprisonment for a term not exceeding three years or a fine not exceeding KES 5 million (approximately US\$43,698) or both.<sup>25</sup>

The regulation, among other things, deals with the licensing, management and lending practices of DCPs.<sup>26</sup> It also ensures consumer protection, the exchange of credit information and establish the DCP's responsibilities in relation to AML/CFT.<sup>27</sup> All digital loan providers are prohibited from harming borrowers either through intimidation or other means of coercion. To protect the privacy of all digital loan applicants, CBK prohibits disclosure of customer information without securing advance consent of the customers. All DCPs are not allowed to submit negative credit information of a customer or any other person to a Credit Reference Bureau (hereinafter called CRB), where the outstanding amount relating to the credit information does not exceed Sh1, 000.<sup>28</sup>

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<sup>24</sup> The Central Bank of Kenya (Digital Credit Providers) Regulations, 2022.

<sup>25</sup> ENS - News - Digital lending and providing now regulated in Kenya (ensafrica.com).

<sup>26</sup> Sharon Maombo, Digital lenders on tight leash as new regulations kick in, (March 2022, the star), [Digital lenders on tight leash as new regulations kick in \(the-star.co.ke\)](https://www.the-star.co.ke/news/2022/03/22/digital-lenders-on-tight-leash-as-new-regulations-kick-in).

<sup>27</sup> *Id*

<sup>28</sup> CRB is an agency licensed by the Central Bank of Kenya. Its purpose is to gather data from credit agencies and compile it into a credit report. These reports provide an objective view of borrowers' credit histories, helping financial institutions and other credit providers make informed decisions. CRB is an agency licensed by the Central Bank of Kenya. Its purpose is to gather data from credit agencies and compile it into a credit report. These reports provide an objective view of borrowers' credit histories, helping financial institutions and other credit providers make informed decisions.

A lender who intends to furnish negative information about a customer to a bureau is required to notify the customer of at least thirty days before reporting. Posting customer's personal or sensitive information online or on any other forum or medium shaming purposes has also been prohibited. In order to combat money laundering, the CBK requires all digital credit providers to furnish sufficient proof and sources of the fund invested or offered for investment in the company and prove that the fund was not the fruit of some kind of criminal activity.<sup>29</sup> Additionally, the Central Bank of Kenya (Digital Credit Providers) Regulations 2022 (DCP Regulations) declares that DCPs may only engage in pre-approved business activities and may not accept cash deposits or collateral for loans.<sup>30</sup> Investments in DCPs or Certain thresholds for investment and financing of DCPs may require prior approval or notification by the Central Bank.<sup>31</sup> On the same token, the Central Bank of Kenya (CBK) requires prior written approval for transactions involving the amalgamation or transfer of assets and liabilities of a Digital Credit Provider (DCP), except those conducted in the ordinary course of business.<sup>32</sup> DCPs are required to share credit information with credit reporting agencies, subject to certain restrictions set out in the Regulations, and are required to obtain CBK approval for their products and changes to product specifications.<sup>33</sup>

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<sup>29</sup> Sharon Maombo, Digital lenders on tight leash as new regulations kick in, (March 2022, the star) [Digital lenders on tight leash as new regulations kick in \(the-star.co.ke\)](https://www.the-star.co.ke/news/2022/03/29/digital-lenders-on-tight-leash-as-new-regulations-kick-in/).

<sup>30</sup> Cynthia Amutete & Dominic Kenya: Regulation of Digital Lenders in Kenya" *Bowmans* (April 2022), <https://bowmanslaw.com/insights/kenya-regulation-of-digital-lenders-in-kenya/>.

<sup>31</sup> *Id*

<sup>32</sup> *Id*

<sup>33</sup> *Id*

## 2.2. Uncollateralized Digital Lending in India

India is among the nations that are in forefront software development. It has a strong fintech system. The role of technology in India's financial service sector has been increasing significantly. On August 10, 2022, the Reserve Bank of India (hereinafter called RBI) established a framework for regulation of digital lending landscape in the country. The move aims at ensuring smooth and secure transactions across digital platforms. The guidelines were introduced to protect borrowers from unscrupulous practices by digital lenders and promote transparency in the digital lending realm.

India, digital lending businesses can only be carried out by entities that are regulated by the Reserve Bank or entities that are permitted to do so under other pertinent laws.<sup>34</sup> Lending service providers (hereinafter called LSP) or third parties are not allowed to have a pass-through or pool accounts.<sup>35</sup> Data collection by Digital Lending Apps/ Platforms (DLAs) is only permitted if necessary and with the express consent of borrowers.<sup>36</sup> Access to cellphone resources, including files and media, contacts, call logs, etc., is not permitted by DLAs.<sup>37</sup> Only with the express consent of the borrower, lenders can get one-time access to the camera, microphone, location or other device. Unless otherwise provided by law, before transferring borrower's personal data to third parties, express consent of the borrower must be obtained. It is generally believed that the borrower must have the opportunity to decide whether to consent for the use of certain data, or restrict disclosure to third parties, limit data storage, and to revoke consent if already granted for collection of personal data.<sup>38</sup> The digital lending

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<sup>34</sup> Reserve Bank of India Press Release.

