BACKGROUND AND INTRODUCTION: DIGITAL FINANCIAL SERVICES IN THE EMERGING MARKETS

Digital finance\(^1\) offers a potential to accelerate financial inclusion in low income countries and emerging markets. In 2014 the Global Findex consumer survey reported that 2.0 billion adults are unbanked worldwide, whereas it is estimated that in 2014 there were over 3.6+ billion unique mobile phone users. Furthermore, by 2020 an estimated 80 percent of adults worldwide will have SmartPhones.

Mobile phone technology has a potential to extend financial access dramatically, in particular to low income households who previously had limited or no access to formal financial services. This potential digital platform for delivery of financial services has larger outreach than traditional brick and mortar bank branches (including ATMs) due to the ubiquity of mobile devices and a much larger distribution network through agents.

However, the effectiveness of digital platforms and delivery channels to foster full financial inclusion depends on their ability to evolve beyond the offer of money transfer and payments services\(^2\) to additional financial services - savings, credit and insurance - offered in an appropriate, reliable, affordable and secure manner. To harness the digital finance potential, mobile network operators (MNOs) have teamed up with financial service providers (FSPs) to extend digital financial services that include micro savings and credit. However, recent crises driven by aggressive lending to lower-income consumers in several markets (India, Morocco, Nicaragua, Bosnia, and South Africa) have shown how it is important to develop sufficient market conduct regulatory and supervisory systems alongside innovative products such as digitally-delivered credit.

The delivery of small loans through digital means (hereafter referred to as “digital credit\(^3\)” offers significant potential benefits to lower-income consumers, as well as likely gains in financial deepening and broad-based economic development.\(^1\) Credit plays an obviously important role in helping households and very small businesses manage their finances, deal with shocks and swings in income/revenue, and capitalize on opportunities. Digital delivery of credit, when it is done carefully and responsibly, can result in substantial cost savings and improved credit risk management, as well as potential for diversification of product offerings and fuller financial inclusion.

However, from the perspective of consumer protection and market conduct, the product features and business models associated with digital delivery of credit can also create new risks, elevate existing risks or shift the incidence and the party responsible for managing risks.

Among the potential financial consumer protection concerns are how transparency, fair treatment, prevention of over-indebtedness or debt stress, and effective recourse standards may be achieved when services are delivered digitally and key functions or roles of the lending process are shared or outsourced. Another concern is achieving adequate and equal protection for consumers when some digital lenders are licensed and supervised and others are not. Consumers may also behave differently when presented with relatively “instant” loans in a completely confidential content, when compared with conventional small loans processes.\(^4\) Such risks could affect significant numbers of consumers that have relatively low levels of income, education and formal financial experience, since the models currently observed in various markets can and do scale rapidly and the lenders are not always supervised by financial authorities.

With the objective of promoting responsible lending and healthy financial inclusion, AFI’s Consumer Empowerment and Market Conduct (CEMC) Working Group conducted an investigation of digital credit products and models, the consumer protection issues they raise, and potential regulatory and other measures to address them. This guidance note focuses particularly on potential customer risks from digitally-delivered credit and how policy makers and regulators in emerging markets and developing economies could develop an approach for identifying, monitoring and mitigating the most important customer risks. The guidance note advocates a proportional approach that allows financial regulators to watch and reduce customer detriment while permitting healthy innovation and deepening of credit markets.

Since digital credit is a new development in some markets and has not yet appeared in others, the approach taken in this research is exploratory and any guidance is appropriately preliminary, with a clear need for further investigation, peer exchange on concerns and measures to mitigate customer risks, and identification of emerging good practices over time. To provide a starting point for analysis and dialogue, CEMC analyzed two stylized common models of digital credit delivery and conducted a survey on current issues and existing and planned policy and regulatory measures.

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\(^{1}\) Digital finance in this case refers to financial services offered through mobile phones and other digital platforms.


