Point of View

Risk Management by Fintechs

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Foreword

The financial services sector in India has undergone a significant transformation over the last few years. The sector, which has for decades been dominated by big banks and other major financial services players, is witnessing a growing popularity of Financial Technology (Fintech) companies. Not only are the Fintech companies accelerating the pace of innovation but are also partnering extensively with banks and financial institutions to enhance digital service delivery channel and financial inclusion.

Over the last few years, millions of people in India have started using digital payments making mobile banking the most preferred mode of conducting transactions. The increased adoption of cashless mode accelerates the pace at which processes, controls and risk management practices need to be enhanced for smooth functioning of fintech companies and broader financial ecosystem in India.

The regulatory framework for fintech companies in India is primarily governed by the Reserve Bank of India ('RBI'), Securities and Exchange Board of India ('SEBI') and Insurance Regulatory and Development Authority of India ('IRDAI'). The RBI has issued guidelines and regulations to address various aspects of fintech activities such as digital payments, peer-to-peer lending, and online marketplace lending. In addition to the RBI, SEBI and IRDAI also play a role in regulating fintech activities.

To address systemic risks, regulatory framework covers compliance requirements with respect to Know Your Customer ('KYC') procedures, Anti-Money Laundering ('AML') and Combating the Financing of Terrorism ('CFT') guidelines, regulation of financial and insurance intermediaries, data protection and privacy, cybersecurity measures, treating customers fairly etc.

This Uniqus Point of View publication provides a perspective of key regulations that Fintech's need to comply with including risk management practices that such businesses should embrace as they scale up operations.

We sincerely hope you find this enclosed publication informative. We will be happy to participate in any discussions required to provide clarifications on our views enclosed in the attached publication. We look forward to hearing from you.

Thank you.

Yours faithfully

For Uniqus Consultech Inc.

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Fintech – Business Overview

Fintech companies leverage technology to offer innovative financial products and services. They utilize various technologies such as mobile apps, cloud computing and artificial intelligence to streamline and automate business processes including last mile customer delivery.

These platforms allow customers to access financial services anytime and anywhere, often through their smartphones. Fintech companies may offer services such as payments and money transfers, investment and wealth management, lending, and insurance, among others.

Fintech companies focus extensively on enhancing user experience and it is their agility that sets them apart from conventional financial institutions. By leveraging artificial intelligence and data analytics, fintech companies personalize their offerings with quicker turnaround.

Fintech companies have gained significant traction and they continue to disrupt and reshape the financial industry by offering new and convenient ways for individuals and businesses to access financial products and services.

Business Model of Fintech Companies

Fintech companies operate using various business models, depending on the nature of products and services offered along with due consideration of target market being catered to.

Following are some generally used business models of fintech companies:

Collaboration and Partnerships

- Enables traditional banks to leverage the innovative technology and expertise of fintech companies
- Helps traditional banks gain access to new ideas and solutions that can help improve their existing products as well as develop new products
- Fosters financial inclusion

Digital Wallets and Payment Solutions

- Enables users to make electronic transactions quickly and securely
- Facilitates seamless and convenient payments

Peer-to-Peer (P2P) Lending

- Connects borrowers directly with lenders through an online platform
- Eliminates the need for traditional financial intermediaries
- Streamlines the lending process by providing quicker loan approvals at competitive interest rates

Robo Advisory

- Offers automated investment advice and portfolio management to clients based on algorithms and machine learning
- Enhances efficiency and scalability for fintech companies by automating repetitive tasks and routine portfolio management
- Provides greater accessibility and convenience to clients

Regulations governing Fintech

Fintech companies in India offer a wide range of financial services including lending, borrowing, investing, insurance etc. through digital platforms. The use of innovative technologies for product or service delivery brings with it potential risks and challenges. The nature of risks includes technological, information security, customer related, compliance, reputational amongst others. Accordingly, regulations governing consumer protection, data privacy, and cybersecurity become very relevant in the context of fintech landscape.

The emergence of fintech has brought about several innovations in the financial industry. However, it also poses challenges for regulators as they strive to maintain a balance between encouraging innovation and achieving the necessary level of oversight on fintech businesses.