<sup>35</sup> Anagha S. RBI Guidelines on Digital Lending - Highlights and Implications, (startup talky), [RBI Guidelines on Digital Lending - Highlights and Implications \(startuptalky.com\)](https://startuptalky.com/rbi-guidelines-on-digital-lending-highlights-and-implications/).

<sup>36</sup> *Id*

<sup>37</sup> *Id*

<sup>38</sup> *Id*

platform must disclose credit limit information related to the product features and associated costs. In India loans made through Regulated Entities (hereinafter called RE) or LSP digital lending applications must be reported to the credit Information Companies (hereinafter called CICs), regardless of their term or type.<sup>39</sup> It is also required that borrowers should be given a cooling-off period or a period decided by the REs Council to enable them to exit digital loans by paying the principal amount and the applicable Annual percentage rate (hereinafter called APRs) without incurring fees.<sup>40</sup> REs should ensure that advance consent of borrows is secured before increase of credit limits. Every regulated entity (RE) and credit servicer must appoint a complaints officer.<sup>41</sup>

The digital lending regulations were introduced to ensure transparency, protection of customer interests and accountability of fintech owners and other stakeholders, and to prevent data breaches due to mis-selling, unfair business practices, enforcement of excessive interest rates and unethical debt collection practices.<sup>42</sup> These guidelines ensure that lending via digital platforms is done responsibly and that both parties' benefit from the development of fintech infrastructure.<sup>43</sup> Overall, RBI's Digital Lending Guidelines aim at prioritizing borrower's security, minimize risk to the financial system, and promote innovation. Encourage digital lending companies and platforms to be more accountable and transparent while taking customers' interests into account. In conclusion, India has put in place a regulatory framework to promote orderly credit growth

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<sup>39</sup> *Id*

<sup>40</sup> *Id*

<sup>41</sup> *Id*

<sup>42</sup> Amit Das, "RBI's regulatory framework may overhaul the digital lending ecosystem, *The Times of India* (December 16, 2022). RBI's regulatory framework may overhaul the digital lending ecosystem (indiatimes.com).

<sup>43</sup> *Id*

through digital lending and ensure borrower protection and responsible lending practices.<sup>44</sup>

### **2.3. Regulation of Uncollateralized Digital Lending in China**

China has the world's largest financial technology market and is at the forefront of the fintech revolution in terms of growth and innovation.<sup>45</sup> The growth of China's fintech sector, transformed by Alibaba's launch of Alipay in 2004, has benefited from support from government policies and pioneering companies.<sup>46</sup> Tech giants like Alibaba have deeply integrated fintech services into vast digital platforms. In addition, fintech in China manifests itself qualitatively differently from the original scenario in most Western countries.<sup>47</sup> There are ample reasons why fintech in China is growing faster, more innovatively, more transformative and penetrating society widely compared to the West. Given the underdevelopment of traditional banking services in China and the lack of slowly evolving legacy systems, fintech has easily filled the gap in financial services offerings. At the same time, Chinese fintech companies enjoyed significant regulatory freedom until the end of 2010.

Chinese tech companies, notably the BAT (Baidu, Alibaba, and Tencent), have also played pivotal roles in shaping the fintech landscape in China.<sup>48</sup> Through the development of their financial arms, Alibaba's Ant Group, Tencent Fintech, and Baidu Financial Services Group, and integration of fintech services with the e-commerce and social media platforms these companies provide, they have enabled

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<sup>44</sup> *Id*

<sup>45</sup> Monique Taylor, From Alipay to the Digital Yuan: China's Fintech Revolution, (Institute for Security and Development Policy), p.9.

<sup>46</sup> *Id* at p.13.

<sup>47</sup> *Id* at p.9.