\(^{4}\) For a summary of how consumer behavior may differ in a digital borrowing environment, see http://www.cgap.org/blog/digital-credit-consumer-protection-m-shwari-and-m-pawa-users
MODELS OF DIGITALLY DELIVERED CREDIT AND ASSOCIATED CONSUMER PROTECTION ISSUES

Credit products delivered via digital means, while relatively new to emerging markets, already demonstrate a wide diversity in product terms and key features. In addition, there is a diversity of providers operating in this space—from banks to MNOs to lending-only institutions—alone and in business partnerships. Furthermore, the adaptability of digital interfaces such as SmartPhones with associated apps enables providers to develop highly customized product offerings at relatively low cost.

These innovations create the potential to increase access to credit products to a wider range of consumers (including those with lower levels of income and education, both in urban and rural areas) in a more effective and targeted way through, for example, linkages to mobile money, social media, SMS and internet, and possibly at a lower cost than traditional consumer credit delivery models. However, digital finance raises new risks to consumers and shifts responsibility for managing other risks to new parties who operate outside regulatory oversight.

For policymakers, this diversity of business models may create new challenges that include:

> Determining whether fast-evolving lending practices are appropriate and for monitoring developments in the mass-market credit sector;
> Assessing compliance with existing rules; and
> Monitoring the business conduct of this more diverse set of providers, products and delivery mechanisms than that which has characterized credit products of this type delivered via conventional providers and channels.

As the below table notes, each digitally delivered credit model and provider type or partnership raises particular concerns for consumer protection policy and regulation.

| Unsecured mobile money-based loan | High interest charges due to short term and unsecured nature of loan; potential high initial default rates with bulk “push” offers to consumers via mobile phone. | Insufficient disclosure of terms via mobile handset and limited internet access hinder consumer ability to obtain product terms and conditions. | 
| Social media scored loan | Risk of higher default rates as scoring models are refined. | Insufficient rules in place for disclosure of terms for internet-based loan products in most markets. | Need for protections against improper use of consumers' personal and social media data, as well as on-selling of such data. |
| Savings-linked loan | Need for rules and clarity on permisibility to freeze or strike savings balance to pay down loan balance. | Link between savings and loan obligations not always properly disclosed to consumers at point of enrollment or acceptance of loan offer. | Need for recourse information and access to complaints mechanism to be available through all channels by which products are accessed. |
| MSME loan | Consumer protection provisions may not extend to MSME firms due to classification as a business not an individual. | Need for clear disclosure of use of collateral and/or transaction values as collateral or repayment mechanisms. | 
| Peer to Peer lending | Risk borne by individuals providing capital to on-lend needs to be clearly articulated. | Firm facilitating lending needs to ensure sufficient protection of identity and protect against improper conduct by lenders and borrowers towards each other. | Relationship and responsibilities amongst individuals providing capital, borrower and firm facilitating loan needs to be clearly articulated to all parties. | Protection of personal details of lenders and borrowers from other users. |
SUMMARY OF REGULATOR SURVEY RESPONSES AND ANALYSIS

In May 2015, AFI’s Consumer Empowerment and Market Conduct Working Group (CEMC) reached out to its members and other regulators to solicit their experiences and perspectives on the key consumer protection and market conduct issues raised by digital delivery of consumer credit and how such issues might be addressed by policy, regulatory or supervision measures. The survey also explored concerns and emerging rules and practice on digital financial services (DFS) beyond credit.

Respondents included regulators from fifteen jurisdictions, of which fourteen have digital financial services (DFS) deployments.5

The dominant services in the 14 jurisdictions with DFS are electronic payment, person-to-person (P2P) transfer and withdrawal services. Value added services such as value storage, savings accounts and loans are still rare; only six of the markets have at least one digital consumer credit offering (Kenya, Bangladesh, Tanzania, Philippines, Paraguay and Zambia).6

DFS-Specific Policies

Seven of the 15 respondent jurisdictions have in place specific rules regarding the offering or disbursement of loans via non-branch channels, e.g., via the mobile phone, online, during in-person visits by sales staff or through agents. For example, in Thailand and Turkey while financial service providers (FSPs) can offer loan information, application and repayment through non-branch channels, they are not allowed to disburse loans via a non-branch channel.

