South African Reserve Bank

Opening remarks by Francois Groepe,
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at the Inaugural Intergovernmental Fintech Outreach Workshop

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The fintech phenomenon: five emerging habits that may influence effective fintech regulation

Introduction

Good morning, ladies and gentlemen.

Welcome to the inaugural Intergovernmental Fintech Outreach Workshop.

Let us begin with the words of Joseph Schumpeter: "Situations emerge in the process of creative destruction in which many firms may have to perish that nevertheless would be able to live on vigorously and usefully if they could weather a particular storm."[1]

There is no doubt that we are witnessing a wave of disruptive innovation and technology that one can liken to Schumpeter's 'creative destruction', one that will leave no aspect of human endeavour untouched. Financial services in particular are within the eye of the storm of the change as a result of financial technology, or 'fintech'. An elementary Google search on fintech results in no fewer than 35.2 million hits. Investment in fintech over the last three years is estimated to have been well over US$300 billion dollars.[2]

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1 Joseph A. Schumpeter (2013). *Capitalism, socialism and democracy*. Routledge.
2 KPMG (August 2017). *Global analysis of investment in fintech*.

Attention to the emergence of fintech has come from every quarter. There have been contributions from the World Economic Forum reflecting the potential of distributed ledger technology across wide-ranging financial services and activities. The International Monetary Fund has been vocal about the potential impact of cryptocurrencies. More recently, under the Argentinian presidency, the G20[3] has committed to deepening the analysis on how financial inclusion could be achieved through digital innovations. All of these examples suggest a heightened expectation of shifts to financial services as a result of fintech.

At the outset, it may be appropriate to attempt to define what fintech is. 'Fintech' usually refers to innovative start-ups or underlying technologies such as blockchain, cloud computing, and machine learning. Founded on an activity-based analysis conducted by the Financial Stability Board (FSB), the evolving definition of 'fintech' is that it is neither the fintech firms, nor the start-ups, nor the emerging technologies. Rather, 'fintech' is the technology-enabled innovation in financial services as a result of the process of 'creative destruction'. It may lead to new business models and new configurations within financial services.

The potential of financial technology

The potential of fintech is well described in one of the earliest reports on fintech commissioned by the UK[4] Treasury. This report is useful in that it outlines how countries can positively position themselves in relation to fintech. A key finding of this report is that a country could establish a well-functioning fintech ecosystem and competitively position itself provided that a holistic view is taken that focuses on the following four core ecosystem attributes: policy, talent, capital and demand.

Policy refers to the following:

(i) regulatory regimes, which includes regulatory support for new entrants and innovative business models;

[3] Group of Twenty
[4] United Kingdom

(ii) government programmes, including sector-growth initiatives which, in turn, include efforts to open up the sector, increase competition, attract foreign fintechs, and improve cyber-resilience; and

(iii) taxation policy, which refers to the introduction of appropriate incentives to drive greater investment in fintech, but, dare I add, should also include revisions to the tax code to ensure that profits generated are included in the taxation net of this nascent sector.

While clear and appropriate fintech policies are important catalysts to innovation, without talent and capital, fintech is likely to grow at a slower pace.

Talent refers to both the availability of technical, financial sector and entrepreneurial talent as well as the strengthening of the talent pipeline through immigration policies and the promotion of fintech in schools and universities with specialist modules, apprenticeships and sponsored work placements.

Capital refers to access that start-ups and scale-ups should have to seed and growth capital as well as to public capital markets. The report, for example, lists investor-focused programmes such as the sponsorship of events for venture capital funds to meet early-stage fintechs and the creation of a growth capital fund to finance fintechs.

Last, but not least: although each of the previous factors is necessary for the emergence of fintech, actual demand relates to the end-client demand across consumers, corporates and financial institutions. Governments can play a significant role in promoting the adoption rate of fintech through the modernisation of payment and supply chain solutions. Although demand is not a prerequisite, without it innovation in financial services is likely to take off at a slower pace.

