ILLUSTRATION: AJAY MOHANTY

The new fault lines

Fintech promoters, their private equity backers, and regulated entities that have teamed up with new-age firms will need to go back to the drawing board, reports **Raghu Mohan**

Marquee financial firms have of late been at the receiving end of the Reserve Bank of India's (RBI's) displeasure. MasterCard International, American Express and Diners Club International were barred from on-boarding new customers for non-compliance with data-localisation norms (Diners is now back in business). And in December 2020, HDFC Bank was prohibited from launching new digital products — a restriction that was lifted only last month.

Will fintech firms' governance standards, their arrangements with RBI-regulated entities (banks and non-banking financial companies), and the role of private equity (PE) firms also attract stricter scrutiny? That time may well be upon us.

The setting

"New fault lines are opening up. This will impact fintechs and PEs in the larger financial ecosystem," says Romesh Sobti, former managing director (MD) and chief executive officer (CEO) of IndusInd Bank.

Of late, the emphasis has also been on related-party transactions. "Assume a situation where a PE has invested in a fintech, which also has a relationship with a bank for generating business. This may fall under the ambit of a related-party deal. It can't be business as usual," Sobti adds.

What he calls attention to mirrors the standards in bank boards. An independent director (who is a promoter of a company), or a whole-time director on the board of a bank can't have a lending relationship with that bank. It may not be business as usual on first-loss default guarantees (FLDGs) as well — the amount offered by digital platforms (or other unregulated entities) as guarantee to regulated lenders on whose behalf they source business. The RBI is said to be taking a fresh look at how FLDGs are structured — many are issued by unregulated, non-rated entities, and ride on PE capital.

The central bank may well insist that only regulated entities can issue FLDGs, and this can turn the buy-now-pay-later (BNPL) business — for one — on its head. And, so too, for PE investments in such firms.

L'affaire Ashneer Grover at BharatPe couldn't have cropped up at a more delicate time — soon after the RBI had issued a small finance bank (SFB) licence to Centrum Capital for Unity SFB. BharatPe holds 49 per cent in the bank. Centrum's chairman, Jaspal Bindra, has allayed fears that this messy boardroom battle has nothing to do with the bank, but it continues to worry Mint Road.

The arrangement had been put in place after the fiasco at the Punjab and Maharashtra Urban Co-operative Bank, and many reputations rode on it. After what transpired at BharatPe, a mechanism that will make fintechs' functioning more transparent may be in the offing.

The tanking of Paytm parent One97's share price by nearly 75 per cent after listing has sent many fintechs' ambitions off the rails. The Securities and Exchange Board of India is to revisit the capital float norms for startups, and an insistence on a three-year dividend-paying record ahead of a public offering could be back on the discussion table.

It has also come to light that Paytm Payments Bank has yet to comply with the RBI directive to appoint an audit firm for IT processes, a fact stated in the Lok Sabha by the minister of state for finance, Bhagwat Karad, ten days ago. If an audit issue at a private firm figures in Parliament, clearly, it's bad optics for fintechs.

Incidentally, the turbulence at both BharatPe and One97-Paytm coincided with RBI setting up a dedicated department for fintechs this January, a move seen by many as a first step to mainstreaming them.

RBI in the picture

At the policy level, the banking regulator is set to act on the feedback it has received on the *Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps*. Its recommendations will act on three levels: RBI-regulated entities; other regulated and authorised entities; and unregulated entities, including third-party service providers functioning in the digital financial realm. Leading PEs may have cottoned on to what's around the corner.

"Chasing both growth and governance need not be a zero-sum game. Governance failures can happen in low-growth situations as well," says Gopal Jain, co-founder and managing partner at Gaja Capital. He "prefers serial entrepreneurs whose experience makes them more amenable to making the right choices early on."

The main thrust of Mint Road would be to protect the integrity of the system against entities that are not regulated and not authorised to carry out lending activity. It is to ensure "orderly growth in the digital lending ecosystem without it being unduly disruptive towards the existing players in the ecosystem," the report of the working group said. Simply put, words like "disruption" can no more be bandied about, and fanciful ideas espoused by fintechs and their backers will have to be consigned to the bin.

Flow from the tap

According to the KPMG report *Pulse of Fintech H2 2021*, total global fintech funding — across PE, venture capital and mergers and acquisitions — was $210 billion in a record 5,684 deals in 2021. Of this, H2 2021 accounted for $101 billion — down from H1 2021's $109 billion. Payments attracted the most funding at $51.7 billion globally in 2021, up from $29.1 billion in 2020.

A continued surge in interest in areas like BNPL, embedded banking, and open-banking-aligned solutions has helped keep the payments space robust, the report noted. India, too, rode the mood — Vastu Housing Finance raised funding of $200 million; Netherlands-based Prosus has announced it will acquire payments platform BillDesk for $4.7 billion; and Australia-based BNPL firm Zip acquired a minority share in ZestMoney. Will the good times last?

Geopolitics and the switch in the global interest-rate cycle will need watching. Influential names can put a damper on the outlook on fintechs, too. A report in the *Financial Times* a fortnight ago has it that SoftBank founder Masayoshi Son recently told the group's top leadership to go slow on technology investments, owing to the crash in its holdings.