Fintech firms often operate in an interconnected environment, which can increase vulnerabilities in areas such as cybersecurity and data protection. Hence, regulators need to establish robust frameworks to safeguard consumer interests, maintain financial stability, and achieve a level playing field for both traditional financial institutions and fintech businesses. and thereby eliminate possibilities of regulatory arbitrage.

Some key regulations applicable to fintech companies in India include:

RBI

The RBI has introduced guidelines such as:

- **Guidelines on digital lending, 2022** - Applies to all the RBI regulated entities and the Fintech platforms that have been engaged by regulated entities to offer digital lending products.
- **Master Direction on Digital Payment Security Controls 2021** - These prescribe that RBI regulated entities such as banks, and credit-card issuing NBFCs must:
    - Have a robust governance framework for digital payment products and services;
    - Implement minimum security control standards; and
    - Conduct risk assessment
- **Master Directions on Prepaid Payment Instruments (PPIs), 2021** - The PPI Directions govern the issuance and operation of PPIs. Some key examples of PPIs include digital wallets, prepaid cards, gift cards, travel cards etc.
- **Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs, 2021** - The SBR provides capital guidelines including internal capital adequacy assessment process (ICAAP), prudential norms and governance standards for different categories of NBFCs in India.

- **Guidelines on Regulation of Payment Aggregators (PA) and Payment Gateways, 2020** - Bank and non-bank PAs handle funds as part of their activities. These guidelines prescribe authorisation process and eligibility criteria for non-bank PAs.
- **Storage of Payment System Data, 2018** - This requires the payment system operators to ensure that entire data relating to payment systems operated by them are stored in a system only in India
- **Master Directions on Non-Banking Financial Company - Peer to Peer Lending Platform (NBFC-P2P), 2017** - NBFC P2P platform acts as an intermediary providing the services of loan facilitation via online medium or otherwise to the participants who want to lend or avail loans.
- **Master Direction - Know Your Customer (KYC) Direction, 2016** - These KYC Master directions aim at:
    - Compliance with KYC , AML, CFT and FATF (Financial Action Task Force) guidelines.
    - Ensuring the integrity of the financial system and preventing illegal activities such as money laundering and terrorist financing.
    - Providing guidelines for opening of accounts by Politically Exposed Persons (PEP)

SEBI

SEBI (Securities and Exchange Board of India) has implemented regulations for listed companies in order to ensure a fair and transparent market for investors.

- **Guidelines on AML Standards and CFT /Obligations of Securities Market Intermediaries under the PMLA, 2002 and Rules framed there under** - These guidelines are aimed at preventing money laundering and terrorist financing activities in the securities market
- **SEBI Listing Obligations and Disclosure Requirements (LODR), 2015** - These regulations focus on enhancing transparency and safeguarding the interests of stakeholders in listed companies
- **SEBI (Investment Advisers) Regulations, 2013** - This regulation applies to fintech companies that provide investment advice or consultancy services to clients. It requires such companies to:
    - Obtain registration with SEBI; and
    - Comply with various obligations, including maintaining a minimum net worth, adopting a code of conduct, and conducting risk assessment and suitability analysis for clients.

IRDAI

IRDAI regulations in the insurance fintech sector broadly govern insurance brokers, web aggregators and corporate agents:

- **IRDAI (Insurance Brokers) Regulations, 2018** - These regulations aim to:
  - Safeguard the policyholder's interest by ensuring that insurance brokers are qualified, registered and licensed
  - Regulates online sales, telemarketing and distance marketing and highlights measures to be followed upon non-compliance
- **Insurance Web Aggregator Regulations, 2017** - This regulation aims to oversee and monitor web-aggregators acting as insurance intermediaries
- **IRDAI (Registration of Corporate Agents) Regulations, 2015)** - This regulation provides a framework with respect to the ownership and control, record keeping, registration, conduct, and operations of corporate agents operating in the insurance business of life insurance, health insurance and general insurance.

The Digital Personal Data Protection Act, 2023

The Act aims to provide a legal framework for the protection and regulation of personal data in the digital space. The Act aims to establish a comprehensive data protection regime that promotes the privacy and security of individuals' personal information. It seeks to ensure that organizations collecting, storing, and processing personal data comply with certain principles and obligations.

