

An Analysis of the RBI's Draft Framework on Regulatory Sandbox for Fintech

The term Fintech is generally used to describe innovative technology and technological processes being used in the financial services sector. It originated as a term referring to the back-end technology used by large financial institutions, but has expanded to include technological innovation in the financial sector, including innovations in financial literacy and education, retail banking, investments, etc.¹ Entities engaged in FinTech offer an array of services ranging from peer-to-peer lending platforms and mobile payment solutions to online portfolio management tools and international money transfers.

Regulation and supervision of the Fintech industry raises some unique challenges for regulatory authorities as they have to strike a balance between financial inclusion, stability, integrity, consumer protection, and competition.² One of the methods that have been adopted by regulators in certain jurisdictions to tackle the complexities of this sector is to establish a “regulatory sandbox” which could nurture innovative fintech enterprises while at the same time ensuring that the risk associated with any regulatory relaxations is contained within specified boundaries. It was precisely for this reason that establishment of a regulatory sandbox was one of the options put forward by the Working Group on Fintech and Digital Banking established by the Reserve Bank of India in its report of November, 2017 which was released for public comments on February 8, 2018. Acting on this recommendation the Reserve Bank has proposed a Draft Enabling Framework for Regulatory Sandbox, dated April 18, 2019, (“**RBI Framework**”) which is analysed and discussed below.

Regulatory Sandbox and its benefits

While the basic concept of a regulatory sandbox is to ensure that there is regulatory encouragement and incentive for fledgling Fintech enterprises in a contained environment to mitigate risks, different regulatory authorities have adopted varied methods of achieving this objective. While the Australian Securities and Exchange Commission (ASIC) uses a method where the eligible enterprises notify the ASIC and commence testing without an individual application process, the Financial Conduct Authority, UK (FCA) uses a cohort approach wherein eligible enterprises have to apply to the FCA which then selects the best options based on criteria laid down in the policy.³ The RBI has, not surprisingly, adopted an approach similar to the FCA wherein applicants will be selected by the RBI based on pre-defined eligibility criterion and start the regulatory sandbox in cohorts containing a few entities at a time.

A regulatory sandbox offers the users the opportunity to test the product's viability without a larger and more expensive roll out involving heavy investment and regulatory authorizations. If the product appears to have the potential to be successful, it might then be authorized and

¹ Report of Working Group on Fintech and Digital Banking, Reserve Bank of India, November, 2017, available at <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=892>

² Jenik, Ivo, and Kate Lauer. 2017. “Regulatory Sandboxes and Financial Inclusion.” Working Paper. Washington, D.C.: CGAP, available at <https://www.cgap.org/sites/default/files/Working-Paper-Regulatory-Sandboxes-Oct-2017.pdf>

³ Other countries which have regulatory sandboxes are Netherlands, Bahrain, Abu Dhabi, Saudi Arabia, etc.

brought to the broader market more quickly.⁴ If there are any problems with the product the limited nature of the sandbox ensures that the consequences of the problems are contained and do not affect the broader market. It also allows regulators to obtain first-hand empirical evidence on the benefits and risks of emerging technologies and business models, and their implications, which allows them to take a considered (and perhaps more nuanced) view on the regulatory requirements that may be needed to support useful innovation, while mitigating the attendant risks. A regulatory sandbox initiative also sends a clear signal to the market that innovation is on the agenda of the regulator.⁵

RBI Draft Framework

Since the RBI has adopted a cohort approach for its regulatory sandbox process (“RS”), it implies that fintech entities will have to apply to the RBI to be selected in the RS. The eligibility criterion provides that the applicants will have to meet the eligibility conditions prescribed by the government for start-ups as per the Government of India, Department of Industrial Policy and Promotion, Notification GSR 364(E) April 11, 2018.⁶ The RS will focus on areas where (i) there is an absence of regulations, (ii) regulations need to be eased to encourage innovation, and (iii) the innovation/product shows promise of easing/effecting delivery of financial services in a significant way.⁷ The Framework also provides an indicative list of innovative products and technologies which could be considered for RS testing,⁸ and at the same time prohibits certain products and technologies from being considered for this programme such as credit registry, crypto currencies, ICOs, etc.⁹

The RBI Framework also lays down specific conditions that the entity has to satisfy in order to be considered for the RS such as satisfaction of the conditions to be considered a start-up, minimum net worth requirements, fit and proper criteria for Directors and Promoters, satisfactory conduct of bank accounts of promoters/directors, satisfactory credit score, technological readiness of the product for deployment in the broader market, ensuring compliance with existing laws and regulations on consumer data and privacy, adequate safeguards in its IT systems for protection against unauthorised access etc. and a robust IT infrastructure and managerial resources. The fit and proper criteria for Directors and Promoters which requires elements of credit history along with the minimum net worth requirements in the RBI Framework are conditions which may be too difficult for some of the

⁴ Report of Working Group on Fintech and Digital Banking, Reserve Bank of India, November, 2017, available at <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=892>

⁵ Jenik, Ivo, and Kate Lauer. 2017. “Regulatory Sandboxes and Financial Inclusion.” Working Paper. Washington, D.C.: CGAP, available at <https://www.cgap.org/sites/default/files/Working-Paper-Regulatory-Sandboxes-Oct-2017.pdf>

⁶ These conditions are fairly liberal in that they require that the entity should be less than 7 years old; should not have a turnover of more than 25 crores, and should be working for innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

⁷ Clause 5 of the RBI Framework.