This framework lays the foundation for developing fintech, especially at a time when the demand for cheaper, faster, simpler and more convenient financial services is high. As policymakers and regulators, we have been acutely aware of the power of developing ecosystems. I further believe that fintech can play a significant role in addressing broader public-policy objectives such as financial deepening, increased competition, and greater efficiency in the provision of financial services. For regulators, though, the challenge is to balance the benefits that fintech may bring with its potential risks.

The global and domestic approaches to financial technology

Over the past year, the FSB and the Bank for International Settlements (BIS) have also analysed fintech and its implications for policy objectives such as greater financial inclusion and financial stability. Although the BIS concluded that, at present, there are no compelling risks from emerging fintech innovations, it does highlight that the assessment of financial stability implications for fintech are challenging due to the limited availability of data and the fact that many innovations have not yet been tested through a full financial cycle.

South African policymakers and regulators have been following the developments and discourse on fintech very closely. Given the global developments, the local innovations as well as the fast-paced and cross-cutting nature of fintech, we have established an Intergovernmental Fintech Working Group (IFWG). The IFWG comprises National Treasury, the Financial Services Board, the Financial Intelligence Centre, and the South African Reserve Bank. It is anticipated that the National Credit Regulator and the Competition Commission will join the working group in due course.

Effective coordination between policymakers, central banks, financial supervisors, regulatory authorities, financial ombudsmen and others, all with responsibilities related to fintech, is key to ensuring that that policy is coordinated and synchronised in the financial sector. Regulation has to be harmonised. Given the cross-border nature of digital services, coordination on a global scale is vital, and the role of bodies such as the FSB and G20 will be important in this regard.

In South Africa, the Twin Peaks model of financial sector regulation, which is currently being implemented, aims to put in place a regulatory framework that better responds to the dynamic nature of the financial sector, including fintech. The model places emphasis on ensuring consistent, harmonised regulatory approaches to activities in the financial sector, so that comparable activities face similar regulatory requirements - regardless of whether the institution performing the activity is a 'traditional' financial institution or a new fintech entrant. This approach is intended to better keep pace with changes in the sector, including those brought about by technological innovations. An example is the establishment of the IFWG mentioned earlier, which is a positive development in driving a coordinated and consistent approach under the Twin Peaks model.

Given this broad background and context on fintech, and with this coordinated approach in mind, I would like to turn our attention to this inaugural fintech outreach established by the IFWG. Why is this outreach important? And what is the IFWG attempting to achieve through these engagements?

The importance of IFWG outreach

To position this outreach initiative, and to draw out its importance, allow me to synthesise the findings from three seminal reports. These reports collectively point to possible best practices related to regulators' efforts on fintech. The reports are:

- the FSB's Fintech Issues Group (FIG) report on *Fintech supervisory and regulatory issues that merit authorities' attention* (published in June 2017);
- the Basel Committee on Banking Supervision (BCBS) report on *the Implications of fintech developments for banks and bank supervisors* (published in December 2017); and
- the Fintech Action Plan released by the European Commission in March 2018.

These reports highlight five emerging practices that may influence effective fintech regulation over time. These practices may be important in fostering responsible innovation, promoting financial stability, and aligning regulators' efforts to achieve a more inclusive and a more competitive financial system.

Practice 1: focused attention on innovation as a result of technological advancements and the active review of regulatory regimes

The first best practice is for policymakers and regulators to dedicate attention to fintech innovations and be supportive of them - or at least to ensure that any barriers to fintech innovations are limited. This could be achieved through ensuring clear and appropriate regulatory regimes. The pro-innovation stance is drawn out in each of the reports.

The FIG report suggests that regulators should be agile whenever there is a need to respond to the fast changes in the fintech space, and they should be quick to implement or contribute towards a process of reviewing the regulatory perimeter regularly. The suggestion is to adopt an approach that is technology-agnostic or neutral, and to focus on financial service activities.

In the BCBS report, it is suggested that while bank supervisors must remain focused on ensuring the safety and soundness of the banking system, they may wish to consider ways of executing their mission without unduly hampering beneficial innovations in the financial industry.