<sup>48</sup> *Id* at p.10.

fintech to become thoroughly blended into the everyday life of the Chinese consumer, transforming the way people manage their finances, access financial services, and make purchasing decisions.<sup>49</sup> China's fintech landscape is dynamic and diverse consisting of fintech companies, established financial institutions that have embraced fintech, and tech giants with fintech arms. Fintech companies have driven disruptive innovation in financial products and services and introduced new operational models, which then led to transformations within the traditional banking system.<sup>50</sup>

China's financial system is dominated by state-owned banks that prefer to lend to state-owned enterprises or large private companies, leaving a large number of small and medium-sized enterprises (hereinafter called SMEs) under-served.<sup>51</sup> Setting aside any political biases, the issue of financing SMEs is a challenge that is faced globally. Lack of credit information and insufficient collateral are seen as the main causes of SMEs' financial constraints. There is evidence that traditional banks are not up to this challenge. P2P lending platforms appeared to offer a better solution, using automated processes to reduce costs and credit risk models that leveraged non-traditional data. Quick decision-making and the absence of collateral requirements have made the P2P sector an important source of financing for SMEs in China.<sup>52</sup> P2P lending, as a type of fintech, offers an innovative approach to online lending that can assist both SMEs and individuals who lack access to traditional banking services. In its purest form, often referred to as marketplace lending, P2P platforms

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<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> Chen Ding et al., "Lessons from the rise and fall of Chinese peer-to-peer lending", *Journal of Banking Regulation*, v.19, (2020), p.135.

<sup>52</sup> *Id.*



facilitate direct connections between individual borrowers and lenders, eliminating credit risk in the process.<sup>53</sup>

The Chinese authorities' hands-off approach to regulation has been another factor in the rapid development of the P2P industry. Until July 2015, the P2P industry remained completely unregulated. This seemed strange at first, considering that China's financial sector has always been tightly controlled by the government. The Chinese government's laissez-faire attitude appears to be based on two premises. The first was to find an alternative source of financing for SMEs. SMEs currently play an important role in the Chinese economy. The second reason for the initial "laissez-faire" approach was the failure of Chinese authorities to understand the risks of P2P lending. Nevertheless, China's P2P industry has become the largest market in the world.<sup>54</sup>

Since launching the first peer-to-peer (P2P) lending platform in 2006, China has been at the forefront of the fintech revolution.<sup>55</sup> In 2013, its P2P lending sector was the largest in the world in absolute terms, leaving its largest competitors in terms of size, the US and UK, "watching them from afar."<sup>56</sup> Problems with China's P2P lending business models first emerged in 2015, when around 896 P2P platforms ran into difficulties, more than half of which were due to fraud cases.<sup>57</sup> In particular, the collapse of Ezubao at the end of the year (2015) brought the troubled sector into the spotlight.<sup>58</sup> Ezubao was once one of the most famous platforms. It was discovered that 95% of projects funded through Ezubao were fake and fabricated by the platform.<sup>59</sup> The Ezubao scandal quickly made headlines in Chinese

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<sup>53</sup> Chen Ding et al, "Too Much Technology and Too Little Regulation? The Spectacular Demise of P2P Lending in China" Accounting, Economics, and Law: A Convivium (2021). <https://doi.org/10.1515/acl-2021-0056>

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> Taylor, *supra* note 45.p.136.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

tech newspapers and tens of thousands of angry investors took to the streets in protest.<sup>60</sup> Some of them even travelled to Beijing to demonstrate in front of the central government offices.<sup>61</sup> The scale of the platform outages and their economic and social consequences were much greater than the government expected. The number of platforms going out of business has increased. Between 2016 and 2018, when the new rules came into force, there was a significant number of affected investors and loan volume on failed platforms.<sup>62</sup> In total, more than 2 million investors were stuck on failing platforms with loans totaling around US\$26.9 billion in mid-2019.<sup>63</sup>

Given the increasingly visible problems associated with P2P business models, the Chinese government quickly abandoned its laissez-faire approach and created a detailed and comprehensive regulatory framework.<sup>64</sup> General legal provisions also apply to P2P platforms, in particular Company law, contract law and Anti-competition Law, Consumer Protection Law and Anti-Money Laundering (AML) Law. The regulation aims to eliminate fraudulent or unfair commercial practices that have plagued the sector and restore all platforms to their role as information intermediaries. According to the regulations, a P2P platform must segregate its funds from lenders and borrowers. The lender's and borrower's funds must be held at a qualified commercial bank. As an information intermediary, the platform is now subject to the obligation to make publicly available truthful, appropriate, complete and up-to-date information about the platform itself, for example about its organization and its functioning. It is also required to disclose basic information about borrowers to lenders in advance and to disclose ongoing information about the borrower's financial situation and factors that may affect his or her ability to repay. The

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<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* p.137.

platform is required to regularly file an information disclosure statement together with relevant documents with the local government in which it is registered and deposit them with the registration authority for public inspection

In addition, the information submitted through the platform must be verified by external intermediaries such as accounting firms and law firms. The heavily intensified focus on regulation of the P2P industry and the government's general crackdown on venture capital funding has led to the close-down of several hundred P2P platforms since 2015.<sup>65</sup> The number of Chinese P2P lending platforms has already fallen massively by 50%. 1,021 in 2018, at the end of November 2019, this number fell again to 369. Since 2017, the Chinese P2P market has experienced a dramatic decline and still shows no signs of halt.<sup>66</sup> The Chinese government's ultimate intentions regarding the P2P sector are not yet entirely clear, although it appears to have lost enthusiasm for P2P lending.<sup>67</sup>

