Regulation and Supervision of Fintech: Considerations for EMDE Policymakers (Regulation Note) by Tatiana Alonso Gispert, Pierre-Laurent Chatain, Karl Driessen, Danilo Palermo and Ariadne Plaitakis with contributions from Ana M. Carjaval and Matei Dohotaru

Fintech is transforming the global financial landscape. It is creating new opportunities to advance financial inclusion and development in Emerging Markets and Developing Economies (EMDEs), but also presents risks that require updated supervision policy frameworks. Fintech encompasses new financial digital products and services enabled by new technologies and policies.[55] Although technology has long played a key role in finance, recent fintech developments are generating disruptive innovation in data collection, processing, and analytics. They are helping to introduce new relationship models and distribution channels that challenge traditional ways of financem while creating additional risks. While most of these risks are not new, their effects and the way they materialize and spread across the system are not yet fully understood, posing new challenges to regulators and supervisors. For example, operational risk, especially cyber risk, is amplified as increasing numbers of customers access the financial network on a 24/7 basis. Likewise, increased reliance by financial firms on third parties for provision of digital services, such as cloud computing, may lead to new forms of systemic risks and concentration on new dominant unregulated players such as big techs.[56]

This note aims to provide EMDE regulators and supervisors with high-level guidance on how to approach the regulating and supervising of fintech, and more specific advice on a few topics. Preserving the stability, safety, and integrity of the financial system requires increased attention to competition and ensuring a level playing field and to emerging data privacy risks. As a general principle, policy response should be proportionate to risks posed by the fintech activity and its provider. While striking the right balance can be challenging in the absence of global standards, the IMF-World Bank Bali Fintech Agenda (BFA), along with guidance by Standard Setting Bodies, provides a good framework for reference.

A sound policy design must start with assessment of the fintech landscape, its risks and regulatory gaps. Simplicity and pragmatism—for example combining simple regulations with supervisory judgment—increases the odds of successful policy. In practice, this will mean different things, depending on local context. In many cases, a clarification or review of existing frameworks will be sufficient and is easily done through enhanced supervisory guidance. In others, a full regulatory overhaul might be required. In some systems, an activities-based, technology-neutral approach, based on the function of the financial service can help balance stability and innovation goals. In others, a combined approach, taking into account the activity and the entity, might be necessary to ensure financial stability. In any case, there needs to be clear definition of which activities are under the regulatory perimeter and which requirements apply, including the need for licenses. Some fintech activities will require licences with integrity (AML/CFT) and conduct requirements. The introduction of data protection provisions in licensing frameworks is common. Activities that could potentially pose risks to stability should face prudential requirements.

Competition and inclusion objectives will become more relevant from a financial policy view, given the growing interdependencies and trade-offs with core priority mandates of preserving stability, integrity, and safety of the financial sector. The multiplicity of new entrants and the potential for dominant players (for example, incumbents, big techs, platforms) and first movers (for example, M-Pesa) to create barriers and generate distortions has led to an increased recognition of the strong links between inclusion, competition, and financial stability. Indeed, a targeted participation by

55. According to the Bali Fintech Agenda and the Financial Stability Board.
56. According to the FSB, big tech firms are large companies with established technology platforms, such as Alibaba, Amazon, Apple, Baidu, eBay, Facebook, Google, and Microsoft. Big techs that offer financial services are a subset of fintech firms—a broader class of technology firms (many of which are smaller than big tech firms) that offer financial services.

financial service authorities in competition policy matters is increasingly being observed in EMDEs. The potential role of prudential and conduct regulation in mitigating barriers to market access and reining in abusive dominant practices should not be understated.

Cooperation, both interagency and cross-border, can help in the design and implementation of a sound supervisory response to fintech, which can be particularly challenging for EMDE countries suffering from supervisory capacity constraints or juggling competing policy priorities. An effective supervisory function for fintech activities is as essential as an appropriate regulatory regime. Supervisory processes and methods may need significant changes. Supervisors' knowledge, skills, and tools should keep pace with the speed of innovation and related risks, including cyber threats. Building proper expertise is crucial and suptech and regtech solutions could be excellent catalysts for this. Fintech is cross-sectoral and cross-country, making cooperation among agencies at the national and international levels essential for sound supervision. While many supervisors in G20 EMDEs participate in international fora, smaller jurisdictions may need to rely on International Financial Institutions (IFIs) and other available channels—for example, Global Financial Innovation Network (GFIN)—to raise issues, keep abreast of global developments, and exchange best practices. Involving the industry in fintech policy coordination efforts in a responsible and transparent way also appears increasingly relevant in areas such as cybersecurity, data, payments and securities, and for the design and implementation of regtech and suptech solutions (Appaya et al., 2020).

Further, authorities need to ensure that client funds are well preserved and that proper wind-down mechanisms are in place for systemically relevant firms operating in fintech. For crisis-management, fintech providers should be treated the same as their peers in traditional finance. For E-Money Institutions (EMIs) and payment institutions, regardless of their size, mechanisms should be established to require adequate ring-fencing of client funds and proper segregation, preferably by keeping them in government securities or deposited with the central banks. Where this is not feasible, segregation could be done by requiring that the funds are deposited with commercial banks, although this bears the risk of the commercial banks' failure, in which case the reserves could be lost. To mitigate this risk, some countries extend deposit-insurer protection to EMI customers, although challenges remain for the implementation of such protection, including that it would not cover the risk of misappropriation or fraud by the EMI as the EMI would not be a direct member of the deposit insurer. Other jurisdictions require that the EMI becomes a direct member of the deposit insurer—thus covering losses due to fraud or misappropriation. But this might clash with the purpose of a deposit insurance and impose costs that are not compatible with EMI business models or pose operational challenges that may render them ineffective.

Reaping the benefits from fintech in a sustainable and durable way will require adapting and strengthening financial-policy frameworks. Policymakers need to put in place a timely and proportionate regulatory and supervisory approach to managing financial risks arising from fintech. Ensuring financial stability, safety, and integrity will remain the core mandates, and these can, in turn, contribute to sustainable development amid healthy innovation and increased competition. Assessing the fintech landscape and related risks is a prerequisite to identifying regulatory gaps at an early stage. Then, authorities can set clear policy goals with a priority on surveillance and oversight mandates. As operational risks are amplified, defining a clear strategy for promoting operational resilience is important. Fintech-related changes may also require financial supervisors to scale up capacity and resources to meet the specific challenges posed by fintech, including through use of regtech and suptech solutions. Domestic and international cooperation is essential to successfully manage cross-sectoral risks, while achieving the benefits of fintech. And if an e-money institution fails, authorities should be well prepared by establishing safe mechanisms to protect customers' funds and to wind down systemic fintechs.