Navigating Fintechs

Mitigating risks and striking balance with growth and robust governance

01 Introduction

India is a host to a thriving fintech ecosystem and are transforming the way financial services are delivered and consumed within the country. Unlike consumer technology companies, which have created new businesses such as e-commerce, social media platforms, marketplace platforms, among others, fintechs have been innovating the way existing financial products and services are delivered through digital channels.

The distinction between consumer technology companies and fintechs is an important one to make since core financial product constructs, viz, payments, credit, deposits, investments, and insurance have evolved over a long time and are also heavily regulated. In the financial services industry, any product construct level innovation requires regulatory approval, and therefore, cannot be done till the regulator has validated and authorised it for operationalisation within the sector. Accordingly, and rightly so, fintechs have so far focused on innovating the financial services delivery channels. They are helping to introduce new relationship models and distribution channels that challenge traditional ways of delivery of financial services, and along the way, have been changing consumer attitude and behaviour towards financial services. The fintech industry, despite these constraints, has been growing at a frenetic pace in the last five years, with strong impetus provided by the Covid-19 pandemic, and has achieved scale in some categories that is non-trivial.

Financial services supervisors around the world and in India work under the concept of 'proportionality', and the applicable regulations and supervisory practices are proportional to the systemic importance and risk profile of the entity. Consequently, with increased scale and developing systemic importance of fintechs in India, the industry can expect a higher degree of supervisory oversight. Therefore, it is incumbent of the fintech industry to gear up to this new reality and prepare for heightened supervisory scrutiny. The Basel Committee on Banking Supervision (BCBS)[1] released a consultation paper to update its core principles for effective supervision in 2023 (last updated in 2012). These principles form a fundamental part of the BCBS's global standards for the sound prudential regulation and supervision of banks. It is pertinent to note that the BCBS revised the core principles to manage the new risks emanating from the digitalisation of finance. The revised principle on operational risk and operational resilience highlights the importance of operational resilience, given that banks are increasingly relying on third parties for the provision of technology services. In addition, core principles have been updated to ensure that supervisors can continue to access relevant information (irrespective of where this is stored) and review the overall activities of the banking group, including those undertaken by service providers. These updated principles, once finalised, will constitute a core part of the RBI's supervisory practices. Similar developments are taking place at other sectoral regulators and supervisors as well. Therefore, even fintechs, which are partnering with regulated entities for providing services, without being directly regulated by the sectoral regulator, will attract supervisory scrutiny in capacity of them acting as service provider to regulated entities.

1. The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. Its 45 members comprise central banks and bank supervisors from 28 jurisdictions, including Reserve Bank of india

02 Key risks emanating from fintechs

Fintechs leverage technology to interact with customers and deliver financial services digitally. Fintechs are transforming the way financial services are delivered and consumed by Indians, are driving cost efficiencies across the sector, enabling better price discovery of financial products and holding immense promise to drive financial inclusion for the country.

However, it is important to make a candid assessment of the incremental risk they introduce since the regulatory action and supervisory practices will be contingent to the risk they pose to the financial services ecosystem. In India, there is significant heterogeneity of the fintech firms in terms of services offered, level of maturity, technology used, capital available, risk culture, among others. Since fintechs principally serve similar products and services as the traditional financial services firms, the related risks are going to be similar in nature to those of traditional firms. However, their speed of materialisation and impact will likely be different.

Regulators are actively looking to mitigate some of the risks highlighted below through regulatory instructions and supervisory interventions:

Conduct risk

Due to the digital form of product and delivery channels, electronic disclosure of terms and conditions, costs of product and services, assessment of appropriateness of product fit with customer, etc., may lack transparency and may result in misselling. Customer grievance redressal mechanisms could be under-developed, leading to sub-optimal responses to customer complaints.

Customer due diligence (Know Your Customer (KYC))

Digital channels allow for the anonymity of the customer to a certain extent. The KYC undertaken through non-face-to-face channels could be prone to misrepresentation if appropriate controls are not applied.

Capital adequacy

Fintechs not directly regulated by the sectoral regulators have no minimum capital requirements. Undercapitalised fintech start-ups may fail due to a lack of solvency, rendering customers with limited recourse to products/services purchased through these fintechs.

Cyber risk

There is heightened cyber risk with fintech activity since digital distribution channels are used and customers can access financial networks 24/7.

Inappropriate commercial use of customer data

Fintech activities often involve collection, storage, processing, analysis, and exchange of consumer data by a variety of players, incumbent firms, and fintech start-ups. These exchanges, if not managed well, can expose consumers to the risk of unauthorised disclosure and use of their personal data, including fraud and identify theft. Use of machine learning/ artificial intelligence models can provide adverse outcomes if they are black-boxes and not tested regularly.

