FINTECH SANDBOXES

Need of the Hour?

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- *In a study, it was found that fintech firms in the UK sandboxes show increased fundraising and higher survival rates.*
- *Younger and smaller fintech companies benefit more from sandbox participation.*
- *In India, RBI's regulatory sandbox has shown promising results with successful exit of several fintechs.*

Fintech start-ups, while pioneering innovation, grapple with stringent regulations and create a discord between novel services and existing laws. This issue, coupled with the sustained downturn in start-up funding throughout 2023, has exacerbated the challenges of fundraising. With a steep funding drop of 44%[1] in the last year, fintech companies face the dual hurdles of regulatory compliance and financial constraints, impeding innovation and market expansion.

The Regulatory Sandbox emerged as a solution, offering fintech companies a controlled environment to test new products with possible regulatory reprieves[2]. This platform not only safeguards consumer interests and maintains market integrity but also enables start-ups to navigate the regulatory framework efficiently, reducing the risk of innovation, fostering resilience in the face of reduced funding, and allowing them to adapt and thrive amidst the evolving financial landscape.

INSIGHTS FROM THE UK'S SANDBOX EXPERIENCE

The paper titled **Regulatory Sandboxes and Fintech Funding: Evidence from the UK** published in the **Review of Finance in 2023,** evaluates the impact of the first regulatory sandbox established by the United Kingdom's Financial Conduct Authority (FCA) on fintech companies' capability to secure funding and the associated tangible outcomes.

The study used comprehensive funding data sourced from the Pitchbook database at the deal level of 106 fintech companies under five cohorts of the FCA sandbox between 2014 and 2019. A random sample of more than 1,400 non-sandbox fintech firms was used for comparison.

Highlights of the study:

1. **Improved chances of fund-raising:** Fintech companies that entered the sandbox saw an increase in the amount and probability of fund-raising. In firm-level regressions, authors found that entering the sandbox is followed by a 15% increase in capital raised over the following two years, relative to fintech companies that entered the sandbox later. The probability of raising capital increased by 50%. The sandbox helps reduce information asymmetries between investors and firms, making it easier for fintech firms to access capital and attract investors.

2. **Higher survival rates:** Fintech companies that enter the regulatory sandbox in the UK have higher survival rates than those not enter the sandbox. The average proportion of sandbox firms still in operation is approximately 75%[3], whereas that of non-sandbox firms is approximately 60%. This indicates that sandboxes help fintech companies survive and continue their operations. Fintech firms in the sandbox are more likely to have patents granted than firms that do not enter the sandbox.

3. **Opportunity for younger firms:** The empirical analysis shows that the positive effect of entering a regulatory sandbox on capital raised is stronger for smaller and younger fintech companies. Fintech companies, which are typically more opaque and face greater informational friction, experience greater increase in funding after entering the sandbox.

[1] Inc42 (2023). Indian Tech Startup Funding Report Q3 2023
[2] RBI (2019). Draft Enabling Framework for Regulatory Sandbox
[3] As of 2021

4. **Rise in venture capital funding:** This study shows that entering the regulatory sandbox in the UK is associated with a significant increase in the amount of capital raised by fintech companies, particularly in the form of venture capital funding.

Thus, the UK's regulatory sandbox experience seems to indicate that it improves fintech's access to capital, chances of survival, and opportunities to enhance innovation.

IMPLICATIONS FOR INDIA

In India, regulatory sandboxes are recent phenomena. The first regulatory sandbox in India was established by the Reserve Bank of India (RBI) in 2019 based on thematic cohorts. SEBI and IRDAI have also launched regulatory sandboxes. Since its rollout, the RBI has released five cohorts under themes of retail payments, cross-border payments, MSME financing, prevention and mitigation of financial frauds, and theme neutral. These cohorts have been instrumental in testing and validating new financial products within the specified themes.

As of October 2023, out of 22 fintechs selected for testing under the first 3 cohorts of the sandbox, 15 have exited with their product deemed as "may be considered for adoption by Regulated Entities subject to compliance with applicable regulatory requirements"[4] (Table 1).

