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SHAPING A VIBRANT INDIA

BFSI – fintech collaboration

An Indian perspective

Content

I. The Indian BFSI - fintech ecosystem

In recent times, the delivery channels for financial services (FS) have been increasingly getting digitalised, and at the forefront of this digital transformation have been the fintechs. Such technology-based financial innovations have resulted in cheaper and convenient services to customers. For the FS incumbents, it has proven to be a cost-effective channel for delivery of their products and services. These developments have fostered greater competition in the market, prompting industry participants to increasingly leverage technology to become more efficient in their operations. Furthermore, factors such as availability of low-cost smartphones, affordable data packs, Indian demographic of young population (early adopters), low penetration of traditional financial services, among others, have provided strong impetus to the demand for financial services that are delivered digitally.

Although initially regarded as threats to incumbent financial services entities, fintechs are now seen as a partner to the FS entities. Since financial services activity is regulated, fintechs cannot directly take up banking unless licensed by respective sectoral regulators. Therefore, the fintechs have so far acted as service providers or outsourced vendors to the banks and other regulated entities (RE) and the FS continue to be powered by the REs, with fintechs as their partners. Some of the fintechs are now increasingly looking to seek authorisation from respective regulators to become the direct suppliers of FS to their customers.

However, what has changed dramatically over previous years is that earlier, FS was a regulated-entity-led model, but now it has become a multi-stakeholder led model, with telecommunications and fintechs as the new stakeholders for the RE ecosystem. **The advances in telecommunications and IT have been instrumental in the growth of digitalisation of FS,** with fintechs building on the digital technology to offer a specific financial service targeted at a specific set of customers. Since **financial innovation creates new ways in which business is carried out as compared to before,** it also creates new sources of risks that the regulator would want to address as the industry evolves.

The fintechs operating in India can be primarily organised as below, along with their respective regulators:

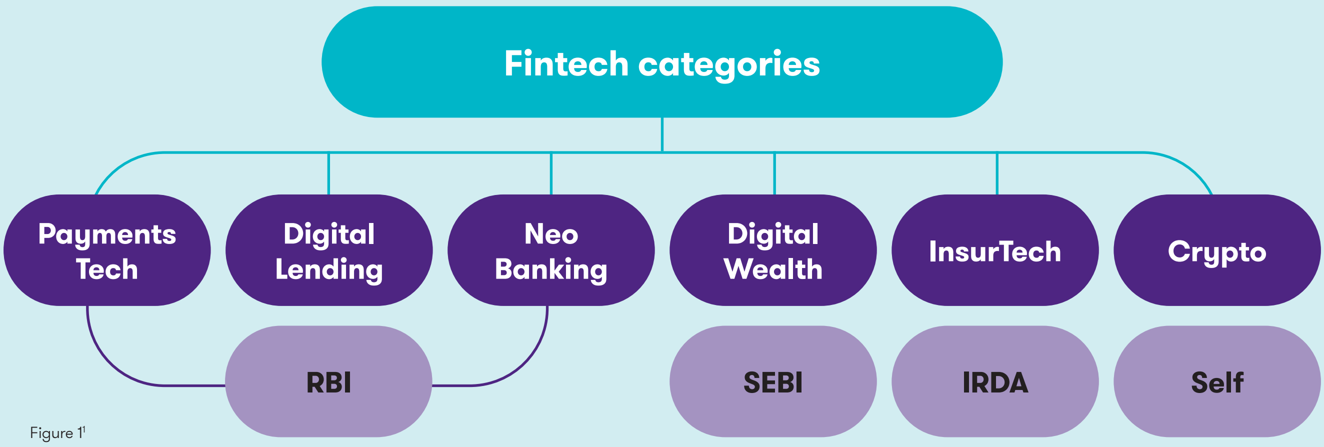

Figure 1[1]

1. Figure 1 is a snapshot of the fintech categories that exist in India. These categories are not necessarily adopted by fintechs in isolation, and some entities participate in multiple categories as part of their business model.

