Regulatory challenges underlying FinTech in Kenya and South Africa

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Introduction

1. Technological innovation in finance, commonly referred to as ‘FinTech’, is rapidly changing the way the financial markets operate. New technological solutions, like virtual currencies, online lending platforms and robo-advisory services, compete with the traditional banking products and services. According to a recent study, more than 50% of all customers globally are already using at least one FinTech firm.1

2. In Sub-Saharan Africa, FinTech presents opportunities that have not existed before. The introduction of mobile money has played an important role in reducing the number of unbanked people in Kenya and Tanzania.2 Online crowdfunding platforms are used to finance projects that could not be funded through the ordinary banking channels.

3. At the same time, the number of highly successful FinTech businesses across the region remains low. In addition, the new technologies are not adopted evenly: the same FinTech solution may struggle to achieve sufficient local demand in some jurisdictions, despite the overwhelming support in other States.

4. Despite its potential benefits, FinTech presents a challenge for the regulators.3 Without clear regulation and enforcement, the new technologies can be used by unscrupulous firms to deceive their clients. In China, the once largest online lending platform Ezubao turned out to be a Ponzi scheme that had collected almost 60 billion yuan (over USD 9 billion) from more than 900,000 investors.4 In addition, the FinTech solutions often do not tend to fit into the existing regulatory frameworks and can decentralise, disintermediate and even anonymise the delivery of financial services, sometimes making it very difficult to apply domestic regulation to the new technologies.

5. This report outlines some of the key regulatory challenges affecting financial technology in Kenya and South Africa, the African regional leaders in FinTech. It is based on a dedicated study involving desk-based research, consultations with the legal experts, and roundtable discussions with various stakeholders within both jurisdictions. The full report will be published in due course.

6. We note that the principal issues currently faced by the regulators are not technology-related. In fact, the most acute challenges revolve around the need for certainty and clarity of existing rules in their application to FinTech solutions, the need to ensure equal treatment of various parties and the need to exercise the regulatory powers within clear limits of discretion defined by law. These concerns form the basis of a rule of law compliant legal regime – one that follows the principle that ‘all persons and authorities within the state, whether public or private, should be bound by and entitled to the benefit of laws’.5

Sub-Saharan Africa Context

7. The majority of the adult population in Sub-Saharan Africa is unbanked, with over 340 million adults without a bank account.6 Africa’s banking sector is held back by factors like currency fluctuations and a low supply of products for savings, insurance, credit, and payment transactions.7

8. FinTech plays a distinct role in the region: in many cases FinTech solutions appear in those areas which have been unprofitable for traditional banks and create financial inclusion opportunities that have not existed before. This forms the basis for the overall favourable perception of FinTech, both among the general population and among the incumbent financial institutions, which can cooperate with the emerging FinTech businesses in order to cover a larger portion of the market. In addition, there have been no major FinTech-related crises in the region, resulting in an overall pro-FinTech sentiment. In

3 In this report ‘regulation’ is limited to formal and binding rules adopted by a competent public authority (a ‘regulator’) and does not include informal regulatory measures (eg industry self-regulation).
contrast, there is a common perception that banking is for the rich, and standard banking procedures like opening a bank account can be ‘painfully bureaucratic’.9

Kenya and South African Context

9. Kenya and South Africa stand out as the region’s leaders not only in terms of financial inclusion (with over 70% of the adult population having access to a bank account),9 but also as major FinTech centres: until the most recent revision of the list of global FinTech hubs prepared by Deloitte, Johannesburg and Nairobi were the only cities on the African continent included in the list (now joined by Lagos).10

10. Kenya and South Africa are the regional leaders in various FinTech areas. Kenya is one of the world leaders in mobile money and home to perhaps the most well-known example of FinTech-based financial inclusion, M-Pesa. The share of adult population in the State with a mobile money account is close to 60%.11 In contrast, in South Africa, where consumers have a much better access to bank accounts and cash out facilities,12 the incentives for mobile money were lower and M-Pesa was discontinued in June 2016.13 Shortly afterwards MTN also scrapped its mobile money business in the jurisdiction, stating that the operating costs of running a mobile money platform had become prohibitive.14 Kenya and South Africa are the market leaders in raising online alternative finance: in 2015 they raised, respectively, USD 16.7 million and USD 15 million from online channels.15 In addition, the two States host the largest number of technology hubs in Africa.16

11. The understanding of the term ‘FinTech’ varies within the industry in Kenya and South Africa. Some of the discussants at the roundtable treated ‘FinTech’ as any new application of technology to existing financial products: under this approach, not only the breakthrough technologies, but even a simple transition from paper-based to electronic means of product or service delivery would fall within the ambit of the term. Others called for a more restrictive approach to defining ‘FinTech’, focusing on the more disruptive, transformative technologies.