Table 1: RBI Regulatory Sandbox Cohort Status

Cohort	Theme	Number of Applications	Selected	Exited Successfully
1	Retail Payments	32	6	6
2	Cross-Border Payments	27	8	4
3	MSME Financing	22	8	5
4	Prevention and Mitigation of Financial Frauds	9	6	Undergoing Testing
5	Neutral	Announced	-	-

Source: RBI Press Releases

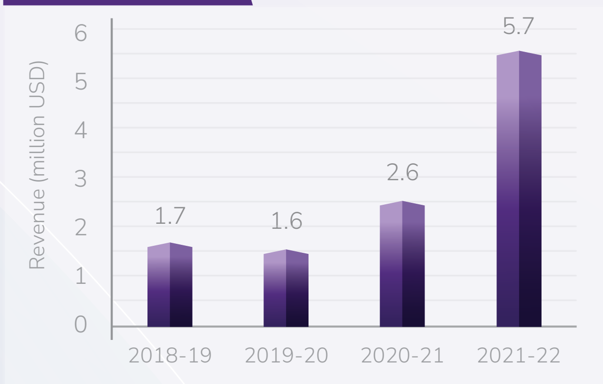
While it is premature to evaluate the sandbox design, post-sandbox capital influx and market success of the products, the successful completion of the sandbox phase does vouch for the product's feasibility and adherence to regulatory standards. Of the six fintech companies that completed Cohort 1, half of them demonstrated growth as shown in Figure 1(a). This growth is evident in both revenue and employee numbers, which have steadily increased since 2020 for these three firms.

[4] RBI Press Releases

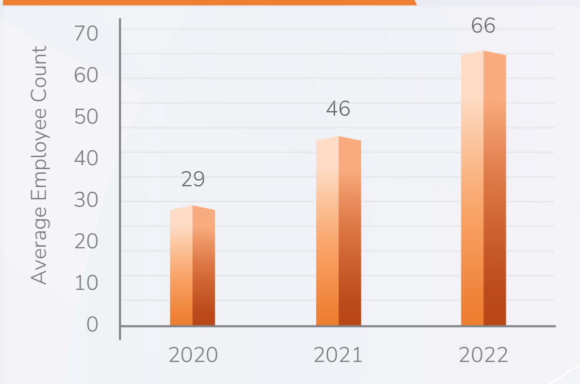
Figure 1(a)

Ubona Technologies Pvt. Ltd. (BHIM Voice)

Revenue Growth

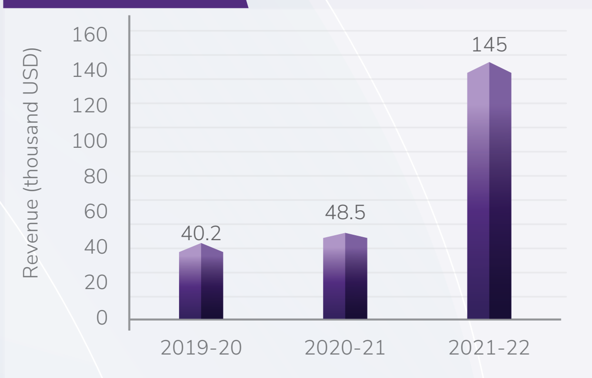


Average Employee Count



Eroute Technologies Pvt. Ltd.

Revenue Growth



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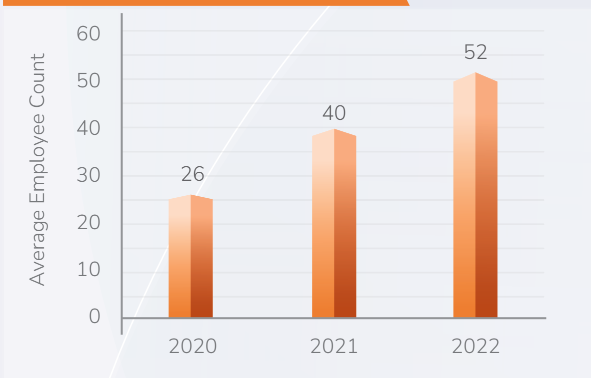
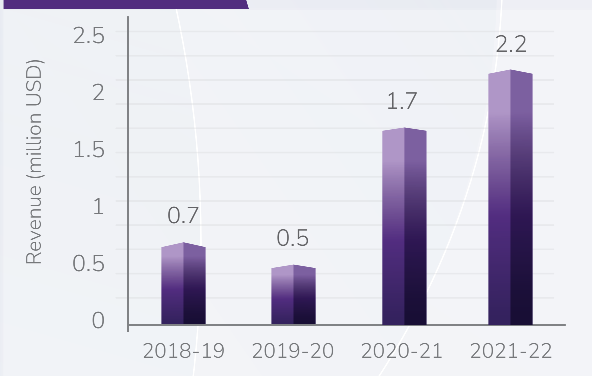
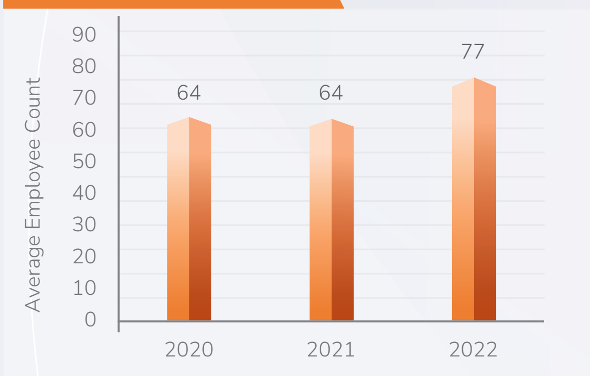