More generally, nine of the fourteen markets with DFS have specific laws or regulations in place covering the delivery of mobile money or other DFS.7 Four regulators are currently developing specific regulations or policies, including Costa Rica which is preparing for the launch of digital banking services. Two markets do not have specific regulations for DFS.

Half of the jurisdictions with DFS surveyed also have rules for the specific delivery channels used for DFS and how products may be offered via these channels. Most of these rules define the type of services that may be offered or delivered through electronic channels. Some regulators including the Central Bank of Kenya opted to provide guidelines rather than creating rules for specific delivery channels with the objective to provide room for innovation.

5 This excludes Costa Rica.
6 The survey was sent to members of CEMC Working Group. AFI received answers from Bangladesh, Brazil, Burundi, Costa Rica, El Salvador, Kenya, Macedonia, Malaysia, Paraguay, Philippines, Samoa, Tanzania, Thailand, Turkey, and Zambia. Costa Rica is the only country where there are no DFS deployments yet.
7 For example, the Regulations on Electronic Funds Transfers in Bangladesh, the National Payment Systems Act and National Payment Systems Regulations in Kenya, the Payment and Securities Settlement Systems, Payment Services and E-Money Institutions Law in Turkey, Section X780 on Issuance and Operations of Electronic Money in the Manual of Regulations for Banks (MORB) of Bangkok Sentral ng Pilipinas, the Payments Systems Act in West Samoa, or the National Payment Systems Directives on Electronic Money Issuance in Zambia.
Market Conduct Policies and DFS
Among the nine markets with specific regulations there are seven that have provisions relevant to market conduct and consumer protection, such as rules on disclosure of fees, transparency and reporting requirements, recourse and complaints resolution mechanisms, or data protection. Regulators seem to acknowledge the need for specific disclosure rules when financial services are offered through a digital channel. Three countries report having DFS-specific policies in place concerning disclosure and product transparency, two will include such rules in their new regulations, and in five countries DFS providers must follow the same rules as any FSP.

With regard to customer redress and complaints resolution most regulators have established general provisions that apply for all types of FSPs. At least half of the respondent countries have a national agency or institution for consumer complaints resolution to which financial consumers can turn if they have a problem or feel treated unfairly by a provider.  

Regulatory Gaps to Address
The survey also asked for regulatory gaps or risks of regulatory arbitrage that can arise with digitally-delivered credit due to the type of service provider(s) or business models in the market. For example, an MNO may partner with a non-regulated financial institution that does not have to meet prudential and market conduct regulations, which could expose consumers to increased risks of misconduct or loss of funds. Among the six respondents that identify regulatory arbitrage risks or gaps in their markets, three are currently looking at how to address these. The Bank of Thailand, for example, revises and updates its guidelines on offering financial services via digital channels regularly to cope with the rapid changes in financial markets.

Looking Forward: Future Regulatory Priorities
Finally, respondents were asked to identify regulatory priorities and measures that would help ensure responsible delivery of DFS in general and with a specific focus on their own market and potential gaps meriting attention. Three priorities were evident in the 10 responses:

i) Ensure full disclosure of product terms and conditions considering the visual limitations of digital interfaces, especially of basic feature phones (6 respondents);
ii) Ensure that all types of FSP are licensed, regulated and supervised, and subject to the same market conduct and consumer protection requirements (6 respondents);
iii) Ensure that consumers know how to use DFS, are aware of the risks associated with digital delivery and know how to find support and resolution if they face a problem (5 respondents).

Overall the survey reveals a general level of awareness among the regulators surveyed of the risks associated with fast evolution of the digital financial market and digital delivery of credit in particular. Jurisdictions are starting to put in place regulatory and other measures to address these priorities. Respondents also reported considerable gaps and inefficiencies in the regulatory frameworks for financial services in general and DFS in particular - especially in terms of market conduct and consumer protection.

According to the survey respondents, first steps to address these gaps include increased communication and collaboration among financial service and other regulators, as DFS are offered by diverse providers including banks, MNOs, payment providers and other non-bank financial institutions. Peer exchange among regulators from different jurisdictions could also be beneficial for exchange of experiences and emerging good practices in policy, regulation and supervision.