12. There is a rising interest in the concept of regulatory sandboxes17 for FinTech businesses. Companies selected for a sandbox often enjoy various benefits, such as bespoke authorisation processes, no enforcement action letters or waivers of certain regulatory requirements. The key challenge in designing national regulatory sandboxes is to ensure that the criteria for selecting businesses eligible for any preferential regime are clear and devoid of regulatory arbitrariness. Otherwise, the preferences obtained by the selected few may be seen as unfair advantage. In June 2017, the Kenyan Capital Markets Authority launched its public consultation on the first proposed regulatory framework applicable to sandboxes in the jurisdiction.18 In South Africa, there is evidence of ongoing discussions relating to the possibility of setting up a regulatory sandbox in the future.19 The future of sandboxing regimes in the two jurisdictions remains uncertain, but the latter have the potential of offering personalised support to innovators (on a case by case basis), while at the same time allowing the regulators to be in close contact with the selected businesses and better understand the new technologies.

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8 ibid.
17 A ‘regulatory sandbox’ is a safe supervised environment created by the regulator and allowing innovative businesses to test the new products and solutions prior to their full implementation. This approach has already been applied by regulators in Australia, Hong Kong, Malaysia, Singapore, the UK – see Herbert Smith Freehills, ‘Hong Kong Launches Regulatory Sandbox in Wake of Regulations in Australia, Malaysia, Singapore, and the UK’ <http://sites.herbertsmitthfreehills.vuturrevx.com/103/12430/landing-pages/2016.09.30-apac-fintech-briefing.pdf> accessed 10 October 2017.
13. Cybercrime prevention is one of the key FinTech challenges in both States. In a 2016 cybercrime and cybersecurity study by Symantec, Kenya and South Africa ranked as the 1st and 2nd source States in Sub-Saharan Africa in terms of cyber-attack numbers, malware, spam and phishing hosts. In an earlier study, South Africa was listed as having the 3rd highest number of cybercrime victims worldwide. A research by Serianu shows that over 70% of people in Kenya have experienced cybercrime. Both States are lacking a comprehensive cybercrime legal framework, but the legislative reform is underway: in Kenya, the Computer and Cybercrimes Bill was published in the Kenya Gazette in June 2017, while in South Africa the Cybercrimes and Cybersecurity Bill was open for public consultation in July 2017.

**FinTech regulatory challenges in South Africa**

14. In 2015 the South African government introduced a new Socio-Economic Impact Assessment System (SEIAS). According to the published guidelines, all Cabinet Memoranda seeking approval for draft policies, bills or regulations must include an impact assessment signed off by a special SEIAS unit. The Department of Planning, Monitoring and Evaluation (DPME) is responsible for the establishment of a SEIAS unit to ensure the implementation, quality control and capacity support for SEIAS. The concept of social and economic impact assessment will be particularly useful in shaping the future FinTech regulation: a comprehensive analysis of potential impact of the new technologies and proposed measures to regulate them will enhance the quality of the regulatory response and will allow regulators to focus on those areas where the need for intervention is highest. Nonetheless, the challenge remains to ensure that the whole process does not turn into a formal box-ticking exercise.

15. The regulatory approach to money in South Africa is formulated in the Position Paper on Electronic Money NPS 01/2009, in which the South African Reserve Bank (SARB) analyses the existing regulations differentiating between payments made to a third person to whom the payment is due, on the one hand, and sending electronic value to a beneficiary who can encash that value without any obligation to that beneficiary, on the other. The former activity could be provided by non-banks as payment service, but the latter would be classified as 'deposit-taking' under the Banks Act and require a license. It remains to be seen whether the fiasco of Vodacom and MTN in the South African mobile money market will result in any changes to the existing rules.

