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Regulatory Sandboxes in FinTech: Existential Need or Overhyped Appendage?

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The FinTech sector in India has shown tremendous growth, with it being one of the fastest in the world. There are around 2100 FinTech companies in India, with the bulk of them (almost 67 percent) having been set up in the last five years. The current valuation of India's FinTech companies is USD 31 Billion, which is expected to nearly triple to USD 84 billion by the year 2025 (InvestIndia 2021). More than 50 FinTech companies are valued at greater than USD 100 million, covering a wide array of areas such as broking, insurance, and software as a service. One key growth sector has been neo-banking, with almost 15 companies vying for that space.

Opportunities and Issues in the FinTech sector

Several factors have spurred the phenomenal growth of the FinTech industry. These include a growing start-up ecosystem, increased penetration of smartphones, and an ever-evolving infrastructure supportive of digital transactions. There has also been a significant push by the current government towards the Unified Payments Interface (UPI) and associated technologies, which have further acted as catalysts in FinTech growth (InvestIndia 2021).

But all is not smooth for this sector. Some areas need immediate redress. The primary pain points are regulatory and compliance laws, unbanked and under-banked population, trust in cash, cyber threats, lack of government support, and complexities unique to the industry such as unbundling and collaboration (Dayal and Narayanan 2021).

Out of these parameters, regulation and compliance are a game-changer. An efficient regulatory system can increase this sector's efficacy manifold and further accelerate growth. The current regulatory ecosystem has been hampered by the involvement of multiple entities such as the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), the Telecom Regulatory Authority of India (TRAI), and the Insurance Regulatory and Development Authority of India (IRDAI). The lack of a unified body leads to redundancies and functional issues. Furthermore, the contrasting view of respective states on start-ups increases the complexities. Given the inherent challenges discussed above, a focussed look into regulatory sandboxes is warranted.

Regulatory Sandboxes

A sandbox allows FinTech organizations to test new service offerings, assess their risks, and create an additional buffer between the market and the end consumers, thus reducing adoption risk (Dayal and Narayanan 2021). An ecosystem like this allows a collaborative atmosphere for FinTech and refinement of offerings based on customer needs.

Regulatory sandboxes fulfill several objectives. They provide a closed environment for testing products in FinTech. Furthermore, they enable the creation of new business models unprotected by regulations. They also aim to balance compliance and financial regulation during the design and launch of new financial products. Finally, they act as a catalyst for creating an ecosystem that fosters innovation while insulating the consumers from the inherent risks of new products.

Assessing Regulatory Sandboxes

In the regulatory sandbox, a contained space is provided to contestants and challengers experimenting with designs that lie outside of the active regulatory structure. The initiative of this framework started in the information technology sector, where new stuff is examined, and the database is secluded from the critical system resources (BakerMcKenzie 2020). However, sandbox test products that are already live.

The regulatory framework allows financial institutions and industry leaders to do live experiments with financial products and services. Consequently, they can identify likely problems and thus mitigate future risks. As a result, businesses can test innovations and concepts with consumers under specific oversight (WorldBank 2020). The sandbox includes appropriate safeguards to contain the consequences of failure and maintain the financial system's soundness. Notably, the sandbox is anticipated to support and assist the positive discourse between the regulator and what is regulated. Across the world, many nations have agreed to sandboxes, and at present, 46 initiatives are implemented in different stages (WorldBank 2020).

The concept could be mapped out to the U.S. Project Catalyst. It was a program formed by Consumer Financial Protection Bureau in 2012 for encouraging customer-friendly improvement and start-ups for financial services (BakerMcKenzie 2020). The program is an important extension of the Consumer Protection Act and Dodd-Frank Wall Street Reform, providing consumers with clear, spirited, and modern marketplaces.

The U.K.'s Financial Conduct Authority (FCA) recognized the modern regulatory sandbox in 2015. It called the framework a safe place for companies to test new products, trade concepts, models, and services and to deliver optimal results without incurring standard regulatory costs. Of the 99 companies that applied for FCA's fifth cohort in 2019, 29 were accepted, including small start-ups and established banks (InvestIndia 2021).

Regulatory Sandboxes in India

In 2016 RBI initiated an inter-regulatory functioning team to look at the new and finer aspects of FinTech. RBI also released guidelines for the sandbox in August 2019 after the suggestions made by the working group. Furthermore, both the SEBI and the IRDAI have announced their plans for regulatory sandboxes. The SEBI regulates India's securities markets, whereas IRDAI regulates the insurance and re-insurance sectors (Dayal and Narayanan 2021).

Maharashtra already has policies for encouraging financial start-ups. The government launched a sandbox exposing bank application programming lines to endorse open banking proposals. Several private bank institutions, such as ICICI Bank, YES Bank, and HDFC Bank, have an initiative where programmers and developers are asked to create a new application through banking APIs (BakerMcKenzie 2020).