01 Payments tech

The fintech revolution in India started in the payments space. It is one of the oldest categories among the fintech ecosystem and over time has become the most evolved in terms of stability and predictability. Payments tech fintechs leverage technology to process payments online, for both non-face-to-face (e-commerce) and face-to-face payment methods. Historically, the incumbent banks outsourced most of the merchant acquiring activities to third-party vendors and only undertook the core payment processing in the payment chain. Since online payments in India at the time were still developing, the RBI had taken an accommodative stance to allow the payment space to develop and innovate. Therefore, low entry barriers and the existing market opportunity encouraged a large number of players to enter the market. The entry of these players coincided with significant improvement in telecommunications infrastructure of the country, penetration of smart phones among the citizens of the country and low-cost computing and data storage. These formed the basis for allowing the fintechs to leverage the burgeoning technological advancements to develop and deploy innovative solutions to create superior user payment experiences. Accordingly, fintechs have been instrumental in driving the Government of India (GoI) agenda of a 'less-cash' economy.

02 Digital lending

It has been defined by the RBI[2] Working Group on Digital Lending (WGDL) as a remote and automated lending process, majorly by use of seamless digital technologies in customer acquisition, credit assessment, loan approval, disbursement, recovery, and associated customer service. In recent times, digital lending has witnessed the entry of a large number of fintechs, which have partnered with banks and NBFCs to deliver credit to customers digitally. The retail lending market has been under penetrated due to the high cost of customer acquisition in the physical space and non-availability of appropriate credit data for effective underwriting of Indian customers. As in the payments tech ecosystem, the development of a digital lending ecosystem was made possible by telecommunications infrastructure, penetration of smart phones among the citizens of the country and low-cost computing and data storage and availability of a digital ID (Aadhaar). This allowed for an instantaneous, cost effective and digital method of undertaking KYC. Further, fintechs are harnessing the alternate data of customers as available in the digital world as surrogates for assessing the financial and social condition of the customer. This has resulted in faster underwriting of credit, has led to efficient pricing of risk, and has made credit delivery cost effective. There is almost universal consensus in the potential of digital lending as being a transformative force in solving the problem of under penetration of credit among Indians, individuals and MSMEs alike.

2. Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps

03 Neo-banking

Neo-banks do not have a banking licence and they partner with incumbent banks to provide banking services through their mobile application. Neo-banks usually have a limited product line ('core banking products') and augment their product line with personal financial management tools. A neo-bank's mobile application acts as a separate channel for incumbent banks to deliver their banking services digitally and are preferred by customers for seamless on-boarding, intuitive and user-friendly platforms, among others.

04 Digital wealth management

Digital wealth management has taken off in India with multiple applications being offered to customers by various fintech players, which have given insights to customers to tap the niche market products. They are able to get knowledge of various debt and equity instruments along with mutual funds. The platforms also provide AI-enabled recommendations to the customer to rebalance the portfolio and manage the long- and short-term goals. They are further able to integrate various third-party tools into these apps and are able to provide information related to money management as well. These tools are available for professional wealth managers as well and they are able to use the same in providing personalised services to the clients too. INDmoney, ASKWealth, etc., are examples of some fintechs that are using such tools.

05 InsurTech

This is an innovative use of technology in insurance. It is a part of the larger fintech ecosystem where businesses put emphasis on creating, distributing and aggregating digital insurance products. InsurTech innovation is occurring across the entire insurance value chain, i.e., distribution, marketing, product design, underwriting, claims management, balance sheet management and across all lines of insurance - property and casualty, life and health. InsurTech start-ups are reaching customers through new distribution mediums - addressing changes in the manner people communicate, get access to information and make decisions, while not disrupting traditional channels. The nature of the insurance business is transforming, driven by technological advancements and somesocio-economic trends. Although traditional distribution models have long dominated the Indian insurance scene, InsurTechs have emerged as disrupters, by leveraging on technologies such as artificial intelligence, machine learning, big data, and Internet of Things (IoT) to improve process efficiency. The InsurTech sector is still in its very early stages in India. The number of players in the Indian InsurTech industry is increasing day by day. Key players in India include Policy Bazaar, Acko, Digit Insurance.

