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DIGITAL LENDING APPS IN INDIA: REGULATORY CHALLENGES UNDER RBI FRAMEWORK

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1. ABSTRACT

This is not just an upgrade in technology for lending money. It is an upgrade in the entire financial system. Digital lending apps in India are at the point where money, data, and technology intersect. They rely on algorithms and new data points like online behaviour and device data, not traditional credit checks. This is helping more people access credit than were able to access it in the past. However, it is also changing how lenders and borrowers relate to each other. It is shifting from a traditional, structured model of banks to something more decentralized. Therefore, digital lending is challenging traditional notions of financial regulations, particularly with regard to accountability, transparency, and what regulations apply.

The Digital Lending Guidelines, 2022, issued by India's central bank, aim at bringing this new sector of lending more under control. The guidelines ensure that money is transferred directly between regulated entities and borrowers. They also make more disclosures. Furthermore, they recognize (LSPs). The RBI wants digital lending to be contained within existing safety standards. However, these guidelines have been formulated on a system of delegated regulation rather than a dedicated legislation. Therefore, there are some real-world issues that have not been fully addressed, such as unregulated fintech players in the middle, algorithmic decisions, and data collection.

This paper is a quiet study on the regulatory hurdles that digital lending is facing in India with the RBI system. It claims that there is a need for a more effective approach that is not fragmented or reactive. It also considers issues with guideline-based regulation, overlap in regulators, and what all of this means for protecting consumers or maintaining stability in the financial system. The study claims that effective regulation in India requires a clear legal approach that is principle-based, integrating financial regulation, data protection, and accountability in technology. This is necessary in order to prevent regulatory integrity or borrowers' rights from being undermined by innovation in digital finance.

KEYWORDS

Digital Lending Apps, RBI Regulatory Framework, Algorithmic Credit, FinTech Governance, Loan Service Providers, Regulatory Arbitrage, Data Privacy, Consumer Protection, Digital Finance, India

2. INTRODUCTION

The rise of digital lending apps in India represents a significant shift in credit distribution. Conventional banks and lending institutions are being replaced by technology-based financial systems. Digital lending is not like traditional lending, where there were physical checks, good credit history, and accountability. Digital lending is more about fast interface with algorithms, using alternate data, and mobile access. Digital lending is making it easier for more people to access credit, especially those not in the formal financial system. However, much of this growth in digital lending apps is happening in an environment where there is no strong regulation in place. This is creating a complex situation where innovation is moving much faster than regulation.

The key change in digital lending is that there is a significant shift in the role of lenders. Conventional regulated lenders, including banks and NBFCs, are relying more on third-party digital platforms, also known as Loan Service Providers (LSPs), for customer sourcing, credit origination, and loan servicing. This model creates confusion about accountability, which is further creating multiple regulatory risks. The Reserve Bank of India is trying to address all these risks with the Digital Lending Guidelines, 2022. However, with unregulated apps, ambiguous digital interfaces, and high-pressure recovery practices, it is evident that regulation is still in its infancy.

However, beyond the institutions themselves, digital lending is part of the broader phenomenon of data-based governance in which personal data is seen as an important economic asset. Digital lending apps may be able to access considerable personal data of users, such as their contacts and location, in evaluating them for creditworthiness without any real or informed consent. This poses important legal questions around issues of privacy and data protection and the extent of user control in online transactions. In the absence of data protection regulations and with the lack of enforcement of existing regulations, such practices may continue to persist and threaten the personal dignity and freedom of the borrower.

The problem with digital lending is bigger in scale because these digital lending platforms are operating across countries and are targeting Indian consumers. These lending applications are owned, operated, or backed by foreign groups. This is why it is hard to monitor them. Old regulations are designed for banks and companies operating in only one country. These are not suitable for cross-border operations. There is a gap in which there is no accountability and enforcement is weak. This is an indication that existing regulations are not good enough for digital finance.

The research problem that is being tackled in this paper is centered on the growing divide between sophisticated digital lending platforms and scattered legal provisions that apply to them. There is an array of legal tools that apply to digital lending, which include RBI directions, data protection laws, and consumer protection laws. However, there is no clear law that is specifically dedicated to digital lending as if it were its own form of financial activity. The primary aim of this study is to assess with utmost care how effectively the RBI's regulatory approach is working, what inherent flaws in the system were built in, and what all of this means in terms of protecting consumers or maintaining financial stability. It also aims at identifying any logical flaws in the system and suggesting a more logical approach that is appropriate for hybrid financial systems.