Over the past decade, China's online P2P lending industry has experienced a period of rapid growth, initially with rapid growth, and has now become the largest market in the world.<sup>68</sup> but it has also faced significant challenges and regulatory changes. Between 2013 and 2017, Chinese P2P lending expanded by a staggering factor.<sup>69</sup> It became much larger than in any other country, both in absolute terms and relative to the size of the economy. However, during this period, the industry operated in what was effectively a regulatory vacuum, leading to problematic and often fraudulent business models. Until

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<sup>65</sup> *Id* at p. 138.

<sup>66</sup> *Id* at p.140.

<sup>67</sup> *Id* p.141.

<sup>68</sup> Huang RH. *Online P2P Lending in Fintech Regulation in China: Principles, Policies and Practices*. (Cambridge University Press; 2021), p.14-51.  
<https://www.cambridge.org/core/books/abs/fintech-regulation-in-china/online-p2p-lending/569F0E8EB1CD8B319E9377129234FC5>.

<sup>69</sup> Das, *supra* note 42.

2015, there were no strict regulations governing P2P lending in China.<sup>70</sup> Limited regulation was introduced in 2015 after several platform failures, but it couldn't prevent new risks from emerging. The technology alone cannot eliminate the inherent risk of fraud and uncertainty in lending. Without appropriate regulation and robust internal controls, financial institutions will always operate in ways that result in instability. Scandals and risks associated with P2P lending prompted the Chinese authorities to establish a strict new regulatory regime. This regime addresses issues such as capital requirements, registration, and investor protection.

In 2016, China issued extensive regulations on online lending and introduced a number of important measures, such as restrictions on the business model that platforms can adopt, registration requirements, custody requirements, disclosure requirements and credit limits.<sup>71</sup> This regulation has far-reaching consequences, including market disruption and closer cooperation between online lending platforms and traditional banks. However, at present regulation does not appear to have achieved its objectives due to problems with both the substantive provisions and the enforcement mechanisms.<sup>72</sup> As a result, the volume of P2P lending has significantly decreased due to the implementation of these regulations.

Especially in 2022, the market faced a stricter regulatory environment.<sup>73</sup> This regulatory trend began back in 2020 when online financial giant Ant Group's IPO,<sup>74</sup> was suspended, and in the following year (2021), tech giants faced increased regulatory scrutiny

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<sup>70</sup> Taylor, *supra* note 45.p.135.

<sup>71</sup> *Id.*.p.137.

<sup>72</sup> Das, *supra* note 42.

<sup>73</sup> <https://iclg.com/practice-areas/fintech-laws-and-regulations/china>.

<sup>74</sup> Ant Group, formerly known as Ant Financial Services Group, is an affiliate company of Alibaba Group and operates various financial technology (fintech) services, including Alipay, one of China's leading digital payment platforms.

on issues such as data privacy.<sup>75</sup> In 2022, regulators have tightened regulations on aspects such as banning unlicensed fintech companies, tightening regulations on cybersecurity and data protection, and improving consumer financial protection.<sup>76</sup> In July 2022, China further tightened rules for digital lending to; clarify loan management requirements and independent risk control for commercial banks, increase data protection, strengthen loan fund management, Protect consumer rights. In summary, China has been proactive in regulating digital lending, emphasizing data security, consumer protection, and prudent risk management.

The rise and fall of China's P2P sector have provided important lessons for financial innovation in emerging markets. Economic growth in these markets is often limited by the availability of financial resources and weak financial regulation. Financial innovations (including but not limited to P2P lending) that use automated processes to reduce costs, do not require collateral, and rely on non-traditional data are seen by some as a useful way to address financial regulation vulnerabilities and enforcement issues to circumvent. The experience of China's P2P sector shows that financial innovation carries a particular risk of wasting economic resources when financial regulation is weak. We therefore conclude that financial authorities in low-income countries and emerging markets need to pay particular attention to promoting innovative fintech activities. On the one hand, regulations should not be so strict that they completely prohibit innovation. On the other hand, when innovation occurs, authorities must be particularly vigilant to ensure that such innovation does not jeopardize regulatory security and stability or the protection of customers and investors.<sup>77</sup>

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<sup>75</sup> Taylor, *supra* note 45.p.135.

<sup>76</sup> *Id.*

<sup>77</sup> Jain, *supra* note 8.p.12.

To sum up, the regulatory landscape for the uncollateralized digital lending in China has been a fascinating journey, marked by rapid growth, challenges, and eventual through regulatory intervention. China's experience with uncollateralized digital lending serves as a cautionary tale about the delicate balance between innovation, regulation, and financial stability.

