# Regulating FinTech:
# challenges and implications for Kenya and South Africa



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# Presentation outline

- Introduction
  - What is FinTech?
  - How is it linked to SMEs?
  - Why should we regulate it?
- Key challenges in FInTech regulation in Kenya and South Africa
- Suggestions for improving the regulation

# What do we mean by 'FinTech'?

- An industry? A technology? A business? An activity?
  - No uniform approach
  - Schueffel (2016): 'Fintech is a new financial <u>industry</u> that applies **technology** to improve financial **activities**'
- Recent international attempts to define 'FinTech' (2017):
  - **FSB**: 'technology-enabled <u>innovation</u> in financial services that could result in **new business models**, **applications, processes or products** with an associated **material effect** on the provision of financial services
  - **EU**: technology-enabled <u>innovation</u> in financial services, regardless of the nature or size of the provider of the services
    - Non-disruptive FinTech: 'triggers **incremental** innovation increases efficiency'
    - Disruptive FinTech: 'more **radical** breakthroughs'
- Due to uncertainty we suggest a **broader** interpretation

# 'FinTech': the key points

- 'FinTech' concept is **flexible,** as 'innovation' means different things
  - in different time periods
  - in different countries/regions
- 'FinTech' has an **inherent disruptive element** – ie it covers those business models which deviate from the existing financing models
  - but how to clearly determine what is 'in'/what is 'out'?
- **Examples:**
  - Virtual currencies (Bitcoin, Litecoin, Ethereum, Zcash, Dash)
  - Mobile money (M-Pesa)
  - Online peer-to-peer lending platforms (Lending Club, Funding Circle)
  - Robo-advisory services

# FinTech: relevance for SMEs

- New technology developed by **start-ups/SMEs** (often in collaboration with incumbent financial institutions)

- Crowdfunding/peer-to-peer lending platforms are **a source of alternative finance** for SMEs;

  - UK Bank Referral Scheme to refer unsuccessful SME applicants to alternative platforms

- Mobile money (eg M-Pesa) was developed as an alternative to a bank account/bank transfers for unbanked population (ie **financial inclusion**)

- Virtual currencies can be used as an **alternative investment** model

# Why regulate FinTech?

- Existing regulations are often **incompatible** with the new technology
  - Eg what is the legal status of Bitcoin? A currency? An security?
- Start-ups **cannot compete** with financial institutions
- FinTech solutions allow easy access to financial services by **unsophisticated parties** who may require additional **protection**
  - Eg investments in virtual currencies are very risky
- Existing regulatory models are not suitable for addressing the **fast-paced developments** in the FinTech sector
  - Eg rapid growth of online lending platforms
- Some FinTech solutions are **decentralised**, making it difficult for regulators to exercise 'domestic' oversight and control
  - Eg distributed ledger technology

# FinTech in Kenya and South Africa

- **Pro-FinTech sentiment** in Sub-Saharan Africa
  - FinTech often operates in areas deemed unprofitable by banks (ie comparing something new with nothing at all)
  - FinTech can serve as instrument of financial inclusion
- **Low number** of highly successful FinTech businesses in Africa
- Kenya and South Africa as the FinTech **leaders in Sub-Saharan Africa**
  - Regional leaders in alternative finance (USD 16.7m and 15m in 2015)
  - M-Pesa mobile money system in Kenya (covers 90% households) – but closed in South Africa in 2016
  - M-Akiba launched in Kenya in 2017 – world's first mobile-only government bond

# Our findings: common features in FinTech regulation in Kenya and South Africa (1)

- **No uniform approach to defining 'FinTech'** (may cover simple digitization of paper-based processes)