⁸ Clause 6.1 of the RBI Framework.

⁹ Clause 6.3 of the RBI Framework.

smaller and newer start-ups to satisfy even though the technology and products they offer might be sound. The applicants are also required to: (i) highlight an existing gap in the financial ecosystem and how they intend to address that, (ii) show a regulatory barrier or gap that prevents the implementation of the solution on a large scale, (iii) clearly define the test scenarios, expected outcomes, boundary conditions, exit or transition strategy, assessment and mitigation of risks, etc.¹⁰

The RBI Framework specifies that the focus of the RS should be narrow in terms of areas of innovation and limited in terms of intake.¹¹ While limits on the number of entities per cohort may be justified based on paucity of resources, limiting the focus of the RS by narrow areas of innovation is a lost opportunity in terms of sharing of ideas and learning from the mistakes of their colleagues who may be employing technologies and principles which could be useful in fields other than those where they are currently being applied.

The RBI Framework specifies that the boundaries of the RS have to be well defined so that any consequences of failure can be contained. These boundary conditions include a specific start and end date, target customer type and limits on number of customers, cash holdings, transaction amounts and customer losses.¹² The Framework does not put in place any hard numbers on the boundary conditions which ensures that the RS process can be customised to the needs of specific entities since the sample sizes and data needed to determine the viability of fintech entities and products may vary from product to product. However a major dampener is the hard limit of 12 weeks imposed on the testing phase of the RS, which is the most important phase since all the data from the operations is generated during this phase and 12 weeks may not be enough time to generate enough reliable data so as to reach a determination of the viability of the product.

Although the RBI has shown a willingness to relax regulatory requirements for RS participants on a case to case basis, it has specified that there shall be no relaxation on issues of customer privacy and data protection, security of payment data, transaction security, KYC requirements and statutory restrictions.¹³ Since this is only an initiative by the RBI the RS participants dealing with the insurance or securities sector would not be entitled to any relaxations from the IRDA or the SEBI even if they are found eligible for relaxations from RBI regulations. This would severely limit the efficacy of the RS process and is an issue that could have been addressed if all three regulators had collaborated thereby encouraging innovative start-ups offering a broader spectrum of services.

Once the RS is finished, the regulatory relaxations provided by the RBI will expire and the fintech entity will have to either stop operations or comply with the relevant regulations. In case the entity requires an extension of the RS period, it would apply to the RBI at least one month prior to the expiry of the RS period with reasons for the extension. The RBI also has the option of prematurely terminating the sandbox process in case the entity does not achieve

¹⁰ Clause 6.5 of the RBI Framework.

¹¹ Clause 6.4 of the RBI Framework.

¹² Clause 6.7 of the RBI Framework.

¹³ Clauses 6.2 and 8 of the RBI Framework.

its intended purpose or if it cannot comply with the regulatory requirements and other conditions specified at the relevant stage of the sandbox process. The fintech entity is also entitled to quit the RS process prematurely by giving one week's notice to the RBI, provided it ensures that all its existing obligations to its customers are fully addressed before such discontinuance.¹⁴ Infact customer obligations have to be met by the fintech entities irrespective of whether the operations are prematurely ended by the entity or it continues through the entire RS process; no waiver of the legal liability towards consumers is provided by the RS process. In addition, customers are required to be notified upfront about the potential risks and their explicit consent is to be taken in this regard.¹⁵

The RBI Framework itself lists out some of the risks associated with the regulatory sandbox model such as (i) loss of flexibility in going through the RS process, (ii) case by case determinations involve time and discretionary judgements, (iii) no legal waivers, (iv) requirement of regulatory approvals after the RS process is over, (iv) legal issues such as consumer complaints, challenges from rejected candidates, etc. While acknowledging the above risks the Framework also mentions that atleast some of them may be mitigated by following a time bound and transparent process thus reducing risks of arbitrary discretion and loss of flexibility.

Conclusions

While there are some who are sceptical of the entire concept of a regulatory sandbox for the reason that it loosens regulation too much while at the same time putting customers at risk,¹⁶ the cohort model adopted by the RBI would reduce that risk to an extent since it ensures comprehensive screening and supervision by the RBI with clear exit strategies and an emphasis on consumer interests. On the other hand the eligibility criterion for applicants prescribes minimum net worth requirements as well as credit history, etc. which may impose conditions too onerous for some start ups which may be their infancy. Further the clear emphasis on protection of customer privacy and consumer interests also ensures that the RBI will not put the interests of ordinary citizens at risk in order to promote new and untested technologies. That said, the regulatory sandbox process is a welcome initiative by the RBI which may send a signal to the financial community that it is aware of the potential advantages as well as risks of Fintech and is willing to play a proactive role in encouraging new technologies to improve the financial sector in India.

¹⁴ Clause 6.6 of the RBI Framework.

¹⁵ Clause 6.9 of the RBI Framework.

¹⁶ Jemima Kelly, A "fintech sandbox" might sound like a harmless idea. It's not, Financial Times, Aplphaville, <https://ftalphaville.ft.com/2018/12/05/1543986004000/A--fintech-sandbox--might-sound-like-a-harmless-idea--It-s-not/>