### **3. The Emerging Practice of Uncollateralized Digital Lending in Ethiopia: The Call for Immediate Action**

Access to credit is one of the most important factors for economic development and growth. Despite significant efforts by various organizations such as the IMF, the World Bank and microfinance institutions in facilitating access to credit in the developing countries,<sup>78</sup> most households in these economies have limited opportunities to borrow from the formal financial system. The emergence of digital lending in recent years has transformed the consumer lending market in substantial number of developing countries. Over the last decade, many financial services providers in developing countries have adopted digital lending through mobile applications.<sup>79</sup> Digital loans are applied for, disbursed and managed via individuals' mobile devices, with digital lenders having access to "non-traditional" digital data on these devices, including individuals' travel habits, social media and transaction history. Using this data and machine learning algorithms, digital lenders are developing alternative credit scores that allow them to lend to millions of people with no credit history.

A modern, growing and solid economy rests on the pillars of increasing financial inclusion. This includes ensuring access to financial services and products for all individuals and businesses from

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<sup>78</sup> World Bank's "Financial Inclusion Support Project in Burkina Faso", <https://www.worldbank.org/en/results/2022/05/16/afw-unlocking-access-to-credit-for-underserved-borrowers-inburkina-faso>.

<sup>79</sup> Kflip, *supra* note 4.

all walks of life at affordable, timely and reasonable costs from reliable and responsible providers. In recent years, technology has revolutionized industries around the world, including the financial sector. Digital loans are considered an easy way out of the tedious banking process, which also allows for careful monitoring and in-depth analysis. Digital lending involves offering applied for, disbursed and managed loans through digital channels, with lenders using digital data to make lending decisions and create intelligent customer engagement.<sup>80</sup>

Uncollateralized digital loans have become a significant phenomenon in the Ethiopian financial sector. The Ethiopian law permits granting of loans to several categories of traditional financial institutions, including banks, micro finance institutions (hereinafter called MFIs), saving and credit cooperatives (hereinafter called SACCOs) and capital goods financing companies. While digital lending is new in Ethiopia, the concept of uncollateralized credit goes back even further. However, the situation is changing as in 2020 the Central Bank published guidelines regulating the provision of mobile money services (issuers of payment instruments). This development paves the way for a new lending model where fintech companies can provide microloans.<sup>81</sup>

In early 2022, Cooperative Bank of Oromia and Kifiya Financial Technology announced that they would be launching uncollateralized digital lending product.<sup>82</sup> The product, called *dubbed Michu*, is based on *Kifiya's Qena* uncollateralized lending platform and aims to meet the financial needs of micro, small and medium-sized enterprises.<sup>83</sup> Accordingly, more than 40,000 small and medium-sized enterprises have so far issued small loans totaling over Birr 450 million birr. Of

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<sup>80</sup>Digital Lending: Revolutionizing the Loan Process Using Technology ([analyticsinsight.net](https://analyticsinsight.net))

<sup>81</sup> See Kflip, *supra* note 4.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

this, more than 300 million Birr was returned.<sup>84</sup> *Michu* focuses mainly on small and medium-sized enterprises as their financing needs are rarely met by traditional financial institutions such as banks and MFIs. With *Qena*, *Kifiya* aims to expand the use of the product to meet individual financial access needs.

In early August 2022, Ethio telecom's mobile money service, *Telebirr*, launched the first fully digital microcredit services with automatic payout and notification features.<sup>85</sup> These services are *Mela* (credit option) and *Sanduk* (overdraft credit line where customers can make payments via *Telebirr* and settle them later). Using Huawei's mobile money technology, *Telebirr* uses customers' telecommunications usage data and *Telebirr*'s trading history to determine creditworthiness and credit limits. The platform now offers daily, weekly and monthly loan options for any amount. Borrowers are charged a processing fee of 1% to 10%.<sup>86</sup> *Telebirr* reported more than 50,000 borrowers within a few months of launching these services.<sup>87</sup>

The growing demand for innovative lending solutions has forced many financial industry players to test their own digital lending products, while others have been rushing to create platforms. *Apollo*, a digital banking platform from Bank of Abyssinia has also started using microloans. Competition between financial institutions for a share of the digital lending market creates opportunities for new partnerships and new products.

The rapid rise of *Michu* and *Telebirr* highlights the huge demand for uncollateralized digital loans in Ethiopia. New players such as *Kacha* Digital Financial Services have also expressed interest in the

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<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *telebirr*, <https://www.ethiotelecom.et/mela-micro-credit>.



microcredit market.<sup>88</sup> The impending entrance of Safaricom's M-PESA in the Ethiopian digital lending market will undoubtedly have an impact, but the Company will have to wait for the National Bank of Ethiopia (NBE) to lay down the rules before it can enter the fray.