06 Crypto

A cryptocurrency exchange or DCE (short for Digital Currency Exchange) is a service/platform that enables clients to trade cryptocurrencies for other resources, such as other cryptocurrencies, standard fiat cash or other digital currencies. They allow the trading of one cryptocurrency for another, the buying and selling of coins, and exchanging FIAT into crypto. Different crypto exchanges may have different options and features. Cryptocurrency exchanges are in some ways similar to regular stock exchanges, the difference being the way traders make profit. Traders buy and sell assets in a stock exchange to get profit from their changing prices. However, traders use cryptocurrency pairs in crypto exchanges to get profit from the very volatile currency rates. While stock exchanges have set working hours, crypto exchanges are also open 24 hours a day, seven days a week, 365 days a year.

Over the recent years, the crypto currency sector has witnessed a tremendous growth in multiple aspects, such as number of tokens to trade or invest to the increase in number of investors, an increase in the number of crypto exchanges and increasing market capitalisation. As per the results from a recent study by NASSCOM, they are expecting that the Indian crypto currency market will reach **USD 241 million by 2030**. Currently, it is estimated that there are **15 million to 20 million active investors in the crypto currency market in India**, with the overall market value of cryptocurrencies increasing by approximately **USD 1.5 trillion in 2021 to roughly USD 2.3 trillion as of December 2021** owing to **15,000 to 20,000 available tokens.**

Our Finance Minister's proposal of a digital currency in India in her 2022-23 Union Budget speech has given a boost to the digital economy in the country. Currency management through currency chest services has been one of the most significant operational responsibilities of the banking system. The central bank backed digital currency initiative helps bring in much-needed efficiency in the currency management system.

II. Regulatory landscape for BFSI – fintech ecosystem

Fintech start-ups commence operations with a strong focus on product customisation and customer interfaces to deliver enriching and seamless consumer experience. At the early stage, fintechs invest heavily in product development, technology stack, growth marketing, data science, among others, to facilitate onboarding of new customers, at scale. The rapid scale up of the country's fintech ecosystem has resulted in enhanced regulatory scrutiny and the sectoral regulators are exploring ways to enhance the governance and conduct of fintechs. This has resulted in fintechs' heightened sensitivity towards regulation, their governance structure and conduct.

The sectoral regulators, off late, have been vocal about their expectations from the fintechs and have stated publicly that while they support innovations brought about by the fintechs, they are also concerned with the new risks that these innovations and business models are introducing in the FS industry:

> I wish to assure the fintech community that the RBI will continue to encourage and support innovation. At the same time, we would expect the ecosystem to pay attention to governance, business conduct, regulatory compliance and risk mitigation frameworks. **The fintech road ahead will witness ever growing traffic in addition to the large number of existing players who are already there.** It is, therefore, imperative that every player on this road follows the traffic rules for his/her own safety and the safety of others…
>
> **Mr Shaktikanta Das, Governor, RBI**[3]

> Business model that relies on a black box and that cannot be audited or validated will not be permitted… Anonymity in the financial world is an absolute no-no and that should be the first guiding principle for businesses… **The regulator will be supportive if a fintech's business model facilitates financial inclusion… Founders cannot say that they want to own the infrastructure…** SEBI does not want 'Abhimanyus' in the market... The principle of 'ek baar bakra aa gaya toh usko bahar jaane nahin denge' won't work…
>
> **Ms Madhabi Puri Buch, Chairperson, SEBI**[4]

3. Fintech as a Force Multiplier (Address by Shri Shaktikanta Das, Governor, Reserve Bank of India - September 20, 2022 - at the Global Fintech Festival, Mumbai)
4. SEBI chairperson speech on September 20, 2022 – at the Global Fintech Festival, Mumbai

Furthermore, the WGDL introduced the term **'Responsibilisation'**, defining it as 'Subjecting financial service providers to a broad duty to treat consumers fairly but not specifying in detail how it is to be done'. This principle-based regulation requires fintechs to conduct themselves in the manner that is as per established industry standards and within the extant regulatory guidelines. These recent events have led to a strong conviction among the fintechs that they want to be on the right side of the regulator's expectations so that their businesses are not disrupted by undesirable regulatory actions. Accordingly, fintechs are now focusing deeply on evolving regulations, governance structure, conduct and on being on the right side of regulatory expectations.

