A ‘regulatory lab’ for financial inclusion

In a recent report, the Reserve Bank of India's (RBI) household finance committee found the average Indian household keeps just 5% of its wealth in financial assets. Most is held in real estate and gold. When borrowing, Indian households are nearly as avoidant of formal financial services. In times of emergency, half of households turn to family, friends and moneylenders.

The July 2017 report, “Indian Household Finance”, found many barriers to participating in the formal financial system. While some of these barriers are cultural, such as low trust in financial institutions, many are supply-side frictions. Banks’ “one-size-fits-all” products don’t account for the complexity of Indians’ financial lives, and transaction costs are high.

While Indians’ low participation in the formal financial sector is unusual compared with households in other countries, these supply-side frictions are not. Globally, technological innovation is bringing more customized solutions to market for underserved households. Used in new and creative ways, technology can reduce supply-side frictions by lowering costs, enhancing trust, and improving access at a massive scale.

For example, a financial technology (fintech) model that has proven successful in many markets is personal credit based on alternative data sources. Advanced analytics and mobile platforms enable providers to make small-ticket loans to first-time borrowers with no previous credit score. Another fintech model, robo-advisors, helps consumers manage small portfolios with tailored advice at low cost.

Regulatory barriers to innovation

While innovation is thriving in India with an active fintech landscape, regulators need to keep pace with the brand-new business models that are rapidly emerging. The RBI has been proactive in developing new regulations, such as differentiated licences for new categories of banks, conducting pilot tests before stipulating new limits on digital transactions, and publishing a white paper on blockchain technology in banking. Yet, some regulatory barriers need to be addressed to allow these new solutions to proliferate and scale.

Fundamentally, existing regulations are not designed for fintech products. For example, many banking regulations are written for branches, but the definition of a “branch” is quickly becoming limited. The long, drawn out policymaking consultation process is cumbersome for new entrants, such as person-to-person (P2P) digital lending platforms. Overall, regulatory uncertainty hampers attempt to scale, especially when new products might fall under multiple jurisdictions. For example, it’s unclear which authority would have oversight over a savings-cum-insurance product delivered via mobile.

Safe zone for innovation

The July report offers several recommendations for fostering the introduction of more customized financial products to meet Indian households’ complex needs. The report calls for a more flexible regulatory process to encourage more financial innovation. One promising recommendation is to set up a “regulatory sandbox” to allow innovators to test new products and services in a controlled, yet live, environment.

A sandbox, or perhaps more appropriately a RegLab, is a safe zone where regulators facilitate small-scale roll-outs of new products to real customers without serious risks to consumers or financial stability. Usually, regulators impose a variety of security and customer safeguards on

companies participating in a sandbox, including enhanced disclosures, dispute resolution programmes, and customer compensation plans.

In addition, through the testing process and the empirical evidence gathered therefrom, a sandbox could facilitate proactive policymaking and remove some regulatory uncertainty. Regulators in countries like the UK, Singapore and Australia are using sandboxes to evaluate the risk of new products and technologies.

As described in a recent report by the Aspen Institute's Financial Security Programme, the widespread interest in sandboxes has "exposed an underlying demand for a different approach to financial regulation—one that embraces a greater role for regulatory collaboration in the innovation process". Learnings from the sandbox allow regulators to not only keep pace with financial innovation, but stay ahead of the curve. That way, insights from the sandbox inform changes in market-wide regulation, opening the doors to even more innovation and competition, not just sandbox participants.

Test and learn

The challenge of increasing usage of formal financial services is daunting. Technology offers a means to deliver financial services directly to consumers in a much more frictionless manner. However, technology is evolving fast, and regulators need a more efficient approach to understand new models, protect consumers, and ensure the stability of the financial system without choking off innovation.

To harness the power of financial innovation, regulators must move away from the drawn out consultation and white paper-based process, to a "test-and-learn" approach. A regulatory sandbox provides a platform for testing, learning, and adapting—striking the right balance between fostering cutting-edge innovation and the policy objectives of stability and inclusion.

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