16. There is no bespoke crowdfunding regulation in South Africa. As a result, a whole array of different rules may apply to the crowdfunding activities, depending on their mode of operation. These include the Banks Act (where crowdfunding involves deposit-taking), the Companies Act (applies in relation to companies and disclosure requirements), the Collective Investment Schemes Control Act (if investments are pooled and channelled into securities), the Financial Advisory and Intermediary Services Act (in relation to intermediary services or advice), the Financial Markets Act (when online platforms match investors with issuers and securities are traded on an over-the-counter basis), the National Credit Regulation Act (if the platform matches lenders with borrowers to provide unsecured loans). It is unclear whether a more streamlined approach to crowdfunding will be developed in the future.

17. The SARB has expressed a cautious attitude towards virtual currencies like Bitcoin. The current approach is summarised in a Position Paper on Virtual Currencies NPS 02/2014 by the SARB, which stresses that it “does not oversee, supervise or regulate the [virtual currencies] landscape, systems or intermediaries for effectiveness, soundness, integrity or robustness” and that activities related to the acquisition, trading or use of [virtual currencies]... are performed at the end-user’s sole and independent risk”. Some of the discussants at the roundtable suggested that, despite the co-existence of various regulators in South Africa, the guidance in terms of next steps in the regulation of virtual currencies is likely to come from the SARB, which sets the tone. Hence, unless the SARB reverses its current hands-off approach, it is unlikely that other regulatory measures will be adopted by the other regulators in the area of virtual currencies.

18. An important challenge underlying virtual currencies concerns anti-money laundering/countering the financing of terrorism (AML/CFT) restrictions: without adequate know-your-customer (KYC) checks the modern cryptocurrencies like Bitcoin can be used to move large volumes of value with no real means

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27 See n 13 above.
28 See n 14 above.
29 Financial Services Board, FSB Bulletin (Financial Services Board Newsletter; First Quarter 2016; Strengthening South Africa’s Financial Institutions, 2016) 15.
to identify the actual transacting parties. Currently, the relevant client identification rules in South Africa are listed in the Financial Intelligence Centre Act (FICA), which contains a closed list of entities subject to the AML/CFT duties in Schedule 1. However, care must be taken to ensure that all businesses engaged in operations with virtual currencies are covered by FICA. Consequently, an amendment of Schedule 1 might be required to extend the relevant obligations to them.

19. Discussants at the roundtable in South Africa felt that not enough dialogue took place between the regulators and other stakeholders in the FinTech space. While the possibility of industry self-regulation was mentioned, it was noted that the diversity of FinTech businesses would make it problematic. Nevertheless, the need for greater representation, a 'voice', of the industry was considered highly desirable in shaping the future regulation in the FinTech area.

FinTech regulatory challenges in Kenya

20. According to the recent communications sector statistics report by the Communications Authority of Kenya, the leading mobile money platform M-Pesa dominates the local mobile money transfer market, with over 22.6 million subscriptions out of the total of 28 million, and 380 million transactions out of the grand total of just over 480 million. The volume of transactions on the platform is equivalent to over 40% of the State’s GDP. For some time the regulators have been attempting to level the playing field for the other market participants. In 2014, the Communications Authority of Kenya ordered Safaricom (the mobile operator which controls M-Pesa) to open up its network. This was followed by plans to ensure full interoperability of mobile money networks in 2017 and even proposals to separate the mobile money business (M-Pesa) from the controlling operator earlier the same year.

Implementation of the various initiatives aimed at diversifying the mobile money market remains a challenge for the near future in Kenya.

21. The dominant position of M-Pesa in Kenya was used as an example of a situation when regulation significantly lags behind the development of technology. At launch of M-Pesa in 2007, the Central Bank of Kenya only issued a ‘Letter of No Objection’ to Safaricom, while the dedicated payment systems regulations were rolled out much later, starting with the adoption of the National Payment Systems Act in 2011 and the National Payment System Regulations in 2014. The rapid growth of FinTech companies and the emergence of new technologies challenge the regulators’ ability to respond to the change in a timely fashion. It remains to be seen whether the regulators will eventually develop a pro-active approach to FinTech.