01 Payments tech

It is one of the 'oldest' verticals among the fintech ecosystem and over time has become the most evolved in terms of stability and predictability. Historically, the payments ecosystem was lightly regulated and did not require authorisation from the RBI to act as payment aggregators. However, as the ecosystem has grown, concerns around financial stability, market integrity and consumer protection took precedence over favouring competition. Accordingly, in March 2020, the RBI released the guideline[5] on regulation of Payment Aggregators (PAs) and mandated that entities operating as PA (online, non-face-to-face) are required to seek authorisation from the RBI. ~180 entities[6] had applied for the authorisation, which are under review by the RBI. On 30 September 2022, as part of the Statement on Developmental and Regulatory Policies, the RBI confirmed that offline PAs who handle proximity/face-to-face transactions shall also be regulated and would require prior authorisation from RBI to operate. We may expect a large number of applicants in this space as well. Further, the guidelines require a host of audit reports and certifications on an ongoing basis from these entities and mandate baseline GRC posture.

02 Digital lending

There has been a significant rise in complaints from the borrowers in the recent past regarding lending apps charging excessive interest rates, pursuing aggressive recovery practices, committing fraud and breaching data privacy. Considering these recent developments and a significant growth of the digital lending ecosystem in India, the RBI issued a press release on 10 August 2022, with the recommendations of the working group on digital lending, followed by consequent guidelines dated 2 September 2022. It focuses on the classification of digital lenders and defined certain key action points emanating from the recommendations provided by the WGDL. These guidelines are an initial step in the right direction to regulate and bring entities in the digital lending space under the ambit of the RBI's supervision. While the press release presently governs only regulated entities, it ultimately aims to narrow down the digital lending ecosystem to permit only such entities that are either regulated by the RBI or entities permitted to do so under any other law. These regulations reaffirm the faith that digital lending will be pursued strictly by regulated entities in compliance with the guidelines issued by the RBI, without involving fraudulent third parties and thereby significantly reducing the scope of malpractices and ensuring customer protection.

5. Guidelines on Regulation of Payment Aggregators and Payment Gateways (Updated as on November 17, 2020)

6. https://www.livemint.com/news/india/razorpay-pine-labs-among-firsts-to-get-rbi-nod-for-payment-aggregator-gateway-licences-11657255192138.html

7. SEBI chairperson speech on September 20, 2022 – at the Global Fintech Festival, Mumbai

03 Neo-banking

Neo-banks do not have a banking license and they partner with incumbent banks to provide banking services through their mobile application. Neo-banks usually have a limited product line ('core banking products') and augment their product line with personal financial management tools. A neo-bank's mobile application acts as a separate channel for incumbent banks to deliver their banking services digitally, and therefore, operate in the capacity of an outsourced vendor for the incumbent banks. There are three primary RBI guidelines that apply to the neo-banks: Outsourcing Directions (2022), Business Correspondent Guidelines (2014), and Master Direction on Digital Payment Security Controls (2021). Neo-banks and their partner banks have to comply with these directions on an ongoing basis.

04 Digital wealth management

The wealth management industry has seen considerable technological innovation and disruption in recent years. These innovations include the rise of robo-advisors who use sophisticated software to generate investment advice and portfolio allocations for their clients with little or no human intervention. The SEBI chief recently articulated her expectations[7] from fintechs in this space pertaining to their business models, use of machine learning/artificial intelligence algorithms, exit barriers, among others. These initial inputs from SEBI signal that there will be enhanced scrutiny from the regulator in the near to medium term.

