

CHAPTER 1

# Accounting considerations for entities in FinTech sector

**This article aims to:**

Provide an overview of the key financial reporting and accounting considerations for the entities in the FinTech sector in India.





## Introduction - FinTech in India

FinTech stands for 'Financial Technology' and is described as technologically enabled financial innovations.

The Financial Stability Board (FSB) of the Bank of International Settlements (BIS) has provided the following definition of FinTech.

'FinTech is technologically enabled financial innovation that could result in new business models, applications, processes, or products with an associated material effect on financial markets and institutions and the provision of financial services'

Indian FinTech sector is experiencing a strong exponential growth in recent times. The past decade has witnessed high growth in the payment system, which has fostered economic development and financial stability<sup>1</sup>.

This sector has attracted massive investment from large venture capital and private equity firms. The FinTech companies have capitalised on the rising demand for digitisation of financial services during COVID-19.

The role of Reserve Bank of India (RBI), being the regulator, has transformed to create a platform for development of the payment ecosystem in India.

FinTech companies are redefining the way companies and consumers conduct transactions by offering a wide range of financial products and services and promoting financial inclusion. A majority of the FinTech companies have been focussed on enhancing the user experience through use of smart interface and Application Program Interface (APIs), which are linked to RBI's regulated entities such as banks, Non-Banking Financial Companies (NBFCs) and financial institutions. Such tie-ups between FinTech companies and the RBI's regulated entities are majorly governed by outsourcing guidelines issued by RBI.

With the primary focus of the FinTech entities in India being on raising capital and accelerated growth through innovative solutions, it is important to understand some of the key financial reporting and accounting considerations for common transactions entered into by FinTech entities in India:

### 1. Accounting for arrangements in the nature of First Loss Default Guarantees (FLDG)

FLDG is an arrangement whereby a third party compensates a lender if the borrower defaults. In an FLDG setup, the credit risk is borne by the Loan Service Provider (LSP) i.e. the FinTech company. The FLDG model was primarily introduced by

FinTech companies to tap into a market that traditional lenders would not be able to access.

An FLDG transaction, sometimes involves a 'guarantee' given by the FinTech entity to the partnering bank/NBFC. This quantum of guarantee is generally substantially higher than the actual loss that could be incurred by the bank/NBFC in case of a default by a customer. Therefore, the transaction would need to be carefully assessed under the principles of Ind AS 109, *Financial Instruments*. As per Ind AS 109, when an entity transfers a financial asset, it requires it to evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. Such an arrangements would be evaluated under the derecognition principles of Ind AS 109.

Where the FinTech has retained substantially all the 'risks and rewards' of the portfolio of assets being guaranteed, the FLDG structure may warrant recognition on the balance sheet both a loan receivable from borrower (customer) and borrowing

from the RBI's regulated entity (partnering bank/NBFC).

On recognition of the loan receivable from the borrower and related interest income, the FinTech company would also have to carefully evaluate its assets and the income pattern. The company could be considered and required to be registered as an NBFC, as per the press release issued by RBI vide No. 1998-99 1269 dated 8 April 1998 if its financial assets are more than 50 percent of its total assets (netted off by intangible assets) and income from financial assets is more than 50 per cent of the gross income.

The FinTech company would also be required to assess impairment under the principles of Ind AS 109 on the loan receivables recognised on the balance sheet.

1. RBI's vision document - Payments Vision 2025 dated 17 June 2022





## 2. Regulatory implications arising out of RBI's digital lending guidelines

RBI has issued the 'Guidelines on Digital Lending on 2 September, 2022 (DL Regulations). These guidelines apply to all entities regulated by the RBI (regulated entities) and the FinTech platforms or lending service providers/Digital Lending Applications (DLAs) that have been engaged by regulated entities to offer digital lending products. The guidelines have significantly impacted the lending industry, particularly for models which leverage the use of pool/or pass-through accounts, Buy-Now-Pay-Later (BNPL), and co-lending models.

### Consequential implications of the guidelines for FinTech companies

**a. DL Regulations:** The DL Regulations state that in case of financial products involving contractual agreements such as FLDG in which a third party guarantees (in this case FinTech company) to compensate up to a certain percentage of the default in a loan portfolio of the RBI's regulated entities, then it must comply with the securitisation guidelines. This means that a provision relating to synthetic securitisation (which means a structure where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of credit derivatives or credit guarantees that serve to hedge the credit risk of the portfolio which remains on the balance sheet of the lender (bank/NBFC)).

As per the securitisation guidelines, the RBI's regulated entities are not permitted to undertake synthetic securitisation transactions. Where such transactions have been undertaken by the RBI's regulated entities, besides regulatory action, they are also subject to a 100 per cent capital charge<sup>2</sup>.

While the restrictions are still unclear and additional clarity is expected on the topic, if the intention of the RBI is to restrict such FLDG transactions, the most impacted are expected to be new-to-credit borrowers which obtained loans from banks and NBFCs via the FinTech entity using the FLDG model. The FinTech company has the primary responsibility of evaluating the borrower and quality of the loan portfolio. Therefore, from the lender's perspective this model ensures that the lending service providers and FinTech companies have skin in the business. In simple terms, the credit risk is borne by the FinTech company with no requirement to maintain any regulatory capital and the RBI's regulated entity benefits from minimum cost incurred for the loan origination.