**MAIN ISSUES RAISED REGARDING DIGITAL CREDIT**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited KYC</td>
<td>31%</td>
</tr>
<tr>
<td>High interest rates and penalty fee</td>
<td>19%</td>
</tr>
<tr>
<td>Low term and amount</td>
<td>15%</td>
</tr>
<tr>
<td>Limited disclosure of T&amp;C</td>
<td>13%</td>
</tr>
<tr>
<td>Lack of guarantee</td>
<td>12%</td>
</tr>
<tr>
<td>Instant access to credit facility</td>
<td>8%</td>
</tr>
</tbody>
</table>

**MAIN MARKET CONDUCT AND CP ISSUES**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ltd. disclosure of costs</td>
<td>31%</td>
</tr>
<tr>
<td>High costs of loan</td>
<td>14%</td>
</tr>
<tr>
<td>Ltd. suitability and misleading advertising</td>
<td>14%</td>
</tr>
<tr>
<td>Data security and privacy</td>
<td>12%</td>
</tr>
<tr>
<td>Unfair sales and debt collection practices</td>
<td>11%</td>
</tr>
<tr>
<td>Recourse and dispute resolution</td>
<td>9%</td>
</tr>
<tr>
<td>(Agent) supervision and monitoring</td>
<td>9%</td>
</tr>
</tbody>
</table>

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8 Seven respondents mentioned a national agency that handles consumer complaints. However, the survey did not ask whether there is a national institution for financial consumer recourse; Hence, more regulators may have such a mechanism in place.
CASE STUDY: THE ZAMBIA NATIONAL PAYMENT SYSTEMS DIRECTIVES ON ELECTRONIC MONEY ISSUANCE MONEY ISSUANCE

Within five years, mobile money subscriptions in Zambia have grown to 5.2 million surpassing already the number of active traditional bank accounts. Today, there are four mobile money services offered by the two biggest MNOs in the region, MTN and Airtel, by Zanaco Bank and by the state-owned operator Zamtel.

Having followed other regulators’ “lean regulation” approach, Bank of Zambia (BoZ) has allowed financial innovations to reach the under-banked and unbanked Zambian population. This year, however, Zambia reacted to the accelerating uptake and usage of electronic money transfer services - BoZ recorded 35.5 million mobile money transactions in 2014, twice as many as in 2012 and 45% more than in 20131 with the National Payment Systems Directives on Electronic Money Issuance (hereafter referred to as “the Directives”), for increased and more prudent regulation of Electronic Money Issuers (EMI).

Pursuant to the Directives non-bank DFS providers are not allowed to extend credit but can partner with an institution licensed to provide credit. In such case the licensed institution will be responsible for the management and extension of credit while the DFS provider provides the delivery channel.

The Directives lay down specific provisions relevant to market conduct and consumer protection. For example, they stipulate that:

- DFS providers, or EMI’s, must fully disclose costs, terms and conditions before extending credit to the customer. This involves ensuring that customers have an understanding of the services being offered including all costs and the inherent risks of using the services.
- All charges be displayed in a conspicuous place within the EMI’s premises and the premises of all their agents.
- Customers’ data and information be protected and kept confidential.
- An EMI is liable to its customers for business conducted by its agents and must ensure that its agents comply with all legal and regulatory requirements related to the provision of electronic money services. If BoZ considers an agent to be non-compliant it has the right to request an EMI to remove an agent from its register.

The Directives require EMIs to provide a customer support center with a mechanism for resolving customer queries and complaints on a timely basis. A customer that is not satisfied with the resolution provided by the EMI can take the complaint to BoZ as the regulator or to the Competition and Consumer Protection Commission established under the Competition and Consumer Protection Act.

The level of disclosure is relatively limited in many of the current digital credit products in market. For example, often details of the digital credit offer and key terms and conditions are only available online, an arrangement which limits key information to those who lack internet access and use SMS, USSD or other channels to acquire digital credit products.