05 InsurTech

Most large fintech platforms are already registered as brokers with IRDAI and are now seeking licenses to underwrite insurances. This is one of the most highly regulated sectors in India and start-ups can find it extremely challenging to navigate through the myriad regulatory requirements and compliances. The regulations are dynamic and require in-depth insurance knowledge. While InsurTech start-ups can assist insurance companies in building their capacities, they themselves cannot enter into the insurance foray for any solicitation activities unless they are registered as an insurer and licensed as an insurance intermediary. To further foster innovation in the insurance sector, the Insurance Regulatory and Development Authority of India (IRDAI) introduced regulatory sandbox in 2019 to facilitate innovation in the insurance sector by providing InsurTechs with a testing environment for new business models, processes and application in a protected environment.

III. Fintechs and traditional BFSI sector: collaborative or competitive roles?

The Indian financial services sector has been getting increasingly digitalised and this movement is leading to increased efficiency within the system, better reach of the financial services to citizens of the country, reduced cost of access, time saving, and improved customer service, which in turn is leading to greater financial inclusion. At the forefront of this digital revolution have been the fintechs, which have leveraged technology to digitise FS products and delivery channels. These developments have blurred industry boundaries within the FS space and new business models are being developed due to economies of scope available to the fintechs, wherein they are bundling their offerings from FS under multiple sectors, e.g., digital lending (RBI), wealth management (SEBI), insurance (IRDA), etc.

The REs, by virtue of having obtained licenses from sectoral regulators, and having years of experience working in regulated regime have deep expertise in regulation and compliance. The fintechs in India offer their financial services in close direct or indirect collaboration with incumbent REs to access the regulated financial system. These arrangements are in the form of partnerships such as a SaaS engagement, or as technology service provider or as agents. In the Business-to-Consumer (B2C) space, fintechs that compete directly at the customer interface level still rely on incumbent REs to provide the end product, and therefore, the customer enters into a separate direct relationship with the incumbent REs.

On the other hand, fintechs have been adding new products to their offerings, via partnerships and platform approaches. This allows fintechs to bundle multiple FS products for cross-sell to existing customers and attract new ones. The bouquet of offerings helps them to fulfil the customer's lifecycle needs, resulting in better customer experience and eventually better revenue opportunities. In a technology-led business, since scale and scope economies are material business considerations, fintechs are focusing on a range of products to amortise investments in technology, customer acquisition costs and investments in brand recognition across a sufficiently large customer base. Since these are evolving businesses and fairly dynamic in the current environment, it will be interesting to see how the market of newly re-bundled products will evolve. Newer companies are building up a set of services.

The FS sector is highly regulated, and the 'manufacturing' of FS can only be undertaken by entities authorised or licensed by the respective sectoral regulator. Fintechs, till recently, have stayed away from financial activities that carry licensing, capital, and regulatory burdens. While they have significantly increased competitive pressure with incumbents by directly engaging with the consumer, the battle to 'own the customer' will be closely fought, since in the value chain, the entity closest to the customer earns the highest margins. Till recently, most fintechs focused on activities such as payments, cards and financial advice, and avoided highly regulated, capital-intensive activities, such as on-balance sheet lending and securities underwriting. However, now as fintechs re-bundle FS products, some are now increasingly seeking licenses from regulators to become 'manufacturer' of FS themselves, and in turn, own the entire FS value chain and the revenues therein. However, these are early days for fintechs seeking licenses, and many other continue to partner with incumbents.

> It will be interesting to see how the ecosystem evolves in the long term, and whether licensed fintechs will eventually turn out to be credible competition to incumbents or not. For now, however, **fintechs play a collaborative role to the incumbent REs. In the process, fintechs have increased competition within the incumbents themselves**, resulting in higher efficiency, better price discovery, customised products, faster delivery, and finally democratising access of FS to Indians.