The Consumer Protection Act, 2019

A comprehensive legislation aimed at protecting the interests and rights of consumers. This Act includes establishment of Central Consumer Protection Authority ('CCPA') with wide-ranging powers to regulate, investigate, and take action against unfair trade practices, misleading advertisements, and violations of consumer rights. It also provides for the setting up of Consumer Dispute Redressal Commissions at the district, state, and national levels, to provide speedy resolution of consumer complaints.

The Companies Act, 2013

Fintech companies must register under the Companies Act 2013 and abide by all of the Act's laws and regulations, just like any other business in India. They are required to establish and maintain Internal Financial Controls ('IFC'). IFC is crucial to ensure the accuracy and reliability of financial statements, safeguard company assets, achieve orderly & efficient conduct of business and prevent fraudulent activities.

Payment and Settlement Systems Act, 2007

Fintech companies involved in payment systems need to abide by the provisions of this Act.

It covers various aspects including:

- Licensing and regulation of payment systems operators
- Ensuring the safety and efficiency of electronic payment systems.

The Prevention of Money Laundering Act ('PMLA'), 2002

Fintech companies are required to have effective policies, procedures, and controls in place to prevent money laundering and terrorist financing.

Fintech companies need to ensure:

- Conducting thorough customer due diligence, including identification and verification of their customers
- Monitoring and reporting of suspicious transactions and maintaining proper records of these activities

Information Technology Act, 2000

This Act governs data protection and cybersecurity in India. Fintech companies need to ensure compliance with provisions of this Act, such as data privacy, electronic signatures, and prevention of cyber crimes.

Foreign Corrupt Practices Act ('FCPA')

In case of fintech companies in India, having any presence or operations in the United States or if they are listed on a U.S. stock exchange, they may fall under the jurisdiction of the FCPA. This means that these companies need to ensure compliance with the Act and take necessary measures to prevent bribery and corruption.

Foreign Account Tax Compliance Act ('FATCA')

FATCA aims to prevent tax evasion by U.S. taxpayers who hold assets in foreign financial institutions ('FFIs'). Indian Fintech companies may be subject to FATCA if they qualify as FFIs and would be required to perform due diligence on their account holders and report certain information to the Internal Revenue Service ('IRS') about U.S. account holders.

The need to comply with aforesaid regulations necessitates robust compliance and governance mechanisms to operate within the applicable legal framework.

Processes and internal controls for fintech

Fintech firms have disrupted traditional banking by offering new ways for individuals and businesses to manage their finances, including digital wallets, peer-to-peer lending platforms, and online payment services.

In order to mitigate risks arising from use of technology and public money being involved in Fintech landscape, there are necessary regulations in place to avoid non-compliances. Fintech companies typically handle sensitive financial data and transactions, making it crucial to ensure the integrity, confidentiality, and availability of this information.

Implementing strong process and internal controls is essential to ensure compliance with the necessary regulations and smooth conduct of fintech business in India.

In India, the Institute of Chartered Accountants of India ('ICAI') has issued Guidance on Internal Financial Controls over Financial Reporting ('ICoFR') which provides a framework for companies to establish and maintain effective internal financial controls over financial reporting. The guidance note emphasizes the importance of management's responsibility in establishing and maintaining internal controls. It highlights the need for a sound control environment, risk assessment, control activities, information and communication, and monitoring.

Fintech companies, which operate in a technology-driven and rapidly evolving landscape, must embrace an automated internal control environment to keep pace with growth in business.

Some key risks faced by Fintech companies and the risk mitigants thereof include:

Type of risk	Description of risk	Risk mitigants
Operational risk	Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. Fintech companies heavily rely on technology for their operations, making them vulnerable to operational risks such as system failures, cyber threats, and data breaches	• Implementation of cybersecurity and data protection measures to protect sensitive customer data and prevent cyberattacks is pertinent for risk management. This includes employing encryption measures, multi-factor authentication and regular security audits • Implementing segregation of duties, regular monitoring and reviews, and establishing clear approval processes to minimize the risk of errors or fraudulent activities • Having comprehensive business continuity plans including disaster recovery solutions, off-site data backups, and contingency