It is essential to note that the method of research in this paper is based on doctrinal research. This involves studying laws, regulations, and other written materials to analyze the evolution of digital lending in India. The use of legal theories and current changes in regulations enables the paper to transcend the level of mere description and analyze the underlying theories of regulations. The method also enables the paper to evaluate the effectiveness of the regulations and identify the gaps in which regulations are required.

3. DIGITAL LENDING IN INDIA: CONCEPT AND EVALUATION

3.1 Meaning and features of digital lending

Digital lending today transforms the way credit works. No longer do bankers and paper-based records play a role in lending. Instead, computers, data, and algorithms are the guiding force behind lending. In the past, bankers would consider official documents, human judgment, and banking relationships. Today, computers judge whether a person can pay a loan or not. They look at how a person uses their phone, transactions, and behaviour. It transforms credit from a

document-based system to a data-based system.

One of the most important aspects of digital lending today is that it involves real-time decision-making. The entire loan process, from applying for a loan to receiving the money, can happen within a few minutes. It helps a large number of people who do not have a credit history. However, it also raises important legal issues of checking and seeking informed consent. The entire decision-making process is so quick that a person may not even understand the interest rate, penalties, and usage of the data. It makes the consumer less informed and compromises the informed consent that a contract should entail.

Another important feature of digital lending is that it is based on what may be called 'predictive profiling,' in which the borrower is not judged merely on the basis of his or her past financial behavior but also on the basis of predictive behavior. This creates a degree of probability in the decision-making process in lending institutions. The decisions are made on the basis of probabilities rather than facts.

However, such decision-making is opaque and cannot be explained to the borrower. This undermines the fundamental principles of law that are based on fairness and the right to be heard. In digital lending, the line dividing financial services and data exploitation is thin. The exploitation of personal data is an inherent part of digital lending. The borrower is unaware that he or she is trading personal data for the facility of access to money.

3.2 Growth of FinTech and Digital Lending Ecosystem

This rapid growth of digital lending in India is closely linked to the growth of the FinTech industry as a whole. The growth of FinTech in India can be attributed to a combination of technological, regulatory, and market factors. In the last ten years, India has seen the emergence of a digital ecosystem, including the proliferation of the internet and smartphone usage, as well as the roll-out of digital identity platforms. This has led to the emergence of a financial ecosystem where financial services are delivered through digital platforms, resulting in lower costs and barriers to entry. In this context, digital lending has become a significant part of the FinTech industry, offering quick and convenient credit options to a diverse range of customers. This growth of the ecosystem has also been fueled by a number of socio-economic factors, including the increasing need for short-term, unsecured credit facilities for individuals and small businesses. Conventional financial institutions have not been able to meet this need for credit, primarily because of the documentation and risk involved. Digital lending platforms, however, have taken advantage of this opportunity and offered flexible and quick credit facilities that cater to the needs of this segment of the population. As a result, there has been a

significant increase in the number of people using digital lending platforms, especially young and tech-savvy individuals and those operating in the informal economy.

However, it is also seen that the growth of the digital lending system is not uniform or completely regulated. Along with regulated entities, there are also unauthorised lending applications that are functioning in an unregulated manner. These applications are also taking advantage of the loopholes in the existing financial regulations. They are providing loans with extremely high rates of interest.

These kinds of entities have also introduced systemic risks in the digital lending system. They have also shown the limitations of the existing financial regulations in coping with the changing nature of technology. The structural nature of the digital lending system can be defined in terms of its interdependence among various entities. In the digital lending system, it is seen that there is a high level of interdependence among various entities.

3.3 Role of NBFCs and Loan Service Provider

The operational structure of digital lending in India appears to be primarily influenced by the symbiotic relationship between financial institutions, especially NBFCs and unregulated or lightly regulated financial service providers referred to as LSPs. The role of NBFCs, in this context, is that of the lending entity, where they provide the capital and assume the financial risk for lending activities. The role of the LSP, on the other hand, appears to be that of a mere intermediary, where they are responsible for managing the digital interface for lending.