According to the RBI, regulation of FLDGs is still under consideration. However all FLDG structures are required to comply with Master Directions – RBI (Securitisation of Standard Assets) Directions, 2021.

<sup>2</sup> Capital charge is more formally expressed as a Capital Adequacy Ratio (CAR) that is required by RBI to be maintained by lenders. The CAR is a measurement of a lender's available capital, shown as a percentage of a bank's risk-weighted credit exposures. The reason is to protect the depositors and make sure a bank or an NBFC can absorb a reasonable amount of loss without being at risk of insolvency.

**b. Buy Now Pay Later (BNPL):** BNPL is a short-term financing arrangement that allows consumers to buy a product or use a service, without paying for it upfront. BNPL arrangements are similar to an unsecured consumer loan where in many cases interest or fees are not charged and easier to get approved than other traditional lines of credit. This financing arrangement is usually given at the Point of Sale (PoS), or in other words when the consumer 'checks out' the shopping cart.

RBI in its DL Regulations has prescribed that all funds flowing that relate to loan servicing, disbursement and repayment must be done directly between the bank account of the lender and borrower, without any pass-through or pool account of any third party. However, the DL Regulations have provided the following exceptions for disbursements:

- i. Disbursements covered exclusively under statutory or regulatory mandate (of RBI or of any other regulator), flow of money between regulated entities for co-lending transactions; and
- ii. Disbursements for specific end use, provided the loan is disbursed directly into the bank account of the end-beneficiary.

Therefore, some digital lending structures may still be allowed including BNPL, supply-chain financings, consumer durable financing, etc. where the end use is specified and provided that the disbursement of the loan amount is made directly in the bank account of the end-beneficiary, and not routed through any third-party pass through or pool account, including the accounts of the LSPs and their DLAs. This area needs careful evaluation based on facts and circumstances of the arrangement.

BNPL models which were working on disbursement to Prepaid Payment Instruments (PPIs) like prepaid cards or mobile wallets are nevertheless impacted, given the DL guidelines require disbursements directly to the 'bank account' of the borrower. However, FinTech companies would need to evaluate new models and fund flow structures in line with the DL regulations.

Additionally, due to these guidelines, the role of financial intermediaries such as account aggregators, payment aggregators, marketplace lenders and LSPs is likely to undergo a significant change with regard to their business models and strategies. These guidelines are likely to lead to reassessment of the terms of the agreements between regulated entities and LSP, changes in group structures and reconsideration of revenue generating models.



### 3. Accounting for shareholders' transactions

Investors invest in FinTech companies using a variety of instruments and one of the most common ways to invest is equity shares or convertible preference shares. Generally, these convertible preference shares allow the investors to convert at a future date based on an agreed ratio. In certain cases, the conversion or settlement options are linked to future business performances, providing an exit to the investor e.g., an Initial Public Offering (IPO) event, or any other event agreed at the time of the investment. Such options may contain an unconditional obligation to deliver cash or another financial asset or contain rights to convert into variable number of equity shares.

Accounting for such instruments particularly from a classification perspective under Ind AS 32, *Financial Instruments: Presentation* can be quite complex. Features such as put options or buy back arrangements additionally add to the complexity.

The measurements of such instruments depend on their classification as either an equity instrument or a liability or potentially an embedded derivative. Many FinTech companies attract private equity/venture capital funding and therefore, it is important to understand the impact of accounting for instruments issued to them under Ind AS. FinTech companies should carefully assess detailed terms of each agreement relating to transactions with shareholders to evaluate the appropriate classifications and measurement.

### 4. Revenue recognition

FinTech companies generally have an online platform which is used to provide services of a wallet facility to the end user for purchasing goods or services of merchants such as spending on e-commerce apps/websites, shopping at physical retailers including mom & pop shops, paying electricity, mobile recharge, broadband and credit card bills, transferring money to the bank, etc.

In return for this facility, a FinTech company charges a percentage of commission on the transaction value from merchants. Further, as part of these arrangements, FinTech companies provide discounts, cash back, credits, price concessions, incentives as part of their promotional activities on using the wallet facility. On the other hand, a convenience charge fee may also be charged to end users for providing the wallet facility.

Such kinds of transactions need to be carefully evaluated under the principles of Ind AS 115, *Revenue from contract with customers*. Key areas of evaluation would include whether such cash back and incentives provided are to be assessed under variable consideration or consideration payable to a customer and therefore, reduced from revenue of the FinTech company; are these incentive transactions distinct from the commission revenue earned; would they be considered as promotional expense instead?

Taking into account the innovative incentive schemes introduced by the FinTech companies on a periodic basis, each transaction would need to be separately and carefully evaluated considering the respective terms and conditions.

### Conclusion:

With the growing number of FinTech products in the market, level of innovations and change in regulations governing these entities, it is critical to assess and evaluate new business models that may potentially have a large impact on the statement of profit and loss on a timely basis. At the same time, the RBI has also initiated few steps in regulating this sector and it likely to help the digital lending ecosystem to continue to grow in a responsible and sustainable manner.