Type of risk	Description of risk	Risk mitigants
		plans for key operational processes. This can help companies minimize downtime and ensure minimal impact on their customers • Key functions such as customer support, data processing, and cybersecurity if outsourced to third-party service providers introduce additional operational risks as the company becomes reliant on the performance and resilience of these external entities. Effective risk management is necessary to assess the capabilities and reliability of these service providers, establish appropriate contractual agreements, and monitor their performance to ensure seamless operations • Maintaining risk registers documenting and prioritizing risks, assessing their potential impact, and developing appropriate mitigation strategies • Conducting Risk Control and Self- Assessment ('RCSA') enables to identify potential risks and control gaps, evaluate the effectiveness of existing controls, and implement appropriate measures to manage and mitigate risks
Liquidity risk	Liquidity risk refers to the potential difficulty a company may face in meeting its short-term obligations or funding its daily operations	• Operational disruptions, such as system outages or cyber-attacks, can disrupt the normal functioning of fintech platforms, impacting their ability to provide services and access to liquidity. Effective operational risk management enables firms to identify these vulnerabilities, implement appropriate risk controls, and establish contingency plans to ensure uninterrupted liquidity • Having contingency funding plans i.e., securing multiple sources of funding, such as equity investments, debt financing, or even partnerships with traditional financial

Type of risk	Description of risk	Risk mitigants
		institutions will help minimize the impact of any potential liquidity shocks • Establishing liquidity risk policies and procedures, conducting regular stress tests, and monitoring key liquidity metrics
Credit risk	Credit risk arises when borrowers fail to repay loans availed resulting in financial losses to the lender	• By implementing strong credit risk management frameworks including underwriting practices, fintech companies can identify and address credit risk triggers to enhance the overall quality of their loan portfolio
Regulatory and compliance risk	Compliance risk refers to organization's potential failure to comply with laws and regulations that are applicable to its business operations	• Establishing clear policies and procedures that align with the relevant regulations and maintaining ongoing compliance monitoring • Collaboration and engagement with regulators and industry associations actively participate in discussions and forums, sharing insights and best practices. By doing so, they can proactively address compliance challenges and ensure adherence to evolving regulations
Reputation risk	Reputation risk refers to the potential harm to a company's standing and credibility in the market	• Implementing robust KYC processes, adhering to AML guidelines, and establishing a strong corporate governance framework • Proactive communication with regulators and customers on business policies and related practices will help address business exigency situations

In conclusion, robust internal control and risk management framework will play a critical role in the success and sustainability of fintech companies. By establishing effective controls, fintech companies can manage risks, and comply with regulatory obligations. This will help protect fintech start up ecosystem and foster trust in the digital financial services industry.

Key considerations for Board of Directors

Sound governance practices contribute to stability of broader ecosystem and striking the right balance between growth and effective governance. Corporate governance practices embody the dual goals of protecting the interests of all stakeholders while respecting the duty of the Board and senior management to oversee the affairs of a company, ensure accountability, inculcate integrity and promote long-term growth and profitability.

Considering global best practices, the Board of Directors at Fintech companies should consider following guiding principles to enhance risk management:

1. Establish a corporate culture that is guided by strong risk management and that supports and provides appropriate standards and incentives for professional and responsible behaviour
2. Oversee senior management to ensure that the policies, processes and systems are implemented effectively at all decision levels
3. Approve and review a risk appetite and tolerance statement for operational risk that articulates the nature, types, and levels of operational risk that the company is willing to assume
4. Ensure the identification and assessment of operational risk inherent in all material products, activities, processes and systems is carried out so that inherent risks and incentives are well understood and periodically monitored
5. Implement business resiliency and continuity plans in place to ensure an ability to operate on an ongoing basis and limit losses in the event of severe business disruption
6. Acknowledge and address all regulatory feedback in a time bound manner

In conclusion, risk management comprising financial and non-financial risks is crucial for fintech companies to achieve orderly and efficient conduct of business. By implementing effective risk management practices and controls, fintech companies can enhance their operational resilience, reduce the probability of operational disruptions, and improve their ability to manage shocks.

A TEAM THAT
YOU CAN TRUST TO DELIVER

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