Worse, it is being suggested that fintechs and PE firms have a vested interest in talking up valuations ahead of a listing, and that this excessive focus on growth from inception fosters a culture of undue risk-taking, which continues even as firms grow in size.

"Being privately held with a close set of involved investors is widely different from being publicly listed, and the shift in behaviour, communication, and expectations requires different governance structures," observes Amit Tandon, founder and managing director of Institutional Investor Advisory Services, the country's largest proxy advisory firm.

Despite all the turbulence, Niyo, a consumer neo-banking platform, raised $100 million in series-C funding in February this year (over and above the $50 million mobilised earlier). The firm will use this to fast-track its foray into asset-side businesses over time.

"I understand that governance, when applied to shadow banks — or anyone who is an avid player — could be slightly different. But for us, governance basically means that it's more on the risk and the compliance side of it, as applied to our partner banks. I think we are fairly and adequately covered on that front," explains Virender Bisht, Niyo's co-founder and chief technology officer.

As for PEs pushing an unhealthy investor-return culture, "all I can say is that this appears to be more of an ideological position — something like, is capitalism good?" quips Rahul Bhasin, managing partner of Baring Private Equity Partners (India). "Every investor has a returns horizon and is judged on those returns."

He underscores an aspect that regulators could well be working on. "You can't expect PEs to know the minutiae of everything...the entrepreneur might be fit and proper at the time of investment, but may subsequently start to act differently." It is an oblique way of suggesting that PEs are indeed concerned about their investments, and by extension, their exit options.

Looking within

Nearly two years ago, Mint Road unveiled strict guidelines for private banks, which prohibited CEOs from being on the nomination and remuneration committee, the audit committee, and the risk management committee — only non-executive directors are eligible. Going by the RBI working group's report on digital lending, it would not be farfetched to deduce that some of the bigger fintechs that collaborate with regulated entities may be subject to similar ground rules. Is this desirable and practical?

"As a founder, let's say I'm not on the compensation committee, or on the internal audit committee. But without my approval, nothing will go through, anyway. It's unlike a professionally-managed large multinational," points out Nirav Choksi, co-founder and CEO of Credable. "These things look good on paper, but it's the founders' intentions that matter, not a corporate governance framework."

That said, the changes that are underway will fundamentally alter the way fintechs go about hiring key personnel. "Strengthening regulation will spur demand for risk and compliance experts, especially those who have prior experience of dealing with the regulator," says Ankit Bansal, founder and CEO of Sapphire Human Solutions. Dealing with the RBI's newly set up fintech department will be unlike making presentations to PEs, and a few firms are expected to come up to offer regulatory consultancy.

This leads us to the larger opportunity which is set to open up for PEs in private banks. Of the 21 recommendations accepted by the RBI from its *Report of the Internal Working Group to Review Extant Ownership Guidelines and Corporate Structure for Indian Private Sector Banks*, the stance on non-promoter holdings in private banks has stirred excitement.

Though it doesn't explicitly refer to PE firms, non-promoter holdings in these banks are to be capped at 15 per cent of the paid-up voting equity share capital "for all categories of financial institutions, entities, supranational institutions, public sector undertaking, or the Government."

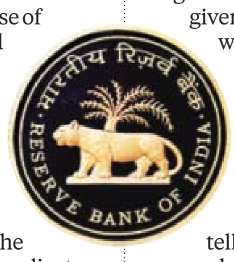
This larger role for PEs in private banks may be determined by the kind of governance standards they have enforced in fintechs. It's highly unlikely that a PE that has been involved in a public spat with a fintech promoter will get the regulatory nod to acquire a stake in a private bank.

Fintech promoters, PEs backing them, and regulated entities that have teamed up with new-age firms may need to go back to the drawing board.

THE CENTRAL BANK SET UP A DEDICATED DEPARTMENT FOR FINTECHS THIS JANUARY, A MOVE SEEN BY MANY AS A FIRST STEP TO MAINSTREAMING THEM

The view from Mint Road

The fintech landscape can be described in Dickensian terms — we are in the best of times, with the promise of technological innovation in finance and hope of substantial efficiency gains, better customer experience and greater social welfare", RBI deputy governor T Rabi Sankar said in a speech on September 28, 2021, on the subject, "Responsible Digital Innovation". He added: "But, we also need to deal with the threats of online frauds, compromise of customer credentials and data privacy and safety for the spring of hope not to turn into the winter of despair".



He also referred to a sobering aspect: "As fintech is transforming the financial landscape, the nature of regulation has to adjust. The sheer diversity in the functions performed by fintech firms necessitates a widening of the regulatory perimeter." Less than two months after this speech came the Working Group's report on digital lending, which says a lot about the RBI's concerns on the sector.

So, what can you expect?

Collaboration between fintechs (which have so far seen "light-touch" regulation) and legacy regulated entities will have stricter oversight. PE firms will have to look at fintechs afresh, and chasing high valuations at the cost of good corporate governance will not work anymore. A slip-up by PEs on this front may also impact their interests in the larger financial services domain, given that an RBI internal working group has made a case for a greater role for them in private banks (though this has not been explicitly stated) by allowing them an equity stake of up to 15 per cent.

And here's another telling bit from Sankar's speech to ponder: "It's virtually impossible for legislation to keep in step with the fast mutating fintech landscape. Until legislation catches up, regulation has to adapt to ensure that the financial system absorbs digital innovation in a non-disruptive manner."

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