One of the key concerns that arises from this structure of digital lending in India is the undermining of the principle of transparency in the lender-borrower relationship. The lender and the borrower are seen to be in a state of total ignorance of the true nature of the lender, as the borrower appears to have no knowledge of the NBFC that is actually providing the loan, as they are only interacting with the digital platform of the LSP. This appears to create a situation of undermining the principle of informed contracting, where the borrower may not be fully cognizant of the entity they are contractually obligated to.

The role of LSPs also raises critical concerns with regards to data management and data privacy. This is because these organizations are also involved in data management with regards to borrowers. In this context, LSPs may have access to large amounts of borrower data, which may be used for purposes other than creditworthiness. Contrary to NBFCs, which are under much stronger regulatory oversight, LSPs may not be held accountable under financial sector regulations. This creates an imbalance in data management and governance.

4. REGULATORY FRAMEWORK GOVERNING DIGITAL LENDING

4.1 Role of RBI

The regulation of digital lending in India is primarily governed by the institutional authority of the RBI, defined as the central banking and monetary authority that seeks to maintain financial stability, regulate credit systems, and supervise banking and non-banking financial institutions. However, the emergence of digital lending has created complexities that go beyond financial regulation, prompting the RBI to operate within a dynamic environment where technological participation is significant. In contrast to conventional banking, where the financial institution directly engages with the consumer, digital lending involves a series of participatory roles, making it difficult for the RBI to regulate the industry.

The regulatory role of the RBI in governing digital lending in India has primarily been incremental and adaptive, as opposed to a predictive role. Initially, the central bank sought to address the issue of digital lending through general regulatory principles applicable to NBFCs and banks, failing to recognize digital lending as a separate entity that requires specialized regulation. However, the proliferation of digital lending platforms, along with the emergence of fraud, harassment, and data misuse, compelled the RBI to take a more specialized role in regulating digital lending. This led to the formation of working groups and the eventual formulation of guidelines that sought to address the specific risks associated with digital lending.

An important part of the RBI's responsibilities is its attempt to strike the right balance between promoting innovation and promoting prudent regulations. While digital lending is part of the larger policy initiatives aimed at promoting financial inclusion and digitalization, there are also risks of consumer exploitation and systemic instability. However, the RBI has attempted to strike the right balance between promoting technological innovations and providing adequate regulations to check the potential misuse of the same. However, the challenge remains complex because there is the potential risk of stifling the very innovations that the RBI is promoting if the regulations are too tight, and there is the risk of exploitation if the regulations are too lax.

4.2 RBI Digital Lending Guidelines 2022

The RBI's 2022 Digital Lending Guidelines are a direct response to rising fraud in online lending. And they don't create new laws - they build rules on top of existing powers over banks and NBFCs. The goal is clear: stop third-party accounts from hiding loan flows. Instead of going through middlemen, funds go straight from lender to borrower. That cuts out fake activity

and makes tracking easier. A direct flow means fewer cover-ups. Borrowers know exactly where money goes. The rules set a firm line on fund movement. Now, this stops shell companies from siphoning funds. Transactions now show the full path No hidden layers. No backdoor accounts. The regulator acts fast because risks change daily.

4.3 Applicable Legal Framework

India does not have one main law for digital lending. Instead, rules come from many different sources. Banking laws sit at the centre, giving the RBI power over how loans are offered. Digital lending doesn't stop there technology laws step in too. Data privacy shows up alongside consumer safeguards. Because so many rule sets apply, oversight splits into pieces. Each part follows its own path. Some rules even touch the same ground twice.

Digital lending runs on tech systems shaped by rules meant for online actions, storing information, and keeping data safe. Since these apps rely heavily on software, they must follow standards about how digital details are gathered, handled, and shielded. Yet those regulations came before finance-focused tools existed, so problems like automated loan choices or using private records for scoring credit often slip through. When tech policies fail to match real banking needs, it shows how poorly broad IT guidelines fit narrow money-related tasks.

Consumer protection laws matter too - Mainly when it comes to shady loans, false claims, and unfair interest rates. If someone gets scammed by a digital lender, they can try to fight back through existing rules.

Anti-money laundering rules also watch over digital lending. Making sure platforms aren't hiding illegal money flows. Lenders have to check identities, keep an eye on transactions, and flag red flags. Still, with so many layers of middlemen and apps splitting up responsibilities, no one really owns the compliance piece. It seems like India's legal setup for digital lending stays broken apart - no clear path forward. A unified system would go a long way in handling the real-world mess of today's online finance.

