CUTS International

Comments by CUTS International on
The Report of the Working Group on FinTech and Digital Banking

Consumer Unity & Trust Society (CUTS International, www.cuts-international.org) is pleased to submit its comments on the Report of the inter-regulatory Working Group on Fin Tech and Digital Banking (hereinafter, the Report).

Submissions

1. The need for a progressive approach to smart regulation

The Report recommends creation of an appropriate framework for "Regulatory Sandbox/innovation hub" within a well-defined space. Countries are experimenting with different variants of regulatory sandbox, such as cohort based live testing, statutory waiver framework, hybrid sandbox, etc. See table 1 below.

Table 1: Models of Regulatory Sandbox
Cohort-based live testing program (UK FCA): Regulatory relief is tailored to the unique risks presented by the product in testing. Applicants are evaluated based on eligibility criteria, including whether the product constitutes a "genuine innovation," offers a "consumer benefit," and is ready for testing. Admitted companies then work with the FCA to craft appropriate testing protocols and consumer safeguards. At the end of the test period, participants either "graduate" to full licensing, or are released from the sandbox without market access **Statutory waiver framework (Australia)**: Allows companies with a limited number of customers and/or low financial exposure to operate for up to one year without a full license. **Hybrid Sandbox (Indonesia OJK)**: Tiered registration requirements that provide participating companies up to a year to apply for full licensing. In the interim, the OJK provides informal coaching to participants to help them graduate to full market access. Each approach offers distinct costs and advantages. For example, the cohort-based approach provides a mechanism for broadly publicizing and generating interest in the regulatory collaboration process, and provides the sponsoring regulator with concentrated exposure to a broad cross-section of innovative companies. Statutory sandbox frameworks lower regulatory barriers to entry for new firms and eliminate regulatory discretion to "pick winners." At the same time, however, statutory waivers reduce the need for collaboration with regulators and therefore eliminate some of the learning benefits of cohort-based sandbox.
Source: Duff, *Modernizing Digital Financial Regulation,* 2017

Creation of regulatory sandboxes in Indian context can allow regulators to facilitate small-scale tests by financial technology firms. In such a carefully controlled environment, certain regulations

may be temporarily relaxed, and consumers can be allowed to participate in new products. The goal should be to collect empirical evidence which can ultimately lead to better policy solutions, whilst simultaneously evaluating the risk of any new product or technology. Such an institution can provide a structured avenue for regulators to engage with the financial supply-side, develop innovation-enabling regulations, and holds promise to facilitate the delivery of relevant, customised, and low-cost financial products to Indian customers.[1]

However, structures such as innovation hubs and sandboxes need to be considered carefully. The success of these structures is dependent on a clear regulatory purpose, open and transparent participation criteria[2], and measurable success criteria.[3] Further, with the growing demand of risk based regulation, and the regulators becoming entity and technology neutral, the regulators might not fully understand the risks which new technologies bring with themselves, without appropriate nudges.

Consequently, there is a possibility that sandbox like frameworks might end up providing unfair treatment to some entities over others. To avoid which, such a framework should ensure fair and balanced oversight, maintaining obligations to meet Anti-Money Laundering and Countering Financing of Terrorism requirements consistently with international standards, while ensuring that no participant in the pilot obtains an undue advantage. And the framework should balance the risks of digital financial inclusion with the costs of supervision and compliance.[4] Therefore, regulators must be mandated to focus on fundamentals. A progressive approach to smart regulation could be adopted, as given in Table 2.

Table 2: Progressive approach to 'smart regulation'
1. A testing and piloting environment
2. A regulatory sandbox, which widens the scope of testing and piloting, is transparent, and removes the regulators' disincentive to grant dispensations (and depending on the ecosystem and the importance of cross-border recognition the sandbox may take the form of a sandbox umbrella)
3. A restricted licensing/special charter scheme, under which innovative firms can further develop their client base and financial and operational resources
4. When size and income permits, the move to operating under a full license

[1] Ramadorai et al, *Report of the Household Finance Committee: Indian Household Finance*, July 2017

[2] On 19 February 2018, the Monetary Authority of Singapore has published Fintech Regulatory Sandbox Application Form, which is publically accessible. See, http://www.mas.gov.sg/~/media/Smart%20Financial%20Centre/Sandbox/FinTech%20Regulatory%20Sandbox%20Guidelines%2019Feb2018.pdf