IV. Key emerging risk themes in Indian BFSI - fintech ecosystem

Fintechs are transforming the way financial services are delivered and consumed by customers and have become key enablers in expanding the access of FS to the underserved population of the country. While this technology-led transformation has significantly benefitted consumers in general, there are certain risks that need to be addressed to ensure that the fintech ecosystem truly delivers the promise it holds for our country. Some of these risks are new, arising out of use of technology, new business models, product features, delivery channels, complexity or unfamiliarity of the product for the consumers. Whereas other risks are new manifestations of existing risks. This section thematically covers some of the key risks in the fintech ecosystem in general. However, the relevant risks may play out differently for each of the fintech categories.

a) Market conduct

The way fintechs design their product and services, promote their offerings to consumers and manage the relationship with the customer during the product / service lifecycle constitutes the market conduct. In recent times, the conduct issues in certain fintech categories have been a cause of concern for the sectoral regulators and consequently have resulted in heightened scrutiny and a swift regulatory action. Regulators are focusing on following:

01 Regulatory arbitrage

The design of product and services needs to ensure no regulatory arbitrage exists between what is available physically and those delivered digitally by fintechs. Regulators have not specifically come out with regulations dealing with the digital-only delivery of FS. Therefore, same guidelines apply, whether the FS products and services are being delivered physically or digitally. This requires fintechs to be aware of the extant regulatory regime governing their product and services. The regulatory guidelines need to be factored into the product/service design and appropriately tested before launch. Due to the digital nature of their products, if fintechs discover conflicting guidelines on a particular aspect, the more conservative of the applicable guideline needs to be adhered to. Furthermore, fintechs need to have robust monitoring and testing programmes to identify any gaps during the lifecycle of the product / service and have processes in place to take a time-bound corrective action plan to remediate the identified gaps.

02 Transparency

The marketing of products and services, quality of disclosures, ease of exit from relationship, among others, are being critically examined to ensure customers can take informed decisions and are not misled at any point in time. Effective disclosure outcome is not equivalent to providing excessive information as that can overwhelm the customer. Therefore, the need for fintechs is to identify key information regarding their products that can be provided upfront in a comprehensible manner and format, with access to contextually relevant information. The information provided also needs to have appropriate warning/disclaimers of the risks involved and should not be overly optimistic. The disclosures may be designed to provide contextual and relevant information to the customer during the digital journey of the customer with the fintech. Therefore, there is an inherent need for the fintechs to think deeply on how they would want to design and deploy these disclosures. A well-designed disclosure programme will allay concerns of the regulators regarding unfair selling practices that some of the fintechs have been guilty of and for which they have consequently faced supervisory action.

03 Product suitability

The digital delivery of FS products has dramatically increased access to Indian customers, which was not available hitherto. This has resulted in consumers having increased and easy access to novel and complex financial products. With the unfamiliarity of products among customers, even with appropriate disclosures and Key Fact Statements (KFS), lower level of financial sophistication of customers may expose them to losses or other harms. FS delivery to customers must be carried out responsibly, and therefore, it is imperative for fintechs to ensure that the products offered to customers suit their needs and are appropriate for their existing financial condition. To that end, fintechs may undertake target market assessments and design products relevant and appropriate to the target market. They should consider having a governance structure to monitor the post-sale product reviews and customer complaints and use these inputs as basis to course correct, wherever required. Furthermore, fintechs may institute risk-based limits to customer transactions for those who are new to the ecosystem and a consent-based limit relaxation may be carried out after carrying out appropriate customer due diligence.

04 Ethical and fair treatment of customers with due care

Customers are required to be treated fairly and as per acceptable professional standards with due care and diligence during the entire customer relationship lifecycle. There is a well-established Code of Conduct (CoC) for each FS sector that has been in use by the incumbent REs. Fintechs may refer to the CoCs and comply with them in letter and spirit.

05 Access to grievance redressal and legal protection

Customers have access to grievance redressal and have legal rights to protect their rights and interest. To ensure fintechs provide appropriate attention to this aspect of customer service, the regulators have been insisting on the mandatory appointment of a nodal officer, who shall be responsible for the timely redressal of customer grievances. Furthermore, appropriate escalation matrix is being put in place by regulators for aggrieved customers to reach out to in case entities fail to provide time bound redressal. Typically, customer grievances arise from improper product design, failure in processes, technology, or people, resulting in dissonance in the customer's mind with respect to their expectation vis-à-vis product/service delivery. Managing a large number of customer complaints is not only financially costly but also poses a significant reputation risk. Consequently, fintechs need to be proactive in managing this risk by carrying out extensive sandbox testing of products before launch, carrying out timely process reviews to ensure they are delivering the desired outcomes, providing appropriate training to employees and investing in optimal technology infrastructure to ensure high availability and minimise unplanned downtime.