Indian regulators decided on a diverse approach compared to the U.K.'s FCA sandbox. For example, the FCA sandbox allows testing for the products in different sectors such as Know Your Customers (KYC), debt, insurance, and securities. On the contrary, Indian regulators promote new concepts through premeditated sandboxes for each division. However, sandboxes in India are currently in an emerging period as Indian regulators are still standardizing the regulations.

IRDAI's Regulatory Sandbox

IRDAI is tasked with licensing and regulating India's insurance and re-insurance sectors. It looks at products and services in the insurance sector and has a separate section for reviewing requests. According to IRDAI's plan, any application willing to promote and bring innovation in insurance can enter the program. Though, it requires a demonstration of the new invention to the regulators. There is no detailed test period, but it ends when the number of customers reaches 10,000 or when the insurance premium reaches INR 50 lakh (Dayal and Narayanan 2021).

Global perspective

It is essential to delve into some established international structures to understand the regulatory sandbox better. Three different countries – China, the U.K., and Australia – have been chosen for a deeper analysis to comprehend the functional aspects of such a setup.

FinTech regulation in China

China's central bank has strengthened the regulation of the payment sector and requires all companies to be licensed to provide financial services. According to the Governor of the People's Bank of China, China's approach to regulating financial businesses is grounded on three principles: businesses must be licensed; companies providing wealth management and insurance must set firewalls to prevent cross-sector risks; and the direct link between banking information services and non-banks must be cut.

China has been taking a series of recent measures on FinTech regulations. It passed a new law on personal data protection in August 2021 and issued a data security law in June 2021. Furthermore, it has tightened its grip on non-bank payment providers by restricting their activities (Xin 2021).

The United Kingdom

The U.K. Financial Conduct Authority's (FCA) sandbox has an opening for both authorized and unauthorized firms across technologies and businesses. Since its inception, the sandbox has been extremely popular with applicants from multiple sectors, which is reflected in the increasingly diverse nature of the FinTech industry. Examples of such organizations are firms involved in digital identity solutions, platforms that tokenize financial instruments, and services that facilitate greater access to financial services for disadvantaged consumers. Also, blockchain technology is widely used in many firms, consistent with the growth of DLT (Distributed Ledger Technology). Some examples of its applications are automating debt and equity issuance, developing identity verification services, and creating products for cash flow management.

The U.K. also has a set of standards that must be followed strictly. The sandbox is primarily intended for testing on a small scale, and there are strict limits on the size of tests. The customer sets should be big enough to generate actionable and coherent data. This should be done by ensuring that two parameters are in place. One is the management of risks for consumers, and the other is the practical aspect of obtaining consumers for this period. In addition to this, some additional safeguards must be fulfilled and are largely sector-specific. For example, retail consumers should not be a party to any risk during sandbox testing. As for the sophisticated consumer base, the compensation may be limited subject to the availability of informed consent. Certain cases require a U.K. bank account for enlisting in sandbox testing. If there is a requirement for a partner or third party for testing purposes, adequate contractual agreements need to be in place. The testing plan needs to be comprehensive and should meet several criteria. One criterion is the presence of a concrete plan for the timeline involved. The second criterion is key milestones for testing. Some of these are duration and transaction limit. The third one is safeguarding for customers, whereas the fourth criterion is an exit strategy. These must be laid out in detail and comprehensively before sandbox testing begins.

The process in the U.K. has not been without its fair share of challenges. The FAC has identified several obstacles from participants in a sandbox. One main concern flagged by participants is the difficulty of obtaining banking services. This issue is applicable for firms that are into leveraging DLT (Distributed Ledger Technology) or are becoming payment institutions. Acquiring a new customer base is an issue faced by start-ups. One recommendation by the FCA is to set up partnerships between established firms and start-ups. There is also an admission by the FCA that meeting the threshold specifications for start-ups is tougher when compared to traditional organizations. This can be attributed to two factors. One is scale, and the other is the FCA's inability to comprehend the functionalities of these newer organizations. These issues have impacted the reach and efficacy of the regulatory sandbox setup.

FinTech regulation in Australia

The Australian Securities and Investment Commission (ASIC) revealed its first iteration of sandbox in December 2016. Any eligible FinTech company can apply for it after notifying ASIC of its intent to propose products and services within sandbox regulations (BakerMcKenzie 2020). No other approvals are required. However, the timing of the release and restrictive parameters of the sandbox has resulted in limited participation.

Trans-governmental attempts to facilitate cooperation among regulators

One of the best examples of trans-governmental cooperation among regulators can be seen in the case of the E.U. (European Union). In the context of current discourse, the study of this initiative attains great relevance. The risk of market fragmentation primarily accelerated this cooperation. This cooperation was also compounded by potential difficulties in scaling and deploying innovative products across the E.U. market (Allen, 2020). The group of experts on "Regulatory Obstacles to Financial Innovation" recommended the creation of a pan-E.U. regulatory sandbox. While the intricacies of such a cooperative effort are time-dependent, it brings the concept of such a positive symbiotic existence to the fore. Arrangement of cross-border testing between nationally operated sandboxes can accelerate product market penetration and make it more attractive as a business destination.