[3] Groepe, *Regulatory Responses to FinTech Developments*, August 2017

[4] See Principle 3, *G20 High-Level Principles for Digital Financial Inclusion,* available at https://www.gpfi.org/sites/default/files/G20%20High%20Level%20Principles%20for%20Digital%20Financial%20Inclusion.pdf

Table 2: Progressive approach to 'smart regulation'
Source: Zetzsche et al, *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation,* EBI Working Paper Series - 11, 2017

Further, there is a need to realise that regulatory sandboxes alone may not result in desired level of financial innovation, and the regulators will need to take a holistic approach to catalyse fintech innovation and development. This approach includes, *inter alia*: government usage of fintech solutions to create business opportunities for fintech firms; ensuring robust digital connectivity; policies that support interoperability and broadening of financial inclusion efforts; ensuring access to payment channels, data and APIs at fair, reasonable and non-discriminatory terms; improving ease of doing business; and creation of even playing field.[5]

2. In reference to 6.1.11 (p.60), relevant regulatory principles can be added

In addition to the four general regulatory principles highlighted, the following important principles are worth exploring and can go a long way to sustain the growth of the FinTech revolution:

2.1. Regulators should be pro-active in driving innovation and encouraging open access, alongside assessing new risks

The first principle mentions the need to foster competition and doing away with barriers to competition. This not only requires, as suggested a "*neutral stance with regard to technological advances*" (p.60), but also a pro-active one wherein innovation is fostered and access to core infrastructure and banking functionalities is promoted. For instance, regulators in the European Union (EU) and the United Kingdom (UK) considered access to core infrastructure and data as important determinants through which the growth of FinTech can be supported and came out with what is popularly known as the 'open banking' system. The system in the UK has a promise to contribute £1bn to its economy.[6] The PSD2 in EU is expected to break bank's monopoly on their user's data, and allow access of such data to other service providers through open application programme interface (APIs), subject to user's consent.

However, in the Indian scenario, the financial sector has since long followed an entity based regulatory approach, which has negatively impacted the incentives to innovate for new entrants. It is important for regulators to realise that due to modularisation of the financial system, each part of the financial transaction can be performed differently by different entities or institutions.[7]

Hence, an optimal approach to regulating this space would require openness towards innovative business models and inherently embracing the fact that innovation will be at the forefront of

[5] Castri and Plaitakis, *Going beyond regulatory sandboxes to enable fintech innovation in emerging markets,* October 2017, BFA at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3059309
[6] See https://www.telegraph.co.uk/business/2018/02/25/open-banking-contribute-1bn-uk-economy-says-report/
[7] Dvara Research, *Designing Regulations for a Rapidly Evolving Financial System,* (2017)

efficiency improvements. Moreover, there is a need to open up big public data sets for users to consume, in a standard, machine-readable format. In addition, a policy is needed to allow for the free flow of data with express and informed user consent in the private, unregulated spheres, to realise the potential of big data, in areas such as digital lending.[8]

Such an approach will significantly aid in achievement of policy goals such as financial inclusion. The ability of the regulator to support and encourage such innovations will determine the future of FinTech, aid in creation of robust markets and contribute towards socio-economic development.

In furtherance of this, the technology neutral stance should also not be used as an argument that excuses regulators from the need to understand the impact of new technologies on processes (e.g. biometric identification for payments) or business models (e.g. alternative data credit scoring). Instead "technological neutrality" should mean that regulators do not seek to "regulate" technological innovations, but instead focus on the financial processes that technology enables and that ought to be subject to regulation (e.g. it is not automated investment advice that is the problem, but the risk of fraud or improper advice).[9]

2.2. Regulations should indicate best practices and encourage entities to follow the same

From the policy standpoint, the end game of any digital banking initiative is to promote a digital approach towards financial inclusion and move away from cash-dependence. The will to promote public interests is thus inherent in any such initiative, irrespective of the nature of entity or institution behind it.

Thus, an important aspect of the regulatory framework should be inclusion and encouragement of responsible digital financial practices and guidance for market players regarding the same.[10] This would include practices such as imbibing privacy by design, inculcating data protection norms etc.

3. Entity based regulation or risk based regulation? – clarity needed

The Working Group proposes that, "FinTech powered business should ideally be undertaken by only regulated entities, e.g. banks and regulated payment system providers" (p.57). This seems to promote a very static understanding of the FinTech industry and discounts its inherent dynamism and innovation potential. It is also in conformation with the prevalent sub-optimal approach towards financial sector regulation, which has since long focussed on entities rather than the functions that they implement.