06 Automated decisioning

The use of artificial intelligence / machine learning has become increasingly prevalent for facilitating automated decision making for various fintechs. These algorithms may lead to unfair or biased outcomes for the customers. Therefore, such algorithms require extensive testing before launch. Furthermore, fintechs may be required to put in a process of ongoing monitoring by way of back testing to ensure that these algorithmic outcomes adhere to key principles of fairness, explainability, auditability, responsibility, and accuracy.

In addition to the above recommended steps to mitigate the emerging risk, fintechs are working on creating Self-Regulatory Organisations (SROs) for their respective area of operation and are creating a model CoC. It will be critical that fintechs adopt an appropriate CoC and deliver on those consistently to ensure their market conduct is as per the expectation of the regulators. There is a need for fintechs to critically examine their products and processes to evaluate whether they meet the extant regulatory guidelines and the industry standards to comply fully with the regulators and customers' expectations.

b) Fintech platform misuse

Fintechs are connecting the consumers and REs through their platforms, and at scale. As an intermediary or as RE themselves, they need to ensure that their platform remains a safe and trusted place for the delivery of FS. Key aspects of risk arise from the following:

01 Third-party frauds

Due to the non-face-to-face nature of transactions in the ecosystem, external actors have been using a myriad of modus operandi to perpetrate frauds upon the customers of fintechs through phishing, vishing, identity fraud, among others. Since trust is a key element in the BFSI industry, it is critical for fintechs to protect their platforms from being made conduits of frauds. Accordingly, appropriate and ongoing customer due diligence, real-time transaction monitoring, risk-based process audits, periodic review of risk rules, among others, are some of the key elements that can help mitigate this risk.

02 Money Laundering / Terrorist Financing (ML/TF)

FS is the key channel that is used for ML/TF by criminals and terrorists. Fintechs, as part of the BFSI ecosystem, need to ensure they are not the weak links in the economic chain that is used for ML/TF activities. Given the anonymity associated with digital channels and the speed with which transactions are carried out, the ML/TF risk becomes materially high in this segment. We have, in the recent times, witnessed some of the platforms being used to launder large value funds within the country and overseas. Fintechs need to assess how they can be susceptible for being used as conduit for such activities and accordingly design processes to manage the risk effectively.

03 Fraud by unscrupulous fintechs

There have been instances of unscrupulous actors acting as legitimate fintechs perpetrate fraud on unsuspecting customers or be involved in laundering large sums of money. Taking advantage of inherent opaqueness and speed with which scale can be achieved, these entities have done significant harm to India's fast evolving fintech ecosystem. For undertaking certain FS activities, the sectoral regulators are now looking to mandate fintech entities to be licensed and are being vetted prior to being granted such license to filter out unscrupulous entities. Further, regulators are also casting higher obligations on incumbent FS providers for services that are being outsourced by them to fintechs, resulting in higher governance and risk management requirements for the fintechs.

c) High operational risk associated with technology vulnerability

Since the product and delivery modes is largely digital and leverage technology, the technology infrastructure of the fintechs become one of the most critical components for their success. Technology stack, which are unreliable or vulnerable to external threats, poses a significant risk to customer safety and may result in inconvenience to customers, or worse, financial loss or other harms. Heightened cyber risk and related operational risk have been recognised by the sectoral regulators and they have released a host of guidelines on digital security, outsourcing, cyber security, operational risk management, among others, which the fintech and its RE partner need to comply with.

V. Way forward: fintech, BFSI and regulator collaborations

The fintech and incumbents from BFSI have closely collaborated with each other to bring about the financial transformation that we are witnessing today. This transformation was expedited due to the COVID-19 pandemic and has since happened at a rapid pace. This financial transformation, while having benefitted the ecosystem, has also introduced new risks or existing risks are manifesting in newer ways. The sectoral regulators, while acknowledging the power and promise of this financial transformation, have raised certain concerns around these risks. Regulators will therefore seek a balance that supports fintech benefits while trying to minimise any potential risks to the financial system.