Some of the most notable recent developments in digital lending include credit cards. Awash Bank has announced that it will issue credit cards to its customers in the form of secured and unsecured loans.<sup>89</sup> Several hundred thousand Birr in bank loans are available to customers, with limits depending on the type of loan. This is a significant milestone for the Ethiopian financial sector, and this development is likely to be followed by even greater changes.<sup>90</sup>

The implementation of different credit models has advantages and disadvantages. These are the possible opportunities and risks that the Ethiopian market will face due to the upcoming changes.<sup>91</sup>

### **3.1 Digital Lending in Ethiopian Fintech Industry: Challenges and Opportunities**

In Ethiopia, the fintech sector is at its emerging stage, which could have consequences and inconveniences. Diversifying funding sources would allow lenders to experiment with innovative use cases based on their risk appetite since they themselves would be able to bear the risk. Therefore, the rise of digital lending has generated the new lending models such as peer-to-peer lending. Fintech's can develop their own lending products. To enable a more attractive business, also offers alternative credit options for individuals and businesses. It is clear that there is still a significant funding gap for small and medium-sized businesses, as well as for individuals who cannot ensure their own security. Enabling fintech's to raise funds from multiple sources will

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<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> Jain, *supra* note 8, p.12.

ease consumers' financial constraints. Reports from the National Bank show that only 300,000 people have applied for loans from banks.<sup>92</sup>The proliferation of digital loans in the market could benefit millions of people in a short period of time, and competition in the market could lead to lower costs for consumers. The monopolistic nature of the banking sector has given way to uncompetitive pricing. The main trendsetter is the State's Commercial Bank of Ethiopia (CBE), with private banks adjusting their interest rates based on decisions made by CBE executives. The propagation of digital lending products could lead to competitive pricing. However, in reality, the fees associated with digital loans can exceed traditional fees.

Despite its importance, digital lending is not without its deterrent effects. These include: over-indebtedness and debt culture. The most common reasons for applying for a loan were household needs, followed by business needs and mobile airtime. Experts believe that over-indebtedness can be reduced by promoting productive lending to small and medium-sized businesses. They also warn that transparent and understandable terms are key to minimizing unmanageable debt so that potential borrowers can understand the full scope of a deal with digital lenders. Insufficient credit data will be the next challenge for digital lenders. This type of data would help lenders identify borrowers with outstanding loans or previous defaults before making a decision. A Government Credit reference Bureau (CBR) was established in Ethiopia in 2019.<sup>93</sup>The bureau was intended to serve as a repository for borrowers' credit histories, and financial institutions were required to provide complete credit information before disbursing anything. However, this system operated by NBE is not yet integrated into the digital loan delivery system. If the country has to succeed in the digital lending market, there must be a mechanism for data sharing between

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<sup>92</sup> *Id.*

<sup>93</sup> NBE, Directives for the Establishment and Operation of Credit Reference Bureau Directives No CRB/02/2019. (1<sup>st</sup> Amendment).

lenders while data protection regulations must be put in place. The ongoing national digital identification project is expected to make this much easier by providing registrants with a unique digital identifier. While the availability of identification is important, there must be a credit information exchange system through which creditors can refer to outstanding loans. Finally, the concept of regulating the digital credit market is not easy, and the central bank needs to strengthen its human and technological capabilities to achieve this goal. This is the case with the National Bank of Ethiopia (hereinafter called NBE), which is already responsible for the supervision of banks, insurance companies and MFIs. Underperformances in capacity can have serious consequences. Digital loan providers disclose their funding sources, which are mandatory to prevent money laundering, and cash in electronic accounts must be backed by real money in the bank account, as required by the NBE. This can be a difficult task if careful monitoring is not carried out. The NBE is required to create a conducive regulatory environment for the interplay of actors in the digital lending market.

#### **4. Suggestion for Smoothing the Playground for Uncollateralized Digital Lending in Ethiopia**

Uncollateralized digital lending is a product of digital advancement that meant to alleviate bottleneck for raising investment fund. It was a planned change that was purposely designed by the regulatory organ. It mushroomed when the legislature is not ready to manage it. Digital revolution and dynamic nature of global market cannot parallel the conservative lawmaking process but whenever a new situation that was not foreseen by the existing regulatory framework, the law should be enabled to address it either through construction under the umbrella of general rubric of administration of justice, or quick legislative action. Needless to say, an unregulated social interaction can possibly generate chaos that could lead into social unrest. Submittedly, in Ethiopia there

is no specific regulatory framework that meant to govern uncollateralized digital lending market.