---

[8] CUTS International, *Digital Payments: Level the Playing Field to Leverage the Potential,* 59 (2017), available at http://www.cuts-ccier.org/Payments-Infrastructure/pdf/Research_Report-Competition_assessment_of_payments_infra_in_India.pdf

[9] Zetzsche et al, *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation,* EBI Working Paper Series - 11, 2017

[10] For details, see BTCA, *Responsible Digital Payments Guidelines* (2016)

For example, banks have been assumed to be safest entities and have thus been kept at the highest pedestal and allowed direct and interoperable access to key payment platforms. Banking constitutes diverse activities like deposits, payments and credit, each of which pose different risks and can be differently regulated. All entities offering similar services need to be similarly treated, irrespective of their form. Consequently, all banks and non-banks deserve similar treatment to the extent they offer payment services.[11] Another example is the blockchain technology which finds several mentions in the Report. The mere fact that a model or technological development is disruptive and lies outside the scope of regulatory frameworks should not imply that it needs regulation. Regulation should be a systematic process where only those parts or modules of a technology should be targeted wherein potential costs outweigh the potential benefits in a no-regulation scenario.

Paradoxically so, the Working Group does acknowledge this aspect when it states that, "Regulations should foster healthy competition between players, regardless of whether they offer conventional approaches or use new technological solutions" (p.60). Hence, there is a need to clarify the overarching regulatory approach or perspective which the Working Group envisages. Notably, establishing clear market participation rules and certainty in regulation would be integral in generating innovation incentives and protecting competition.[12]

4. **Institutionalise activity based grievance redress and establish collaborations with experienced organisations for better implementation**

Ineffective grievance redress in financial services sector is huge cause of concern, and is one of the indicators of inefficient competition. Complaints relating to payments, such as delay in refunds, unauthorised card transactions, unauthorised transactions from accounts, constitute a significant portion of total grievances in the financial sector, and are continuously increasing.[13]

Although RBI has recently launched an 'Ombudsman Scheme' for non-banking financial companies (NBFC) for redressal of complaints, previous track record shows that such schemes in the case of banking entities have not been a success. Bearing in mind the diverse challenges involved in implementation of grievance redress mechanisms, it is safe to assume that without collaboration with experienced organisations, the ombudsman scheme will not achieve its full potential.[14] Moreover, limited focus on fraud prevention and privacy in products offered by

---

[11] CUTS International, *Digital Payments: Level the Playing Field to Leverage the Potential,* (2017), available at http://www.cuts-ccier.org/Payments-Infrastructure/pdf/Research_Report-Competition_assessment_of_payments_infra_in_India.pdf

[12] See Principle 3, *G20 High-Level Principles for Digital Financial Inclusion,* available at https://www.gpfi.org/sites/default/files/G20%20High%20Level%20Principles%20for%20Digital%20Financial%20Inclusion.pdf

[13] CUTS International, *Digital Payments: Level the Playing Field to Leverage the Potential,* 36 (2017), available at http://www.cuts-ccier.org/Payments-Infrastructure/pdf/Research_Report-Competition_assessment_of_payments_infra_in_India.pdf

[14] For various challenges and lessons from CUTS' experience, see Lessons from Running a Consumer Care Center in India, available at https://cfi-blog.org/2017/03/24/lessons-from-running-a-consumer-care-center-in-india/

service providers is discomforting. Cumbersome processes of filing complaints and sub-optimal redress mechanisms highlight the apathy which consumers are faced with. There is a clear need to establish trust with the consumer and also affix accountability of service providers which will enable a permanent behavioural shift towards digital banking.[15]

Hence, there is a requirement to institutionalise activity based grievance redress. Collaborations with and cross-learning between experienced organisations (e.g. those that are running the Consumer Care Centres like CUTS International) will be beneficial and help in efficient implementation of well-devised schemes.[16]

5. **Conduct periodic regulatory impact assessment and competition assessment in collaboration with stakeholders**

A useful addition to the regulatory recommendations mentioned in the "*Way Forward*" section would be to conduct regulatory impact assessments (RIA) of regulatory proposals, and regulatory evaluations and competition impact assessment (CIA) of existing regulations. Both have been recognised as important elements of an evidence-based approach to policy making.[17] RIA helps to identify and plug regulatory bottlenecks and ensures that regulations meet their intended objectives. CIA helps to identify distortions to competition arising from regulations and facilitates the maintenance of a level-playing field for all market players. Collaboration between policymakers, regulators, industry players and civil society etc. will be vital to any such exercise.