In the European Union's (EU) Fintech Action Plan, one of the explicit goals is enabling innovative business models to scale up across the EU region through clear and consistent licensing requirements. Actions include reviewing regulation on investment-based and lending-based crowdfunding service providers for business. The proposal specifically aims to ensure an appropriate and proportionate regulatory framework, which allows crowdfunding platforms that want to operate cross-border to do so with a comprehensive 'passporting' regime under unified supervision. Another action that supports innovation includes a review of the current authorising and licensing approaches for innovative fintech business models. The European Commission will set up an expert group to assess whether there are any unjustified regulatory obstacles to financial innovation in the EU's financial services regulatory framework.

Authorities should therefore not merely acknowledge or observe innovation but should actively review fintech innovations (including those with new business models) with a view to ensuring proportionate and consistent authorising and licensing regimes. This practice is driven by an underpinning open philosophy and a flexible approach to fintech. Speakers and participants who have had experience of this approach in other jurisdictions will tell us more about the impact of this practice. We will hear how initiatives in cryptocurrencies, digital identity and digital mobile wallets may benefit from a pro-innovation philosophy. We will also hear from jurisdictions with Smart Nation policies about the importance of such national philosophies and policies. Of course, as authorities, we will need to ensure level playing fields and manage the risk of regulatory arbitrage. This is why a coordinated multiple regulator approach is so important.

Practice 2: the creation of innovation facilitators such as hubs and sandboxes to keep close to emerging developments and foster shared learning

The second practice is the review and creation of structural mechanisms to enable ongoing market engagements. These include efforts aimed at collecting fintech data, organising market outreach initiatives, and implementing structures such as innovation hubs, innovation accelerators and regulatory sandboxes.

Each of the reports strongly encourages shared learning with a diverse set of private-sector parties. In order to support the benefits of innovation through shared learning and through greater access to information on developments, authorities should continue to improve communication channels with the private sector and should continue sharing their experiences with innovation hubs, innovation accelerators and regulatory sandboxes, besides other forms of interaction. The reports suggest that the successes and challenges derived from such approaches may provide fruitful insights into new emerging regulatory engagement models.

Given the rapid pace of change as well as the emergence of new business models, I believe that, over time, the second practice that may influence effective regulation is the establishment of innovation facilitators. We will hear and learn from our colleagues from the World Bank about the successes and learnings from those that have already implemented such mechanisms. We are pleased to also have the Monetary Authority of Singapore with us today; they can share first-hand their experience with their Innovation Hub, the Looking Glass and related initiatives, such as Project Ubin.

Practice 3: coordination, collaboration and communication between domestic regulators

We suggest that the third practice relates to coordination and collaboration between regulators. With the emergence of innovations such as crypto-assets or crypto-tokens, initial coin offerings and other alternate financial services platforms, there is often a 'grey area' around the relevance and applicability of current regulatory frameworks. Furthermore, the development of new regulatory regimes, if applicable, requires coordination between regulators. As noted before, such coordination is important in ensuring consistent understanding and approaches between regulators.

The importance of this coordination is emphasised in the FIG report. Due to the growing importance of fintech activities and the interconnections across the financial system, authorities may wish to develop further their lines of communication. The BCBS report highlights that fintech developments are expected to raise issues that go beyond the scope of, for example, prudential supervision, as other public-policy objectives may also be at stake. This may include objectives such as the safeguarding of data privacy, cybersecurity, consumer protection, the fostering of competition, and compliance with anti-money laundering and combating the financing of terrorism regulations.

I would like to emphasise the importance of harmonised approaches and regulatory regimes between domestic regulators. The principle that has to be emphasised is that, as innovations are reviewed and as regulatory frameworks are developed (where required and appropriate), regulators that are best placed to supervise certain activities should be given the task to do so. Regulations should be appropriate and purposeful. Over the next two days, we will hear from you on how important you think this coordination and collaboration between domestic regulators is and what steps we can take to further improve such coordination and collaboration.