5. REGULATORY CHALLENGES AND LEGAL ISSUES

5.1 Regulatory Arbitrage and Overlapping Jurisdiction

A very pressing issue when it comes to regulating digital lending in India is the emergence of regulatory arbitrage. This term means that players who lend digitally figure out ways to dodge full regulation. For example, in many cases these platforms market themselves as mere "technology service providers" instead of acknowledging that they are also financial

intermediaries. Getting classified as a tech company rather than a financial institution is a move that allows them to do lending and profit from it while not having to fulfil the same kind of secrecy or disclosure requirements as banks or NBFCs. In a way, the regulatory framework comes out as unfair as it creates a mismatch between regulated and unregulated players making it difficult for the former to compete.

Moreover, the issue of arbitrage has been amplified by the fragmented regulatory ecosystem where different regulators have only partial control over various aspects of digital lending. For instance, the Reserve Bank of India regulates financial transactions and lending practices. Whereas other bodies are responsible for data protection, information technology, and consumer rights. Yet, none of these entities have a comprehensive mandate to oversee digital lending as a single, integrated activity. The absence of a single regulator means that in some cases, the responsibilities get duplicated and, in other cases, due to unclear mandates, crucial matters are not regulated at all.

5.2 Data Privacy and Surveillance Concerns

Thing is, digital lending apps rely heavily on personal data - collecting, processing, and analysing it to decide who gets credit. Traditional lenders don't need as much detail. These platforms dig into contacts, location history, even what apps you use on your phone. All of it is supposed to measure risk. But often, they grab way more than needed. That raises questions about fairness and if the data gathering actually makes sense. Borrowers agree without realizing how much control they're giving up. Consent becomes hollow when people don't get the full picture.

There's no strong legal guardrail stopping this behavior. Current rules exist but fall short when it comes to complex data models. Algorithms make credit decisions based on huge datasets users can't see. You can't know why a loan was denied or approved, no clear logic behind it. Without transparency, accountability breaks down. When someone's financial future depends on a decision they can't challenge, the system fails them.

One of the more disquieting aspects of data use in digital lending is the capacity for surveillance and coercion that is inherent in such practices. There have been numerous instances of lending applications using access to data as a means of coercion in enforcing repayment of loans, including contacting the borrower's social circle or threatening to reveal their personal information. Such practices not only breach data privacy but also raise serious ethical and legal concerns insofar as they constitute the use of financial transactions as a means of social and psychological coercion. Such practices constitute a departure from legitimate practices and

underscore the more sinister side of data access and use in digital lending.

5.3 Predatory Lending and Recovery Practices

The rapid growth of digital lending has also witnessed the growth of predatory lending, which takes advantage of the naivety of the borrower, especially those who are financially illiterate or who have never used formal financial services. Many digital lending apps offer their customers small loans for a short period with apparently low barriers to entry, but they charge outrageous interest, fees, and penalties for late payment. These are often concealed in complex or unclear terms and conditions, which the borrower may not fully comprehend at the time of agreeing to the loan. This means that the borrower can get into debt in no time, with the amount to be paid exceeding their capacity to pay.

The issue of predatory lending is, therefore, directly associated with the issue of transparency in digital lending interfaces, where key information is either not provided adequately or is provided in such a way that it is difficult to comprehend. Unlike in conventional lending, which involves extensive documentation, digital lending interfaces offer a simplistic user interface that prioritizes speed over clarity. This means that there is an environment where the borrower may agree to the terms of the loan without fully understanding them, which defeats the purpose of informed consent, which is a key component of contract law.

The recovery practices that are in place in some digital lending services also add to the concerns in this regard, as they seem to be coercive and unethical in nature and extend beyond the scope of recovery.

Cases of harassment, intimidation, and shaming have been reported in this regard, in which the psychological pressure on the borrower is exerted through repeated calls and messages and the misuse of personal data. This is not only against the law but also raises important questions about the efficacy of the enforcement mechanisms that are in place in this regard.