- Advertisement: As part of market conduct supervision system, advertisement of DFS products needs to be monitored so prohibited activities are identified and appropriate measures taken.
- Pricing: There is a need for market conduct regulation to require comprehensive disclosure of costs of digital credit to allow for comparison with other credit offers, both digital and non-digital, with a view to promoting pricing fairness.
- Recourse: Ensuring adequate coverage and ease of access to recourse mechanisms for consumers via digital and non-digital channels regardless of whether the provider is regulated by the financial sector authority or otherwise. For example, a telecommunications authority can extend their requirements on consumer recourse mechanisms for MNOs to cover DFS products marketed via these MNOs’ channels.
- Over-indebtedness: It is prudent for regulatory bodies to develop market monitoring mechanisms to review levels of debt on a continuous basis, both from demand-side data and review of digital credit portfolios.
- Credit information systems: a need to report digital delivered credit to the credit reference database to mitigate potential over-indebtedness risks, and make sure that all digital lenders comply equally with reporting requirements.

CONCLUSION: CONSUMER PROTECTION CONSIDERATIONS WITH DIGITAL DELIVERED CREDIT

Regulatory Issues that Arise in the context of Digitally-Delivered Credit

It is evident from the review of experience to date, the survey results, and the case study analysis that digital credit raises a wide range of policy and regulatory issues and potential responses that include but are not limited to the following:

- Regulatory coverage and level playing field among providers: Some complaints have been raised by banking institutions regarding difference in treatment of banks and MNOs in terms of KYC requirements, with requirements being more stringent for banks. Regarding digital finance providers, conditions can become more stringent to regulated FSPs (e.g. the case of M-Pawa in Tanzania, which is offered through a regulated bank teaming up with MNO vs Timiza, a non-regulated Micro-credit Provider which teamed up with an MNO in Tanzania, and is not under the jurisdiction of the financial sector regulator).
- Disclosure: The level of disclosure is relatively limited in many of the current digital credit products in market. For example, often details of the digital credit offer and key terms and conditions are only available online, an arrangement which limits key information to those who lack internet access and use SMS, USSD or other channels to acquire digital credit products.
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- Credit information systems: a need to report digital delivered credit to the credit reference database to mitigate potential over-indebtedness risks, and make sure that all digital lenders comply equally with reporting requirements.

Privacy and Data Protection: These business models may raise a need for an explicit regulation or guidance to clarify that FSPs are required to take sufficient measures to protect the confidentiality and security of a customer’s information against threats and against unauthorized access to, or use of, customer information, including sharing of consumer data to third parties without clear and explicit prior authorization.

Product design: Mitigation of financial consumer risks can be enhanced through regulators’ engagement with and oversight of (approving where feasible and appropriate) providers on product design to address inherent weaknesses in a product and its value chain.

Initial guidance to regulators in markets with currently available digital credit products

- Engage with providers and their partners that are offering or planning digital credit products on an ongoing basis to understand more clearly the specific product features and model for marketing/distribution/scoring/loan management/collections, with an eye towards identifying the key consumer protection vulnerabilities and risks and how they will be mitigated.
- Consider whether pre-approval of new products or business arrangements can and should be required.
- Clarify liabilities for consumer welfare (e.g., recourse arrangements) as feasible, especially when multiple parties are involved in delivery of the digital credit product.
- Analyze available information on current customer experience or collect/commission studies (e.g., mystery shopping, surveys, focus group discussions, etc.) to prioritize and size these risks.
- Analyze the extent to which existing regulation and guidance covers and treats the products, models and risks in the market, to identify gaps and come up with a practical plan to assess compliance; consider whether and how gaps can be addressed.
- Network with peer regulators in other jurisdictions to stay abreast of new developments and emerging good practices.
- In addition, while it is not a matter of regulation/ supervision, jurisdictions (and other stakeholders) will want to consider how best to improve consumer awareness, understanding and behavior over time, including through awareness campaigns and financial capability interventions that might receive policy support or have government involvement.