Third-party risk

Traditional financial services firms are increasingly outsourcing activities to fintechs to hasten and digitalisation of their operations and drive cost efficiency. This may lead to increased operation risk, and the regulators are now mandating the regulated entities to improve their due diligence practices, operational risk management, ongoing monitoring and appropriate execution of contracts with explicit service level agreements, audit rights, etc.

Moreover, the Reserve Bank of India (RBI) may conduct a thorough assessment of diverse businesses within the fintech sector, particularly focusing on services offered by fintech firms that lack a comprehensive record of transactions and their ultimate utilisation. This assessment by the RBI is expected to intensify in the future with identification of new risks within the fintech sector, as the central bank seeks to foster sustainable growth in the fintech industry while ensuring strict compliance with regulatory guidelines and aligning entities with overarching governance principles.

03 Fintechs’ road to building sustainable business

The fintech industry is fast becoming a systemically important part of the financial services sector and should expect the intensity of supervision to increase in the near future. Indian regulatory policy initiatives for fintechs largely aim at

- Identifying, mitigating and addressing risks to financial stability and integrity
- Safeguarding consumer protection
- Enabling new players and approaches
- Promoting competition
- Fostering consumer demand and confidence

Fintechs need to appreciate the risks emanating from the sector and take proactive steps to address those. This will foster trust within the financial services ecosystem, ensure long-term viability of fintechs, and minimise any business disruptions caused by regulatory and supervisory action.

Fintechs focusing on development of the following themes within their organisation will be able to operate within the defined regulatory perimeter while building their businesses through technology-based innovation:

01 Corporate governance

The organisation's culture is largely determined by the kind of corporate governance that the firm has put in place. Accordingly, the 'tone from the top', i.e., the senior management and the board's way of functioning determines the way the firm engages with its external stakeholders. Founders and the senior leadership cannot build a sustainable business model in the financial services industry solely on financial metrics. It is equally important that they develop and promote sound corporate governance practices, culture of risk and compliance, and ethical conduct.

02 Market conduct

The financial services industry's core role is that of financial intermediation. Accordingly, trust plays a crucial role in the process of intermediation and financial services firms must inspire trust for providing services to parties undertaking financial transaction. Therefore, fintechs should have processes in place for equitable and fair treatment of customers, provide information to customers that is free, clear, fair, not misleading through appropriate channels, and undertake customer protection measures on an ongoing basis.

03 Risk management and internal controls

Superior risk management practices and a robust risk culture are key components for success of firms operating in financial services. Risk and audit teams facilitate the development of risk management practices providing oversight. However, the business and operations teams need to internalise the risk mindset to proactively minimise the risk that the entity is put to at the very outset itself rather than rely on the discovery of the same at a later stage when it becomes challenging to course correct. It is important to have risk control self assessments (RCSA) and review whether RCSAs adequately capture all products and services, whether RCSAs comprehensively include risks and associated controls, and if residual risk is acceptable to the firm.

04 Regulatory compliance

Fintechs, which are directly regulated, have to mandatorily comply with applicable regulations. However, fintechs partnering the regulated entities should not think that since they are not regulated, no regulations apply to them. Given that they operate in one of the most heavily regulated industries, it is incumbent on fintechs to proactively identify relevant regulations and set out processes for compliances. Another key consideration for comprehensive compliance is to not see compliance as a checkbox, but rather as a business enabling strategy. Compliance to letter of the regulation will not meet the regulatory expectation and fintechs have to comprehend the spirit of the regulation and comply accordingly. To do so, it is critical to assess what the regulation aims to achieve and whether the compliance controls put in place meet the objectives that the regulation intends to.

05 Financial soundness and solvency

Given that the fintechs not operating as a regulated entity do not have prescribed minimum capital criteria, any wind down on business due to solvency issues can potentially disrupt the financial market. Accordingly, regulators mandate their regulated entities to ensure that the outsourced partners are adequately capitalised and have a viable business model for the long-term sustenance. While there's no guarantee that well capitalised fintechs will succeed in the long term, they will certainly be better placed to handle business cycles and have higher likelihood to get into partnerships with regulated entities for business growth.

The way forward

Fintechs have come a long way in a very short period and are fast gaining systemic importance. As they gain prominence and scale, regulatory oversight will proportionately continue to increase. Regulators on the financial services sectors expect entrants to play the long-term game. While for fintech start-ups, speed is of essence, in financial services, they will have a better chance of succeeding if equal importance is given to corporate governance, market conduct, risk management and regulatory compliance practices. Regulated businesses have entry barriers by design to ensure that the entities entering the space are 'fit and proper' to deliver financial services for the long term. Now is the time for fintechs to step up to the plate, play the long-term game and be counted as a critical component of the financial services industry.

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