5.4 Cross- Border Digital Lending Apps

The rise of digital technology worldwide has also led to the rise of international digital lending platforms, which are often beyond the reach of Indian authorities but still target Indian consumers. These groups often use mobile apps that are easy to download, which enables them to avoid some of the challenges faced in establishing a business with physical presence. As a result, it is difficult for authorities to identify, monitor, and control these groups, especially when they are established in other countries with different laws and regulations.

It is also difficult to know who is in charge and who can regulate these groups when foreign

companies are involved in digital lending, as traditional ways of regulation are often restricted by geographical boundaries. It is easy to regulate local banks and financial institutions, but it is difficult to do the same to those in other countries. This is not fair competition, as local businesses are expected to abide by stringent laws while foreign businesses can do their business with minimal risks.

Cross-border digital lending also makes data rules more difficult to adhere to, given that the data of the borrower could be located elsewhere in the world. This makes data security more vulnerable and makes it more likely that data could be misused, making it more difficult to access legal assistance in case of an emergency.

5.5 Lack of Comprehensive Legislative Framework

One of the big issues that arises while regulating digital lending in India is that there is no specific law that was designed specifically for digital lending. Instead, there are a number of laws, guidelines, and general concepts of law that regulate different aspects of digital lending. Although this may be a flexible approach, it may also result in loopholes and inconsistencies that can be exploited by players in the industry, leading to a lack of clarity and consistency in the way the laws are enforced.

Instead of relying on laws, relying on the guidelines of regulators for regulating digital lending in India makes the situation even worse. Guidelines are meant to be followed, but they are not as powerful as laws. It becomes difficult for the regulators to take concrete action against parties that are not abiding by the laws, especially if they are not part of the formal financial system. In addition, there are no specific definitions of digital lending platforms and Loan Service Providers, etc.

The absence of an established framework also affects the interrelationship of the laws that govern digital lending. Various elements of the activity are governed by different laws that do not necessarily work together in harmony. For example, there are laws related to finance that emphasize prudence and risk management, laws related to data protection that emphasize data privacy, and laws related to consumer protection that emphasize fair practices.

6. CONSUMER PROTECTION AND JUDICIAL RESPONSE

Issue	Harm to Consumers	Legal Protection	Gap
Lack of transparency	Hidden charges, unclear terms	Consumer Protection Act, RBI Guidelines	Weak awareness & enforcement

Issue	Harm to Consumers	Legal Protection	Gap
Data privacy misuse	Access to personal data, contacts	IT laws, privacy under Article 21	No strong unified data law
Coercive recovery	Harassment, threats	Criminal law, RBI norms	Poor monitoring of apps
Unregulated apps	Fraudulent lending	Limited RBI control	Jurisdictional limitations
Algorithmic opacity	No reason for loan decisions	No direct regulation	Lack of AI accountability

- The above table indicates that the risks to consumers in digital lending persist because of gaps in the rules and the enforcement of the rules and technology accountability.

Digital lending in India has significantly impacted consumer protection. The risks associated with it are also different from those associated with conventional lending. For instance, consumers are only required to click on a few buttons through an app interface to enter into contracts. However, there is often limited information provided to consumers regarding interest rates and repayment terms. This is a significant information gap, as the lender and technology provider have significant information and bargaining power, whereas the consumer is not only poorly informed but also has limited bargaining power. This issue is also significant in terms of the definition of consent in contracts and whether it constitutes an unfair practice.

The second significant damage is that of data collection and its usage. For instance, digital lending apps require permission to access contact information, location, and other information in order to assess and determine creditworthiness. However, in many instances, this information is used for other purposes, such as monitoring and repayment, including making phone calls to others and threatening to disclose personal information. The right to privacy, as defined by the Supreme Court in *K.S. Puttaswamy v. Union of India*, requires that any intrusion into personal information be legitimate, necessary, and proportional. However, many instances of app usage fail to satisfy these tests, especially in terms of informed and free consent. This is a dual damage in terms of financial and privacy-related harms, which is only partially addressed by consumer protection.

This is because they generally respond to particular situations. Therefore, they cannot change the system quickly. The judiciary may be helpful in particular fights. It could stop illegal activities, order investigations, or safeguard privacy. However, it cannot develop an entire system of regulation in the fast-evolving sector. This is evident in cross-border cases or in LSP-

NBFC models where there is confusion about accountability.