Naffa Innovations Pvt. Ltd. (ToneTag)

Revenue Growth



Average Employee Count

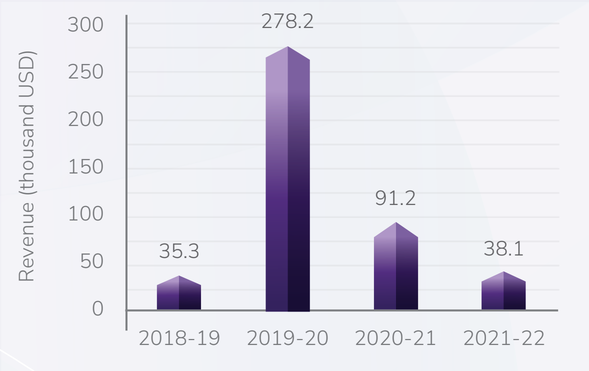


Source: Tracxn.com

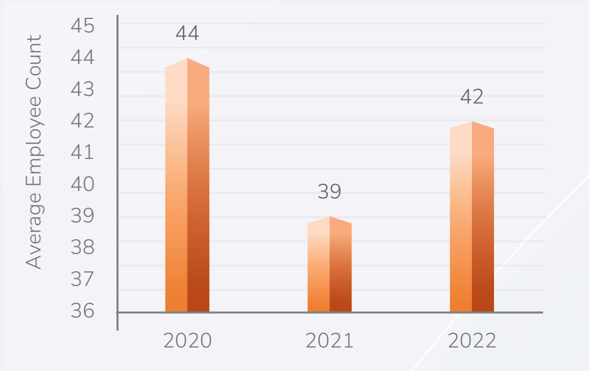
Figure 1(b)

Tap Smart Data Information Services Pvt. Ltd. (CityCash)

Revenue Growth

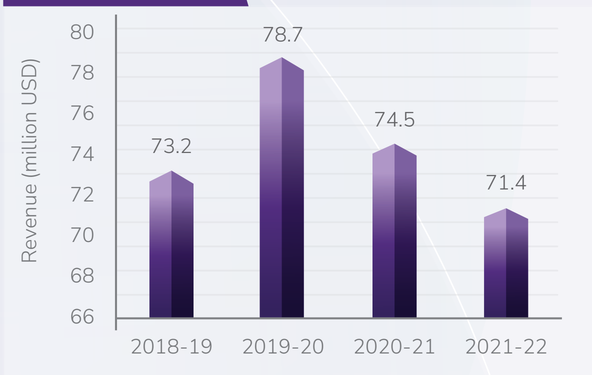


Average Employee Count

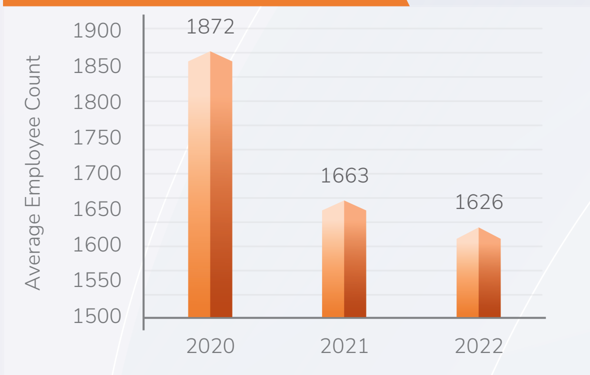


Nucleus Software Exports Ltd. (PaySe)