Incumbent REs are subject to prudential obligations by the regulators that include thresholds for capital and liquidity rules on governance arrangements, compensation guidelines for material risk takers, among others. Additionally, REs are covered under the Prevention of Money Laundering Act (PMLA), customer protection rules and conduct of business obligations, which apply to the different services they offer. With the emergence of fintechs, no material adjustments have been made to the perimeters of regulations to accommodate their activities as providers of financial services. Regulators apply the rule of proportionality while developing the regulatory regime and undertake risk-based supervision. Effectively, as fintechs scale and become material to the ecosystem, they may be subject to some form of regulatory oversight, may have obligations cast on them, and may be subject to greater supervision.

Given this background, since the businesses are still evolving, so will the regulatory posture. It is therefore pertinent that the fintech and incumbents engage meaningfully with the regulators to understand their concerns and proactively take steps to address those. Few things that industry can jointly do include:

01 Greater levels of transparency

Novel engagements can be highlighted to the respective regulators at the testing phase. Since the products in a digital ecosystem scale swiftly and become materially large quickly, a regulatory breach becomes material from the regulator's perspective. This typically results in a supervisory action, resulting in disruption of business models. Therefore, providing a product's details proactively to the regulator before it has been offered to the public at large will enable the industry to address any regulatory concerns at the design level itself.

02 Active participation in the regulatory sandbox environment

Some of the sectoral regulators have enabled regulatory sandbox with the objective to conduct field tests to collect evidence on the benefits and risks of new financial innovations, while carefully monitoring and containing their risks. It provides a structured avenue for the regulator to engage with the ecosystem and to develop innovation-enabling or innovation-responsive regulations that facilitate delivery of relevant, low-cost financial products.

03 Awareness and understanding of the regulatory perimeter

Technology has been a great enabler in the financial transformation that we are witnessing today. However, these tech-based innovations have to remain within the extant regulatory perimeter. Indian regulators follow a 'principle-based' regulation as opposed to a 'rule-based' regulation. Therefore, if these principles are well understood by the participants, the Indian regulatory environment provides for flexibility for innovation to take place. Remaining within the regulatory perimeter will result in regulators having greater confidence in the ecosystem and will result in more meaningful engagements.

04 Market conduct

Consumer protection is one of the key mandates of the Indian regulators. The principle of fair treatment of customers and conduct of operations in a transparent and non-discriminatory manner have to be adhered to at all times and must be driven by the board/top management for it to percolate down to all levels.

VI. Conclusion

The close collaboration between BFSI incumbents and fintechs shall only grow as we go along, with fintechs complementing the BFSI incumbents in production and delivery of financial services. Fintechs, being sharply focused on identifying niche problem statements and solving them using technology, are a trend that shall continue in the near to medium term. New use cases and highly contextualised solutions for customers will be developed where BFSI incumbents and fintechs will collaborate. The industry will need to work closely with their respective regulators to ensure that the development of this ecosystem continues to take place in a systematic manner without adverse disruptions to business models due to regulatory actions. The biggest beneficiary of this collaboration among BFSI incumbents, fintechs and regulators shall be the Indian customers.

Glossary

AI	Artificial Intelligence
B2C	Business-to-Consumer
BFSI	Banking, Financial Services and Insurance
CAGR	Compound Annual Growth Rate
CoC	Code of Conduct
DCE	Digital Currency Exchange
FS	Financial Services
GOI	Government of India
GRC	Governance Risk and Compliance
IRDA	Insurance Regulatory and Development Authority
IT	Information Technology
KFS	Key Fact Statement
KYC	Know Your Customer
ML	Money Laundering
MSME	Micro Small and Medium Enterprises
NBFC	Non-Banking Financial Company
PA	Payment Aggregators
PMLA	Prevention of Money Laundering Act
RBI	Reserve Bank of India
RE	Regulated Entities
SEBI	Securities and Exchange Board of India
SRO	Self-Regulatory Organisations
TF	Terrorist Financing
WGDL	Working Group on Digital Lending

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Notes

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