22. Similarly to South Africa, there is no bespoke crowdfunding regulation in Kenya. As a result, a number of regulators can have the authority to regulate various forms of crowdfunding, including the Central Bank of Kenya, the Capital Markets Authority and the Communications Authority of Kenya. A recent study by the Cambridge Centre for Alternative Finance has identified a number of statutes and other regulations that might apply to the operation of crowdfunding platforms, depending on their mode of operation. These include: the National Payment Systems Act, Money Remittance Regulations, Kenya

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31 One of the most recent examples includes the establishment of the South African Financial Blockchain Consortium, in which two regulators (the SARB and the Financial Services Board) participate as observers. See “South African Financial Blockchain Consortium” <http://www.safbc.co.za/members/> accessed 23 October 2017.


37 The negative publicity targeting the Central Bank of Kenya led to the publication of a statement in January 2009 entitled ‘Mobile Phone Financial Services in Kenya’, which acknowledged that ‘regulation generally lags behind innovation and a pragmatic approach [had been] adopted with regard to the review of M-Pesa’. See Annex C in Alliance for Financial Inclusion, Enabling Mobile Money Transfer: The Central Bank of Kenya’s Treatment of M-Pesa (Case Study, 2010).

38 ibid 1.


Information and Communications Regulations, the Microfinance Act, the Proceeds of Crime and Anti-Money Laundering Act, the Capital Markets Act, the Banking Act, and the Public Offer Regulations.  

The Public Fundraising Appeals Bill proposes additional licensing requirements in connection with fundraising systems. It is unclear whether some kind of consolidation of existing rules affecting crowdfunding will occur in the future.

23. In 2015 the Central Bank of Kenya issued two separate clarifications concerning the legal status of virtual currencies, such as Bitcoin. The first one was addressed to the general public and concluded that ‘public should therefore desist from transacting in Bitcoin and similar products’. The second document was a caution to ‘all financial institutions against dealing in virtual currencies or transacting with entities that are engaged in virtual currencies’ at a risk of ‘appropriate remedial action from the Central Bank’. While there are no immediate plans the revise this approach, future developments (such as the possibility of state-issued ‘official’ virtual currencies) may prompt a revision of the existing regulation.

24. At the Kenyan roundtable, a number of discussants expressed their concerns about the time required to obtain regulator’s approval for start-up FinTech businesses. Others noted the issue of lack of coordination among regulators and potential conflicts of jurisdiction in regulating FinTech.

Concluding comments

25. In Sub-Saharan Africa, FinTech shows the potential for financial inclusion and the absence of major crises resulting from the new technologies ensures an overall pro-FinTech sentiment.

26. Kenya and South Africa, as the FinTech leaders in Sub-Saharan Africa, do not have an overarching FinTech-specific legal framework. As a result, FinTech businesses are being regulated by a variety of statutes and rules governing various financial products, services and market participants, as well as other provisions of more general application (eg company laws, electronic communications laws etc).

27. Instead of formulating a single set of regulatory priorities in relation to FinTech, regulators generally respond to the more pressing issues individually, when the need arises. This can be illustrated by the response of the banking authorities in both States to the risks associated with virtual currencies. This has been in the form of a position paper by the South African Reserve Bank and several notices addressed to the public and to the financial institutions by the Central Bank of Kenya.

28. The notable developments in FinTech regulation in the two jurisdictions include the new system of social and economic impact analysis in South Africa and the new sandbox regulatory framework in Kenya. If utilised properly, the former can provide a solid basis for setting regulatory priorities among various FinTech solutions. The latter has the potential to establish a win-win collaboration between the regulators and the regulated, whereby authorities gain a better understanding of the new technology and the businesses have peace of mind while operating in a safe and controlled legal environment within a clearer rule of law framework.

29. In designing FinTech regulation, both jurisdictions are developing principles-based rules and regulations. In South Africa, the Protection of Personal Information Act (POPI) imposes eight principles on entities processing personal information. In Kenya, the recent sandbox consultation document expressly states that ‘regulatory nimbleness, flexibility and responsiveness provided by principle-based regulation is even more important in the FinTech sector where thriving innovation is the life-line of a vibrant business enterprise’.

30. In the short term, while the new FinTech rules and the overall approach to FinTech are being considered and reviewed, regulators attempt to address the more pressing issues, such as cybercrime, via new legislative initiatives.

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42 ibid 30-31.
46 See paragraph 17.
47 See paragraph 23.
48 These principles are: (i) accountability, (ii) processing limitation, (iii) purpose specification, (iv) further processing limitation, (v) information quality, (vi) openness, (vii) security safeguards and (viii) data subject specification. See Section 4(1)(a)-(h) of the Protection of Personal Information Act of 2013.