Therefore, even though court judgments have started indicating what protective mechanisms should be in place—such as fairness in contracts, responsible data management, and appropriate recovery mechanisms—without an entire system of laws that is constantly being enforced, these ideas do not work well in practice.

6.2 Justice K.S. Puttaswamy v. Union Bank of India

The case of “Justice K.S. Puttaswamy v. Union of India” was mainly about the Aadhaar scheme launched by Government of India under which people had to give their biometric and other details for their identification and access to welfare services. Justice K.S. Puttaswamy, a retired judge of the High Court, questioned the constitutionality of the scheme on the basis that it entailed the massive collection and storage of personal data which was thus a violation of the right to privacy. Besides, privacy was not explicitly considered as a fundamental right under the Constitution then, and some earlier Supreme Court rulings had negated its existence. Since the issue involved an important constitutional question, it was sent to the Supreme Court's nine-judge bench which would decide if the right to privacy is guaranteed under Part III of the Constitution.

The main question that the Court had to decide was whether the Constitution of India provides a fundamental right to privacy and if yes, then how far does the right extend and what are its boundaries. The petitioners maintained that privacy is a very fundamental component of the right to life and personal liberty as per Article 21 and also right to freedom, of which a few are fundamental rights, and therefore privacy must be regarded as a basic human right. On the other hand, the Government argued that privacy is not a right without any limitation and also that the Aadhaar plan is a measure that meets legitimate public interests such as curbing fraud and making the welfare benefit delivery system more efficient. Thus, a larger constitutional issue was triggered as to how a harmony/ balance can be struck between the rights of an individual and the interests of the state especially when the world is progressing towards digitalisation and more and more data are being collected.

The Supreme Court, through a unanimous decision, declared that the right to privacy is a fundamental right guaranteed under Article 21 and also under other parts of the Constitution (Part III). The Court was of the view that privacy not only means the right to keep one's information confidential, but also includes one's physical integrity rights and autonomy of decision-making rights which make it a broad and constantly changing concept. It went on to say that if any person's privacy is violated, a three-fold test must be passed first the violation

action must be legally backed (legality) secondly it should be for a lawful purpose (necessity) and lastly, the means used must be reasonable in relation to the purpose (proportionality). This decision will deeply affect digital ecosystems, for example, digital lending which involves massive collection and processing of personal data. The Supreme Court ruling makes it clear that any data-related practices must conform to constitutional safeguards and thus it opens up a legal avenue for resisting the digital/online practices which are violation and exploitation of user privacy rights.

7. CONCLUSION & SUGGESTION

Conclusion

Digital lending in India isn't just tech - it's a shift to data-driven credit. Now, someone's worthiness isn't based on bank statements or records. It's what algorithms pull from their phone use, location, and search history. Traditional finance runs on known banks, clear rules, and who's accountable but digital lending? Decentralized. Platforms make calls without showing the logic. No one sees how a decision is made. Borrowers don't know who they're dealing with, no name, no office, and no policy. The system hides behind code. Fairness? Autonomy? Can laws keep up when decisions happen without transparency? These aren't questions anymore - they're realities.

The regulatory framework that the RBI has implemented through the Digital Lending Guidelines 2022 among other things, represents a significant, albeit somewhat small-scaled, attempt to re-establish control over this rapidly changing ecosystem. These guidelines do bring in elements of protection around transparency, usage of data, and responsibility of regulated entities, but at the same time, they were born out of a major flaw in the structure: they govern entities, but the dangers in digital lending come from the whole system. Problems like regulatory loopholes, cross-border platforms, hidden decision-making algorithms, and misuse of data still happen because they are partially or completely out of the traditional scope of financial regulation. This therefore points to a more profound issue not just a lack of regulation but a complete disconnect between how the current legal frameworks are designed and the actual situation of digital finance.

Suggestion

1. A unified legal structure is needed for digital lending in India - clear rules for NBFCs, banks, and loan Service Providers, plus cross-border platforms that avoid oversight.

2. Data use must stay limited, consent must be real, and misuse of personal info during credit checks or recovery must be tightly monitored.
3. Digital lenders should explain how their algorithms make credit decisions. Borrowers must have a way to dispute unfair results.
4. Regulators need better coordination to act fast when illegal apps slip through the cracks.
5. Clear disclosures are mandatory. Recovery methods must be controlled. Borrowers need more awareness to protect privacy, dignity, and financial safety.

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