Initial guidance to regulators in markets where such products have not yet appeared

-Peer learning and experience sharing among regulators (learning from jurisdictions with digital credit products already on offer)
- Building on the existing payments systems regulations to create prudential and market conduct regulations to support introduction of digital credit.
- Engage with potential digital credit providers and their partners with a view to understand the specific product features and their associated consumer risks in order to develop regulatory mitigation measures.

Next steps

Digitally-delivered credit products targeted to lower-income consumer segments are diversifying and growing fast in a few markets, beginning to appear in others, and have not yet arrived in many emerging market and developing country markets. These products offer potentially big gains for households that can put them to good use and for the policy goal of full and healthy financial inclusion; digital credit also poses some potential risks to consumers that merit deeper investigation and are likely to require adjustments in policy, regulatory and supervisory frameworks. To date, the experience with these products is nascent and evidence on benefits and risks is similarly very limited. Efforts to identify emerging good practice in the policy and regulatory space are also just beginning. This guidance note is a first attempt to gather and summarize the evidence and experience for AFI members. There is a clear need for further data and analysis including additional country case studies, consumer research, engagement with the industry actors who are innovating with digital credit, and peer exchange and coordination among regulators and supervisors with responsibilities in this area. AFI intends to join with others to support and facilitate that process.

ANNEX: AFI CEMC SURVEY METHODOLOGYS

The first part of the survey asked respondents to comment on the strengths and weaknesses from a consumer protection perspective of two common models for delivery of small unsecured loans via mobile phone. The second part surveyed existing or planned policy and regulatory measures in place in each jurisdiction related to DFS.

First the participants got sensitized by confronting them with the product features of two unsecured mobile credit products as presented in table X. Both are offered in Tanzania by the leading MNO’s and in collaboration with a FSP. One product is offered in partnership with an unregulated credit only micro-finance institution and one in partnership with a commercial bank.
<table>
<thead>
<tr>
<th>PRODUCT FEATURE</th>
<th>TIMIZA (MNO AND CREDIT ONLY MICRO-FINANCE INSTITUTION)</th>
<th>M-PAWA (MNO AND COMMERCIAL BANK)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Term</td>
<td>7, 14, 21 or 28 days, per customer’s preference; Loan amount from $1 to $300</td>
<td>30 days; Loan amount from $.60 up to $300</td>
</tr>
<tr>
<td>Cost of Loan</td>
<td>10% initiation fee, plus .5% interest per day; mandatory Loan Insurance premium charged to customer incorporated into the fees above;</td>
<td>9% of loan value fee</td>
</tr>
<tr>
<td>Penalty Fees</td>
<td>13.5% on outstanding balance with repayment extended for 7 days, with another 10% penalty fee on outstanding balance, after which no further charges; can automatically strike mobile money account balance to make loan repayment; all incoming mobile money funds diverted to loan repayment after second late payment penalty</td>
<td>Additional 9% of loan value assessed if loan not repaid in 30 days; can automatically strike either savings or mobile money account balance to make loan repayment</td>
</tr>
<tr>
<td>Requirements to Borrow</td>
<td>Have been a customer of MNO for 90 days and have active mobile money account with MNO</td>
<td>Have an active mobile money account with MNO for 6 months</td>
</tr>
<tr>
<td>Default Consequences</td>
<td>Blacklisted internally (can never borrow again from provider); reported to credit bureau</td>
<td>Reported to credit bureau</td>
</tr>
<tr>
<td>Partner Institution</td>
<td>Unregulated lending institution, which holds the loan book</td>
<td>Commercial bank, regulated by central bank</td>
</tr>
<tr>
<td>Tied Products</td>
<td>None</td>
<td>Product is both a loan facility and a formal savings account with a commercial bank. Customers must first open the savings account, and deposit an initial minimum amount before being able to apply for or take on a loan.</td>
</tr>
</tbody>
</table>

**TABLE X: TWO EXEMPLARY DIGITAL CREDIT PRODUCTS PRESENTED FOR COMPARISON WITH TRADITIONAL LOANS IN THE AFI SURVEY.**