Revenue Growth

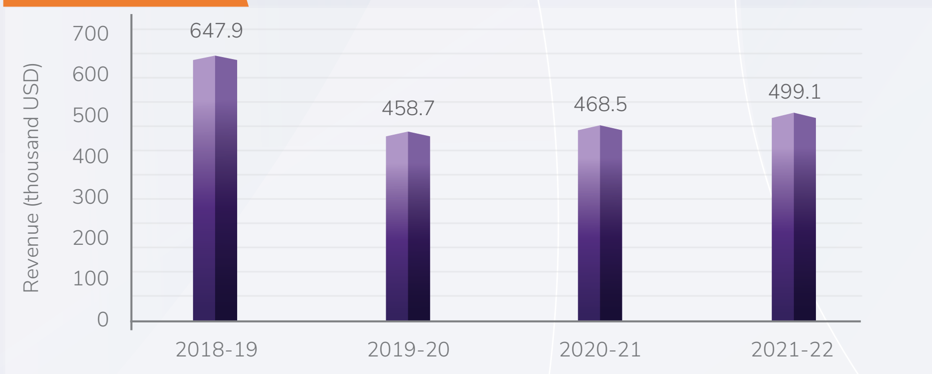


Average Employee Count



Natural Support Consultancy Services Pvt. Ltd. (IND-e-Cash)

Revenue Growth



Source: Tracxn.com

Start-ups often heavily rely on investments, particularly equity financing and venture capital. Regulatory uncertainties throughout the product development cycle can make it challenging for innovators to secure the necessary capital, potentially hindering the launch of novel products. This uncertainty can also lead to reduced company valuation, with investors weighing the risks stemming from regulatory ambiguities. However, based on the UK experience, the introduction of a regulatory sandbox can alleviate these challenges, offering start-up founders clearer paths to funding, as it demonstrates product viability and regulatory compliance. Better access to capital and regulatory compliance also ensure an improved survival rate for these businesses, which is in line with the results of the above research.

Sandbox(es) would also benefit both domestic and foreign investors by reducing the uncertainty surrounding regulatory approval of new financial products and services. This would mitigate the risk of investing in companies that may face regulatory challenges or fail to receive authorisation for their products, thus providing investors with a clearer understanding of the potential return on their investments and a more secure environment for their capital.

Regulatory sandboxes will also help the RBI, SEBI, and IRDAI to understand new technologies and their market implications. They should be able to develop appropriate regulations that can accommodate emerging business models without stifling innovation; identify and manage potential risks associated with new financial products or services before they are widely adopted; foster dialogue with fintech companies to ensure consumer protection and financial system integrity; and stay updated with the evolving financial landscape to better shape future policies and regulations.

Conclusion

The UK's regulatory sandbox has proven beneficial, allowing fintech companies to attract more funding, demonstrate viability, and increase survival rates. These positive outcomes indicate the potential advantages of similar frameworks in India, where sandboxes can foster innovation and ease access to capital. Despite this, with the novelty of sandboxes in India and a dip in cohort applications, it is premature to consider them a panacea.

Marking a significant advancement, the introduction of the interoperable regulatory sandbox (IoRS) in 2022 was a positive step forward. The RBI, SEBI, and IRDAI manage their own regulatory sandboxes. Entities interested in participating have to individually engage with each relevant regulator for sandbox testing. This approach poses challenges when testing innovations that span the jurisdiction of multiple regulators. Therefore, an IoRS was introduced to test these products. The IoRS aims to streamline this process, allowing more efficient testing of such products.

Moving forward, India should focus on the expansion and integration of more sandboxes within its innovation ecosystem, aligned with incubators and accelerators, to foster greater collaboration and technological advancement.

REFERENCES

1. Inc42 (2023). Indian Tech Startup Funding Report Q3 2023
2. RBI (2019). Draft Enabling Framework for Regulatory Sandbox
3. Cornelli, G., Doerr, S., Gambacorta, L., & Merrouche, O. (2023). Regulatory sandboxes and fintech funding: evidence from the UK.*Review of Finance.*