Practice 4: global cooperation with standard-setting bodies

Turning our attention to the fourth practice, we suggest that continued cooperation with our international peers and standard setting bodies remains important. In an environment of financial services that are unconstrained by geographical borders and globally situated third-party financial services providers such as cloud providers, continued sharing and coordination is necessary. Three areas that require international cooperation by authorities are suggested in the FIG report: the monitoring of macrofinancial risks (such as procyclicality), the mitigating of cyber-risks, and the managing of operational risks from third-party providers.

In support of this cooperation, the European Commission's report highlights the importance of the development of standards. Standards for open banking and application programming interfaces (APIs) as well as standards to limit cyber-threats, to improve regulatory reporting, and for distributed ledger technologies (where appropriate) may be areas of priority. Through these engagements, the IFWG would appreciate your feedback on how important you think this global cooperation is and the areas where you think we may need to strengthen coordination with regards to standards development.

Practice 5: building staff capacity through deep knowledge of exponential technologies

The last practice is about developing deep knowledge structures due to the fast-evolving innovation landscape. For the first time in the history of humankind, we have a new form of money: digital money. This type of 'creative destruction' does not have a single issuer, and it is not the liability of any single entity. Rather, it can appear in multiple databases at the same time. It cannot be changed except through defined updating protocols. To understand this, and to apply appropriate regulatory tools to these innovations, is not a simple matter. Equally, assessing the impact of these innovations on monetary policy and financial stability is not straightforward.

Technologies such as the Internet, cryptography, blockchain, Big Data and machine learning are shifting the types of skills and knowledge required to remain relevant in the Fourth Industrial Revolution. Work that is routine will likely be replaced by robotics and/or artificial intelligence. Regulators also need to evolve, and new skills will be required in order to keep pace with market innovations. Making appropriate regulatory assessments will depend on such refined skills sets. We suggest that the last practice relates to building deeper knowledge and related skills sets of regulatory staff. Each of the mentioned reports raises the importance of intentionally building these skills sets.

Conclusion

In conclusion: in reviewing the emerging regulatory practices deemed best, we have hopefully motivated, through reflections on three influential reports, why this outreach event and future market engagements are pivotal. You will notice during this workshop that the IFWG is pursuing the five practices discussed earlier. In this round, we look forward to hearing your views on private cryptocurrencies and initial coin offerings. We welcome a balanced and honest approach to reviewing both risks and benefits. Learning humbly and openly from other jurisdictions on what works and what does not work will help us improve our own regulatory approach and regime. These should be appropriate for our context and conditions. Our society remains divided and sometimes deprived of important financial services. Financial inclusion is an important consideration in this Digital Age. Shifts such as open banking and APIs may play a role in financial deepening. We look forward to hearing how innovation facilitators could be customised for our unique conditions.

Fintech is no doubt the consequence of disruptive innovation and as such will lead to the demise of many previously thriving businesses. It offers an immense opportunity to unlock efficiencies and reduce frictions, and could offer an important boost to our economy. Fintech can therefore play an important role in making inroads in addressing the triple challenges of unemployment, poverty and inequality. In order to achieve this, all of us - whether we are regulators, government or private business - have a vital role to play to deepen our understanding of this nascent sector and the opportunities and risks that it presents, and above all to collaborate and coordinate much better, both domestically and internationally. If we succeed, we would have contributed towards improving the lives of millions. If we fail, we would have missed a golden opportunity to make a meaningful difference. Hence, we do not have the luxury of allowing this workshop to turn out to be yet another 'talk shop'. Too much is at stake.

Please participate actively. We welcome your views, and I would like to assure you that this outreach workshop is designed in such a manner that your inputs will be carefully considered by the IFWG leadership. With this thought, let me wish you well in your deliberations over the next two days.

I would like to conclude with more words from Schumpeter: "Profit is the payment you get when you take advantage of change." We could adopt this saying and claim that economic progress is the payment you get when you take advantage of change.

Thank you.