- **No general 'FinTech regulation**': multiplicity of rules

- **No** dedicated **FinTech-oriented strategy**: whack-a-mole approach

# Our findings: common features in FinTech regulation in Kenya and South Africa (2)

- Development of **principles-based** FinTech regulation
- Interest in developing regulatory '**sandboxes**' (ie controlled environments for preselected FinTech firms)
- Increasing **cybercrime risks** leading to the adoption of dedicated rules
  - Symantec: 1st and 2nd highest source countries in Sub-Saharan Africa in terms of cyber-attack numbers, malware, spam and phishing hosts
  - PWC: 32% of South African organisations reported having been victims of cybercrime
  - Kenya has the highest losses from cybercrime activities in East Africa
  - Both countries published **cybercrime bills** in June and July 2017

# Our findings: FinTech regulation in South Africa

- Established financial services regulation
- Ongoing **reform of financial regulation**: 'Twin Peaks' Act signed in August 2017
- 2015: new **Socio-Economic Impact Assessment System** (SEIAS) introduced for all policies/bills/regulations
- **Virtual currencies unregulated**
  - BUT the central bank created a 'multi-disciplinary task team' to consider the 'regulatory, supervisory and technological opportunities offered by block chain and distributed ledger technologies'
- **No** dedicated **crowdfunding regulation**
  - BUT Financial Services Board was expected to review the existing regulatory approach by 30 June 2017
- Calls for increased **dialogue** with the FinTech industry

# Our findings: FinTech regulation in Kenya

- **Mobile money**
  - M-Pesa retains dominant position (22.6 out of 28 million subscriptions)
  - Competing products from Visa (Mvisa), banks (Pesalink)
  - Potential systemic implications for the economy
  - Attempts to 'level the playing field'
    - 2014: CAK order Safaricom to open up M-Pesa for other firms
    - plans for full interoperability of mobile money networks in 2017
    - calls for the separation of M-Pesa from Safaricom
- Example of regulatory environment **lagging behind the technology**
- **No** dedicated **crowdfunding regulation**
- **Lack of coordination** among regulators, low speed of regulatory response

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# Suggestions for improving the FinTech regulation (1)

- The need for a **clear FinTech policy**/set of **priorities**
  - Prudential (risk prevention) approach
  - FinTech promotion
- Improve **regulatory coordination**
- Enhance **the clarity** of existing (financial services) regulation for start-ups
  - Preparing <u>explanatory materials</u> for non-experts
  - <u>Consultations</u> organised by the regulators

# Suggestions for improving the FinTech regulation (2)

- The need for a comprehensive **social and economic impact assessment**
  - Comprehensive (not 'tick-a-box')
  - Independent, verifiable, based on robust methodology
  - Reflect the cost of new technology/regulation
  - Both ex ante and ex post (ideally)
  - Reflect perception of (ex ante) or actual (ex post) compliance:

- $EI = (A + B) \times C - D$

- A, B – micro, macroeconomic benefit,
- C – perception/level of compliance (from 0 to 1),
- D – cost of creating/implementing new rules

# Suggestions for improving the FinTech regulation (3)

- Regulatory **sandboxes**, if adopted, should observe rule of law principles
  - <u>Clear selection criteria</u> and methodology
  - <u>Making public the outcomes</u> of applications (subject to confidentiality requests from the applicants)
  - <u>Minimising regulatory arbitrariness</u>: avoid the impression of giving *unfair* advantage to selected businesses
  - Instances of <u>preferential treatment</u> should be <u>limited</u> and <u>defined</u> by law

# Suggestions for improving the FinTech regulation (4)

- Consider **principles-based approach** to the regulation of FinTech
  - To address the <u>critical issues</u> that are relevant regardless of the type of technology used (eg fraud prevention)
  - To ensure <u>continuity of the main principles</u> of FinTech regulation in case of development of new technologies
  - As an <u>interim measure</u> to preserve the fundamental basics of FinTech regulation until detailed rules-based provisions are developed.

# Suggestions for improving the FinTech regulation (5)

- The need for **greater engagement with the FinTech businesses**
  - Note the holdout start-ups problem (ie 'a good contact with the regulator is no contact with the regulator')
  - Consider pro-active approach and capacity building among start-ups
- Consider the desirability of special rules for **systemically important** businesses
- In the short term focus on the **prevention of negative effects of the new technology** (eg cybercrime)

# Thank you