Regulating FinTechs

This editorial is based on **“Regulate FinTechs, but not with a Bludgeon”** which was published in The Hindu BusinessLine on 11/08/2022. It talks about the current status of regulation of Fintechs in India and the right approach to regulate them.

For Prelims: FinTech, Neobanks, Cryptocurrencies, RBI’s FinTech Regulatory Sandbox, Payment System Operators License, DeFi, Digital Lending

For Mains: India’s FinTech Space, Significance of FinTechs, Regulation of FinTechs - Initiatives taken and concerns associated

FinTech is **amongst the most thriving sectors** at present in terms of both business growth and employment generation. To name a few, FinTech includes different sectors and industries such as **education, retail banking, fundraising and nonprofit, and investment management.**

India’s FinTech space is touted as **one of the most disruptive, innovative and mature in the world.** The valuations for Indian FinTech players have been skyrocketing, primarily due to the immense potential the market has to offer.

However, along with the deepening of technology and digital services, there’s been a **rise in digital fraud and consumer dissatisfaction**. This has triggered the **need to take a closer look at the operation of the FinTechs,** resulting in the **introduction of certain supervisory steps** to address the risks emanating from their activities.

What is Understood by FinTech?

- **About:** Originally, FinTech referred to the technology applied to the back-end of established consumer and trade financial institutions.
    - However, in the past few years, the term has expanded to include **any technological innovation in the financial sector (financial literacy and** education**,** retail banking**, investment and even** crypto-currencies **(Decentralised Finance (DeFi)).**
    - FinTech is any technology that seeks to improve and automate the delivery and use of financial services.
- **Significance:**
    - FinTechs are an essential part of the Indian financial ecosystem; though they have been around for decades, their **importance is pronounced post** demonetisation, with the **Covid-19 pandemic further intensifying their significance.**
    - FinTech is redefining financial services for the common man and woman; the use of big data **for small credit** through smart analytics and algorithms has vastly **expanded the pool of eligible borrowers in India.**
    - FinTech has **brought down the cost of doing business** drastically. The cost of a digital

    - transaction like payments, credit assessment and fraud check is a fraction of the amount spent on physical processes.
    - Fintech is **breaking geographical barriers** and shrinking the country into the palm of the hand. It is **opening doors to a large number of underserved yet economically viable customers.**
- **Growth of FinTech in India:** India is the **global FinTech superpower** with the **highest FinTech adoption rate** in the world. In 2020, **India overtook China** as Asia's top FinTech market.
    - As per the government of India estimates, the **Indian FinTech ecosystem is expected to reach $150 billion by 2025** from its present level of $50 billion.

What About the Regulation of FinTechs?

- **Types of Regulation:** Worldwide, FinTech firms are subject to three types of regulations:
    - **Activity-based regulation**, in which identical actions are **regulated equally regardless of the legal status** or type of the entity doing the activity.
    - **Entity-based regulation**, which requires laws to be **applied to licenced firms** engaged in comparable and specified activities, such as deposit taking, payment facilitation, lending, and securities underwriting, among others.
    - **Outcome-based regulation**, where firms are required to **ensure certain fundamental, common, and technology related aspects.**
- **India's Initiatives for Regulating Fintechs:**
    - Although there is **no direct intervention by the RBI to regulate FinTech** companies and mitigate the risks they pose to the financial ecosystem, there have been a few initiatives to embrace them.
        - One such example is the **RBI's FinTech Regulatory Sandbox** – established in 2018 with the primary objective of being a controlled regulatory environment for testing FinTech products.
        - Another initiative by the RBI to bring a section of FinTechs under their purview was the introduction of the **Payment System Operators license.**
    - **FinTechs operating as Peer to Peer (P2P) lenders,** alternative credit scoring platforms and crowdsourcing platforms are **being slowly brought under the regulatory ambit.**
    - More recently, the RBI has notified that it has firmed up a regulatory **framework to support orderly growth of credit delivery through digital lending.**
        - The framework is based on the principle that lending business can be carried out only by entities that are either regulated by the central bank or entities permitted to do so under any other law.
- **Concerns Related to Regulation of FinTechs in India**:
    - Regulation is a major problem in the emerging world of FinTech, **especially cryptocurrencies.** In most countries, they are unregulated and have become **fertile ground for scams and frauds.**
    - Due to the **diversity of offerings in FinTech,** it is **difficult to formulate a single and comprehensive approach** to these problems.
        - Regulatory uncertainty in the FinTech sector is making things complicated for both FinTech service providers and consumers.
    - The absence of an overarching regulatory framework for FinTechs have created **multiple points of ambiguity in the system for companies, investors and consumers.**
    - Being away from the radar of the regulator, a number of **unethical practices in lending have also been reported.**
        - **Brutal collection methods, opaque lending** practices, **mis-selling of products, customer harassment**, etc. are some of the instances.

What would be the Right Approach to Regulate Fintechs?

- **Comprehensive Regulatory Framework**: A **sensible regulation with transparency** will strengthen the sector in the long run and facilitate the Indian economy in growing at its potential rate by allowing its growth drivers to **fuel the engine of economic advancement.**
    - A more constructive approach from RBI would be to **recognize the part FinTechs play in India's financial inclusion agenda** and establish a regulatory **framework that will**

remove the current ambiguities while **giving FinTech's sufficient flexibility** to ideate and innovate new propositions.
- **Bringing Bigtechs in Regulatory Ambit:** The real challenge for FinTech comes from **Bigtechs, which have primary businesses in non-financial sectors** such as social media, telecommunications, Internet search and e-commerce.
    - They are **well-positioned** to acquire a major part of the financial services sector.
    - It is important for the policymakers to **focus on Bigtechs and ensure a level-playing field between Bigtechs and banks**, considering the former's wide customer base, access to information and broad-ranging business models.
- **Prioritising Consumer Protection:** Trying to find the **right balance between consumer protection and product innovation** has been a struggle for regulators when looking to govern the FinTech space.
    - RBI shall prioritise consumer protection in FinTech regulation and this needs to be **manifested through the final laws on cryptocurrency and digital lending.**
- **Compatible Policy**: Policies that **target both FinTech firms and traditional banks proportionately** are needed. This way, the opportunities that FinTech offers will be fostered, while risks will be contained.
    - For **neobanks,** this means stronger capital, liquidity, and risk-management requirements **commensurate with their risks.**
    - For **incumbent banks** and other established entities, prudential supervision may need **greater focus on the health of less technologically advanced banks**, as their existing business models may be less sustainable over the long term.
- **Provisions for DeFi:** The absence of governing entities mean DeFi is a challenge for effective regulation and supervision.
    - The regulation should focus on the entities that are accelerating the rapid growth of DeFi.
    - **Supervisory authorities should also encourage robust governance,** including **industry codes and self-regulatory organizations.**
    - These entities could provide an effective conduit for regulatory oversight.

Drishti Mains Question

"India's FinTech space is touted as one of the most disruptive, innovative and mature in the world. However, the absence of a regulatory framework for FinTechs poses grave challenges to India's financial ecosystem." Comment.

UPSC Civil Services Examination, Previous Year Questions (PYQs)

Prelims

Q. With reference to India, consider the following: (2010)

1. Nationalization of Banks
2. Formation of Regional Rural Banks
3. Adoption of village by Bank Branches

Which of the above can be considered as steps taken to achieve the "financial inclusion" in India?

(a) 1 and 2 only
(b) 2 and 3 only
(c) 3 only
(d) 1, 2 and 3

Ans: (d)

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