Utilisation of these tools is more important than ever before bearing in mind the rapid evolution of technology and business models, which are constantly challenging existent regulatory mechanisms.

6. **Definition of possible regulatory actions**

While discussing realignment of the regulatory approach, the Report mentions that, "*the regulatory actions may vary from 'Disclosure' to 'Light-Touch Regulation & Supervision' to a 'Full-Fledged Regulation and Supervision', depending on the risk implications*". This is a welcome suggestion and the matrix (Annex-2) is quite indicative in nature.

However, before the aforesaid actions are applied to a particular market scenario or business model, it would be useful to first identify specific indicators which define the three terms and

---

[15] See http://www.cuts-ccier.org/pdf/Presentationon-Bottom-up_approach_to_grievance_redress_in_digital_payments.pdf

[16] For details of CUTS consumer care centres, see http://www.cuts-international.org/cart/Grahak_Suvidha_Kendra.htm

[17] See http://www.oecd.org/competition/assessment-toolkit.htm ; http://www.oecd.org/gov/regulatory-policy/ria.htm ; http://cuts-ccier.org/ria/ and http://www.cuts-ccier.org/ComPEG/pdf/CUTS_Competition_Impact_Assessment_Toolkit-A_Framework_to_Assess_Competition_Distortions_Induced_by_Government_Policies_in_the_Developing_World.pdf

determine how these will be applied to a particular situation. Application of these actions should be informed through an evidence-based, objective analysis and should not be arbitrary. The rationale to follow a particular regulatory 'action' in a particular instance should be unambiguous and a standardised framework for the same should be designed. Perhaps, a matrix can be framed which includes essential factors such as systemic risk, consumer protection, innovation, competition etc. If the inherent risk is too high and there is a need to protect consumers' interests, then the action of 'full-fledged regulation and supervision' can be applied. However, this should be the exception and the general rule should favour no or light regulation to make the most of technological innovation in this sector.

In this regard, the approach to regulation of retail payments, as proposed in the review of retail payments oversight framework in Canada may be helpful. The report has identified key risks in operation of retail payments: operational risk; financial risk; market conduct risk; efficiency risk; and money laundering and terrorist financing risk. In order to address such risks, the key regulatory objectives should be: safety and soundness; efficiency; and user interests. To achieve such objectives, the regulatory approach should be based on following principles: necessity; proportionality; consistency and effectiveness.[18]

7. Adopting structured stakeholder consultation

While discussing realignment of the regulatory approach, the Report mentions that, "*the financial sector regulators require to engage with FinTech entities in order to chalk out appropriate regulatory response and to re-align existing regulatory and supervisory framework.*"

Hitherto, the engagement between regulator and financial sector stakeholders, including market players, has been unstructured and irregular. There is a need to adopt structured stakeholder consultation process.

The Payments and Settlement System Vision 2018 of the RBI envisaged setting up a Payments System Advisory Council (PSAC) of industry and Government representatives/ experts to strengthen the consultative process.[19] However, the recently released RBI Annual Report 2016-17 notes that PSAC was to be constituted as an advisory body to the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS). Since the Payments Regulatory Board (PRB) is envisaged to replace the BPSS as per the Finance Bill, 2017, no further action is being taken on the formation of PSAC.[20] It needs to be realised that the roles of PRB and PSAC are different and important in their own right. The PRB, despite having representation from outside

[18] CUTS International, *Digital Payments: Level the Playing Field to Leverage the Potential,* 56 (2017), available at http://www.cuts-ccier.org/Payments-Infrastructure/pdf/Research_Report-Competition_assessment_of_payments_infra_in_India.pdf

[19] RBI, Vision document for Payments-2018, June 2016

[20] RBI, Annual Report 2016-17, 30 August 2017

RBI, can substantially benefit from expert structured consultation process, constituted and recognised by the regulator. Thus, the idea of PSAC needs to be revived.[21]

****

[21] CUTS International, *Digital Payments: Level the Playing Field to Leverage the Potential,* 51 (2017), available at http://www.cuts-ccier.org/Payments-Infrastructure/pdf/Research_Report-Competition_assessment_of_payments_infra_in_India.pdf