Absence of legal framework has negative impact both on lenders and beneficiaries of the loan. On the side of the loan providers, since there is no collateral for the loan, in case the loan beneficiary fails to repay their debt, the loan provider may be left in cold (helpless), which would ultimately backfire the emerging loan market and the economy. On the other hand, the loan provider may exorbitantly impose interest rate on the consumer in anticipation of possible risk of bad debts. In the very absence of sector specific regulations makes it possible for digital lenders to look for creative ways of circumventing financial sector best practices, which in this case are not legally binding. This has resulted in adoption of exploitative lending practices. The absence of express redress mechanisms supported by the law for the sector presents a difficulty for aggrieved consumers to find redress. Lack of a legally instituted redress mechanism encourages the digital lending companies to take advantage and engage in exploitative lending practices.

The other key issue arising is in the lack of a substantive definition of what constitutes a contract between a digital lender and the borrower in the context of the loan contract. Those provisions cover loan of money contract in Ethiopian Civil Code (Arts. 2471, 2472, 2473) doesn't cover the issue that now rising with the advancement of technology, and the associated enforceability of the rights of the lender during loan recovery based on the lending process that does not seem to require a signature, whether physical or electronic and electronic Signature Proclamation No.1072/2018 scope of application does not cover signature on digital lending. Additionally, the legality of the digital lending in the eyes of general contract law itself will raise the other question. Accordingly, the legal requirement and guidelines to form a lending agreement should be described by the regulation. In digital lending unlike

conventional loan in banking sectors where borrowers are expected to go to banks or other financial sectors, the borrower may make agreement on platform using their mobile phone and thus, the age and status of the borrower may not be known to the lender. Furthermore, since digital lending is collateral free, ability of the borrower to make decision on the credit and having status to comply with the terms and conditions of the agreement shall be provided as the legal capacity to form digital lending agreement by specific law. The other gap seen in this assessment is that the provisions in the consumer protection laws need to be enhanced in the context of digital lending. There is a need for clear regulatory provisions and set mechanisms to ensure proper redress on issues arising between lenders and borrowers in the digital lending space beside the NBE, Directives No. FCD/01/2020, Financial Consumer Protection, 25 August 2020. The Banking Business Proclamation no. 592/2008” is not adequate enough in regulating uncollateralized digital lending. It deals only with deposit taking institutions and NBE, Directives No. FCD/01/2020, Financial Consumer Protection, 25 August 2020 does not consider digital lenders as financial institutions.

The current practice of digital lending in Ethiopia presupposes the involvement of depositary institutions, yet the lenders do not take any deposits or collateral in digital lending era. However, as the experience in digital lending era shows digital lending activities extend beyond financial institutions, involving both traditional players and new entrant’s big tech companies like Amazon, Apple, Google, Alipay and many more engaged in digital lending as well as individual investors also play their role as lender through platforms like P2P.<sup>94</sup> In Ethiopia, at this point, there is no law which compromises these. Therefore, it

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<sup>94</sup> Big tech companies across the world have started to offer lending services in recent years, either directly or in partnership with financial institutions. For example, Amazon, Apple, eBay, Google, and Paypal in the United States and Alibaba, Baidu, JD, and Tencent in China all offer credit services. Lei Liu, *et,al*, The Big Tech Lending Model. p.1.

needs a legislation to allow non-deposit lending service providers and individual investors to the digital lending land scape.

In the area of digital lending, the role of specific regulatory authorities is becoming increasingly important. Having a dedicated regulatory body that monitors the activities of various industry players and has clear powers will help maintain sanity in the industry. Therefore, it is suggested the NBE to introduce a specific regulation on fintech. With the emergence of innovative technologies and new services, regulators must prioritize consumer protection and addressing grievances effectively in the digital financial landscape. Without ensuring that consumers receive appropriate treatment and trust in digital finance, the entire ecosystem is unlikely to thrive. Strong customer protection systems ensure consumers' rights and minimize the legal risks that customers may face. For this purpose, the regulatory authority should directly take into account, authorization of data collection by digital lending apps, if necessary and with the express consent of the borrower only. Yet again, to protect the privacy of all digital loan applicants, the regulations should prohibit lenders from sharing customer information with anyone else without the customer's consent or obtaining written authorization. The presence of a dedicated and legally empowered regulatory body will direct the digital lending system in a way advancing the economy by making finance available to startups that cannot offer collateral in the tradition credit market. The startups will not only get job but can create thousands of jobs and increase the number of tax paying citizens. A dynamic regulatory body will assess the actual working of credit market and take curative measures proactively and will play a key role in shaping the digital credit landscape by protecting consumers and promoting responsible financial practices.