Some of the proposed aspects to be covered under this cooperative framework are: Circumscribed scope in granting permissions for multilateral trading facilities and securities settlement systems; Limits and safeguards for consumer and investor protection, market integrity, and financial stability; Creation of a harmonized framework from which national authorities can grant exemptions and take alternative measures; Specific permissions to be valid across the European Union for a time-limited period.

GFIN (Global Financial Innovation Network)

This group includes several countries, such as Australia, Abu Dhabi, and the U.K. Some of the other jurisdictions involved are Bahrain, Dubai, Guernsey, Hong Kong, and Singapore. Canada's AMF (Autorité des marchés financiers) and OSC (Ontario Securities Commission), along with twelve other regulators, have proposed the creation of this group for the formation of a single Global Financial Innovation Network (GFIN).

This body aims to foster existing collaborations, speed the process of information sharing, and create easier approach mechanisms for regulators in foreign jurisdictions (BakerMcKenzie, 2020). Better relations would translate to more compatible forms of regulation and thus lead to greater advantages in operation. Some areas of benefit would be new product development, counter-terrorist financing, payments, and financial crime. This framework would allow firms to test their ideas and products across multiple geographies and gain real-time insights. It would also ensure a well-rounded feedback loop, making the products more robust and suited to consumer needs.

Rule-based or principle-based sandbox: pros and cons

There has always been a moral debate regarding the approach to be adopted over any regulation. Two divergent approaches form a part of this paradigm. One is a rule-based approach, and the other is principle-based. The current FinTech market is technology-driven, with innovations fast outpacing existing rules. So, the regulations need to be in tandem and complement growth (Dayal and Narayanan 2021). But, a closer look presents a garbled picture. The FinTech market is highly regulated by rules in India, and that too by multiple agencies. This has driven the market towards a highly contained rule-based regimen (InvestIndia 2021).

Now, let us take a comparative look at the rule- and principle-based approaches. The rule-based approach is highly rule-based in nature and constitution. There is a detailed set of directives set by the regulator and a clear structure for functioning, with explicit functional parameters. This creates a scenario where the companies follow the law in letter but not in spirit. But an inherent flaw in this regimen is its lack of flexibility. So, there is a higher probability of industry changes outpacing regulations. i.e., technological changes outgrowing regulations, as pointed out earlier.

A principle-based approach, on the other hand, is much more flexible. There is a focus on intended outcomes, while parameters, such as laws, measures, and procedures, are left to individual participants of the ecosystem (BakerMcKenzie 2020). Although there is more space in functioning for constituents, it has drawbacks such as inconsistent implementation, uncertainty over the optics of control, and the requirement of high skills for ensuring intended outcomes. A common issue faced by FinTechs is the lack of access to all UPI systems due to strict control on access and KYC rules. This lack of access creates an uneven ground for players and hinders implementation. It is an agreed adage that rules should shadow business models, not vice versa. So, it is well-advised that India adopts a more principle-based approach to regulating FinTech.

Another interesting factor that needs to be considered is culture. All sectors function within a socio-economic space that is well constrained and tempered by culture (InvestIndia 2021). Let us explore this further. India scores relatively low uncertainty avoidance (40) when examined under Hofstede's cultural dimensions (Hofstede Insights, 2021). This index is an indicator of a country's socio-cultural inclinations and makeup, thus serving as an essential tool for businesses in understanding it. This means that culturally India prefers less rule-orientated systems. Flexible structures are more suited for the Indian ecosystem.

Regulatory sandboxes – concluding thoughts

Many countries like France and Germany have adopted regulatory sandboxes with great zeal. On the contrary, one of the early movers like Singapore used sandboxes only as a last resort. It has to be reiterated that Regulatory sandboxes are not a standalone solution. They cannot replace permanent directives or regulatory frameworks. Regulatory sandboxes are enablers, and their application should be targeted and specific. It has to be used as a temporary measure to achieve objectives as a part of a broader policy.

Some recommendations can be suggested for making regulatory sandboxes more effective. There has to be a higher degree of harmony among regulators like RBI, SEBI, and IRDAI to reduce the current system's complexity. There is a need for capacity building with full-time resources. A formal knowledge-sharing platform can accelerate the positive impact of regulatory sandboxes in a country like India. A sandbox, by itself, is not a substitute for an effective and permanent regulatory framework, nor is it a magic bullet.

Sandboxes are a precious tool in the right setting, and they facilitate the industry by providing a broad strategy set. They further empower FinTechs with empirical data. It is vital for countries like India, with a young and burgeoning middles class. A data-centric approach shall ensure higher penetration among the population, thus easing credit requirements and ensuring fluidity in the market. Regulatory sandboxes provide the policymakers with a strategic framework in a highly volatile and risk-laden industry like FinTech. Although not a one-stop solution, it is a stop worth exploring.

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