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Foreign Institutional Investors and Digital Lending Regulation: Evidence from India's Guidelines on Digital Lending

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ABSTRACT

The rapid global expansion of fintech has prompted regulators in emerging markets to balance innovation against consumer protection and systemic stability. Whether such interventions deter the cross-border venture capital that funds these markets, or instead reshape its composition between foreign and domestic sources, remains an open empirical question. This paper provides causal evidence from a sharp natural experiment—the Reserve Bank of India’s Guidelines on Digital Lending (DLG)—to ask whether foreign and domestic investors respond differently when an emerging-market regulator imposes binding conduct rules on digital lending platforms.

India’s digital lending market grew rapidly through the 2010s on a partnership model in which licensed Non-Banking Financial Companies (NBFCs) supplied the lending licence and balance sheet, while technology-first Lending Service Providers (LSPs) handled customer acquisition, underwriting, and servicing through Digital Lending Apps (DLAs). Mounting complaints about predatory rates, aggressive recovery practices, and opaque borrower-facing communications prompted the RBI to constitute a Working Group in January 2021, whose November 2021 report previewed a binding rulebook. The DLG followed in two steps: a 10 August 2022 Press Release accepting the recommendations, and the binding Circular DOR.CRE.REC.66/21.07.001/2022-23 issued on 2 September 2022. The DLG’s perimeter targeted firms whose business model relies on a DLA partnership; non-DLA fintech firms (payments, wealth-tech, insure-tech) were untouched, providing a clean treatment–control contrast.

Using 4,388 fintech deal-rounds across 1,560 Indian companies from 2016Q1 to 2025Q4, we estimate a difference-in-differences (DiD) specification that compares DLA-exposed firms with non-DLA fintech controls before and after the DLG. The probability that a DLA-exposed round attracts a foreign lead investor falls by 9.3 percentage points after implementation; the probability of a domestic lead investor rises by 10.5 percentage points. The near-symmetry of the two coefficients points to substitution rather than capital flight.

This pattern is consistent with a three-layer mechanism. The DLG raises operational compliance costs for the DLA business model: mandatory disclosure of the regulated entity on every loan document, restrictions on first-loss default guarantees, prohibition on automatic credit-limit increases, mandatory key-fact statements, and tighter borrower-data handling collectively narrow the operational autonomy of LSPs and shift liability toward the partner

regulated entity. For unregulated DLAs that depend on commercial flexibility with bank or NBFC partners, the rule reduces the share of value capturable inside the partnership and compresses expected unit economics. The investment-side response is a downward revision of expected payoffs, particularly for DLA firms without their own NBFC licence.

The retreat is concentrated among foreign investors because they bear higher information costs about the new rule's enforcement trajectory and the operational adjustments required for portfolio firms to remain compliant. Domestic investors with closer regulator relationships and a portfolio of pre-existing licensed entities can absorb the same uncertainty at lower cost. Within foreign capital, the retreat is further concentrated among institutional investors—companies and funds with formal compliance functions and limited-partner reporting obligations—rather than individual angels, who deploy personal capital under weaker monitoring. Domestic capital partially fills the resulting funding gap, redirecting toward DLA firms whose regulatory exposure has now been clarified by binding rules.

The findings carry two implications. For policy, the result that conduct regulation in fintech can reshape the composition of capital between foreign and domestic sources without uniformly reducing it nuances the standard “regulation deters investment” narrative; emerging-market regulators face a trade-off between consumer protection and the foreign-to-domestic mix of capital, not necessarily between protection and total capital. For theory, the paper extends the regulatory-arbitrage literature: even absent capital controls or tax differentials, conduct regulation that raises compliance complexity can induce cross-border capital reallocation through differential information and compliance costs that fall asymmetrically on foreign capital.

This paper makes four contributions. First, it provides the first causal evidence on cross-border venture-capital response to fintech conduct regulation in an emerging market, using India's DLG as a sharp natural experiment with a clearly delineated regulatory perimeter. Second, it decomposes the effect into signal and implementation components by exploiting the gap between the November 2021 Working Group Report and the September 2022 binding Circular, finding that the retreat is concentrated post-implementation. Third, it documents heterogeneous responses across investor type (institutional versus angel) and within-treatment regulatory status (DLA-only versus DLA+NBFC), showing that an NBFC licence acts as a credibility buffer that mitigates foreign withdrawal. Fourth, it documents domestic substitution

as a parallel mechanism, recasting the regulatory effect as a reallocation rather than a contraction of capital.