Combating money laundering and terrorist financing in digital lending is a key regulatory issue. The key controlling mechanisms of funds do

not sourced from criminal activities are, Know Your Customer (hereinafter called KYC) and Customer Due Diligence (CDD). Digital lending platforms are required to implement robust KYC and CDD procedures. This involves verifying the identity of customers, assessing their risk profile, and conducting ongoing monitoring of transactions. KYC and CDD measures help identify and prevent the use of digital lending platforms for illicit activities.<sup>95</sup> Digital lending platforms are required to have comprehensive Anti-Money Laundering Policies (hereinafter called AML) policies in place. These policies include risk assessments, internal controls, and reporting suspicious transactions to the relevant authorities. AML policies help detect and prevent money laundering activities in digital lending.<sup>96</sup> Collaboration with Financial Intelligence Units is also among the mechanism. Therefore, when introducing the regulatory framework in uncollateralized digital lending era, the NBE shall take into account all digital credit providers to provide evidence and sources of the funds invested or to be invested in the company and to prove that these funds do not come from criminal activities.

Sufficient and timely information that allows a satisfactory assessment of a borrower's creditworthiness is essential for digital credit providers to make prudent credit decisions. The presence of an effectively functioning credit information system eliminates the risk of over-indebtedness in the event of repeated lending by borrowers, which significantly contributes to improving access to finance in the financial system. To achieve this goal, the NBE issued the Credit Reference Bureau (CBR) established by Directive No. CRB/02/2019. The bureau was intended to serve as a repository for borrowers' credit histories, and financial institutions were required to provide complete credit information before disbursing a loan. However, this system

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<sup>95</sup>European Commission, "Anti-money Laundering and Countering the financing of terrorism of EU level," [https://finance.ec.europa.eu/financial-crime/anti-money-laundering-and-countering-financing-terrorism-eu-level\\_en](https://finance.ec.europa.eu/financial-crime/anti-money-laundering-and-countering-financing-terrorism-eu-level_en).

<sup>96</sup> *Id.*

managed by the NBE is not yet integrated into the digital loan delivery system. If the country wants to succeed in the digital lending market, there must be a mechanism for data sharing between digital lenders while data protection regulations must be put in place. The ongoing national digital identification project is expected to make this much easier by providing registrants with a unique digital identifier. The implementation of the Digital ID in Ethiopia is expected to significantly address several challenges related to uncollateralized digital lending.

The National ID program aims at digitizing identification processes, allowing for better verification of individuals' identities. With a reliable digital ID system, lenders can verify borrowers' identities more efficiently, reducing the risk of fraud or identity theft. This enhanced identification process will contribute to building trust between lenders and borrowers. A robust digital ID system can serve as a foundation for creating credit scoring models. By analyzing borrowers' transaction history, payment behavior, and other relevant data, lenders can assess creditworthiness more accurately. This will enable lenders to make informed decisions about extending uncollateralized loans. Digital IDs facilitate automatic loan appraisal and disbursement. Borrowers can access loans remotely, streamlining the lending process. Automated loan collection methods can reduce associated costs and improve efficiency. With proper identification, lenders can track borrowers and manage repayments effectively. The use of digital ID enhances transparency in financial transactions. It ensures that borrowers' information is securely stored and accessible only to authorized parties. This transparency contributes to a healthier lending ecosystem. Overall, the National Identification Program, once fully implemented, will strengthen the financial sector, improve transparency and facilitate unsecured digital lending in Ethiopia. While the availability of identification is important, there must be a credit



information exchange system through which creditors can refer to outstanding loans.

## **5. Conclusion**

Despite the possible benefit of uncollateralized digital lending system, ineffective or absence of regulation of digital lending market can possibly generate negative consequences that can adversely affect the service or the beneficiaries. To maximize the use of innovative tools in a way advancing public interest, the concerned body should proactively take legislative measures that can direct market actors to the desired path that possibly align with the nation's economic goals. Periodic follow up and observance of global digital market trends can help lead the market in right direction that can effectively filter the bad and promote the goods through legislative tools and executive actions. Unless the ongoing credit market is closely monitored and regulated in a protecting the public, there is no doubt for resurfacing financial crises that can potentially mess the economic system. Therefore, it is suggested that the growing uncollateralized digital lending shall be directed to a right way and planned destination before it reaches to the point of no return. In other words, the Ethiopian financial regulators should craft a specific regulatory framework that can proactively tackle problems that the emerging technology yields. Digital lenders and borrows should act within the bounds of law and closely monitored. An adequate regulatory framework and periodic supervision of digital lending market actors and dynamism will not only avoid exorbitant interest rates but also will protect lenders to offer finance to reliable ventures. In regulated economic system, consumer right will be protected thereby mitigating or avoiding over indebtedness. By striking the right balance between regulation and innovation, Ethiopia can harness the benefits of uncollateralized digital lending while safeguarding the interests of borrowers and promoting a healthy and inclusive financial ecosystem.