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Beyond regulation: Governance of digital financial services for sustainable development

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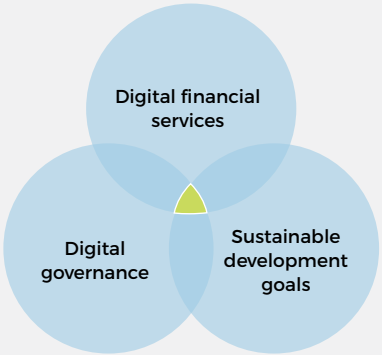
Introduction

Digital innovation in financial services is happening apace, and regulators are not always able to pre-empt or keep up. Traditionally, financial services are highly regulated. But increasingly, "old" models of regulation and supervision, where a static set of rules is set for industry to comply with, are no longer sufficient. This asks for a broader view of *governance that goes beyond just governments*: looking at collaborative, principle-based ways for industry and regulators to work together to ensure positive outcomes for consumers and society.

Interrogating what such a broader view means for regulatory models in emerging markets requires building an understanding of the interplay between governance, innovation in digital financial services (DFS) and sustainable development.

The New Nexus Initiative



In June and July 2021, Cenfri, with support from GIZ and in collaboration with On Think Tanks, hosted a series of digital convenings to explore four topics at the intersection of digital governance, digital financial services (DFS) and the Sustainable Development Goals (SDGs) across emerging economies:

- Responsible deployment of artificial intelligence (AI) in financial services
- Financial sector and data innovation and cybersecurity risks
- The role of financial innovation in transparent supply chains
- Central Bank Digital Currencies and illicit financial flows

In our thinking about DFS and digital governance, we also considered the landscape of data infrastructure, the importance of data sharing and the increasing role of the private sector in shaping global and local governance.

The central underlying question across the topics was: *How do governance models (particularly those in emerging economies) need to be adapted for digital financial services to contribute positively to the SDGs?*

It was clear from the ensuing dialogue that the governance questions arising are not about the tech involved per se, but about the underlying context, principles and risks. It's also about jurisdiction and who or what sets the tone or decision options for governance at a local level in an increasingly integrated global marketplace. It's about asking what the approach to governance should be to dynamically deal with risks, leverage opportunities created by digital innovation, facilitate market development, and take into account the interplay between global and local forces.

This note outlines the cross-cutting considerations, remaining evidence gaps and the corresponding call to action for development partners.

Overview of convening attendees

Key topics arising at the Nexus

We used the convenings to engage around five key hypotheses at the nexus of governance, DFS and sustainable development. The discussions suggested that:

1. DFS is changing the nature, scale and complexity of risks

The risks presented by DFS are not necessarily new, but digitalisation is changing the scale and complexity of familiar risks at every stage of the DFS cycle, such as exclusion, price discrimination, competition or privacy breaches.

To **consumers or users**, there's the risk of bias and exclusion due to the use of AI, supply chain de-risking or the digital divide for those with or without the digital ID and hardware infrastructure to participate in DFS. There's also the risk of theft and loss due to cybersecurity breaches, as well as the risks of personal data being compromised. The COVID-19 pandemic and the corresponding safety measures have resulted in accelerated digitalisation across emerging markets. This meant that many people have had to adopt DFS to get by. Where new users are inexperienced and lack the digital skills or knowledge to transact safely, there is a heightened risk of them falling prey to phishing scams or inappropriate sharing of their data.

DFS providers, likewise, face the risk of cyber-attacks and data breaches. They also face compliance pressure that may cause them to de-risk by severing relationships with certain segments of users that lack the necessary due diligence documentation. Where this is the case, knock-on exclusion is created for consumers, small businesses and informal or small-scale participants in supply chains.

Thus, the risk of **unintended consequences** of regulation and compliance measures is also a risk in its own right. But equally significant is the risk of doing nothing, that is, of a **governance void** for new types of players and activities for which the jurisdiction is not clear, as they do not fit into the traditional mandate of financial sector regulators or operate cross-border.

> **We talk about fintech and digital players, but we cannot look at them in isolation.** The more interoperable the markets are, the more points of connection with traditional financial systems.
>
> – Convening participant

2. Effective governance requires coordination at different levels

Digital innovation in DFS cuts across traditional market players such as banks and new players such as fintechs and digital platforms. It also cuts across fields ranging from ICT, digital identity and data governance to financial sector regulation. Thus, digital governance requires **coordination** across various industry players and various regulators beyond just the financial sector.

Moreover, given the cross-border nature of all the digital innovation topics considered in the convenings, **coordination across borders** is critical for the governance of front-of-mind risks.

Cross-border, multi-stakeholder coordination: the case of the palm oil supply chain

Coordination across borders is particularly important for global supply chains that need to comply with standards and regulations across multiple jurisdictions. In the convening on digital financial services and transparent supply chains, digital platforms were identified as a potential industry partner to integrate into cross-border governance models. Digital platforms have the potential to aggregate small businesses and informal traders and make them visible in global supply chains. Digital platforms that offer financial services can go one step further to incentivise these small businesses and informal traders to get certifications that ensure that they are not excluded from these supply chains in the future.

The case of the palm oil industry is one example of this approach. A significant proportion of the world's palm oil is produced by smallholder farmers. By placing the burden of proof of compliance on these producers, who struggle to meet the standards, there is a risk that buyers will sever ties with them. Doing so will have far-reaching implications for livelihoods. Global coordination, in the form of the Roundtable on Sustainable Palm Oil (RSPO), with more than 4,000 members worldwide, was instrumental in addressing this dilemma. The RSPO has developed a set of environmental and social criteria that companies must comply with to produce Certified Sustainable Palm Oil. Rather than strictly enforcing these criteria on smallholders, it followed a consultative process to create a dedicated smallholder certification standard, which takes the diversity in challenges and situations faced by smallholders globally into consideration. A unique certification process where buyers finance the certification of smallholders via a digital platform was also created.

3. Global DFS policy will set the tone for emerging markets

Policy around the application of new technologies impacting on DFS (including on AI, digital currencies, cybersecurity and supply-chain transparency) is gaining attention in major economic trading areas such as the US, EU and China. Many emerging economy regulators are caught between regulating too early, often in line with what the trading partners have ruled, and being locked out of key trading markets. The convenings emphasised the potential role of emerging markets to generate learning and to share perspectives to ensure **fit-for-context governance** approaches, as it is in the developing country context that many of the risks and opportunities of DFS for sustainable development are realised.

> Don't look at regulation through the glasses of the past, but through the glasses of the future; **regulatory compliance can be coded into digital governance frameworks** so that there's no scope for non-compliance.
>
> – Convening participant

4. Regulating against new technologies is front of mind for regulators, but technology can be part of the solution

Regulators often focus on risk and customer protection, and so they err on the side of caution when regulating new technology. In the case of DFS, rather than prohibiting or suppressing new technology, there is an opportunity for regulators to **work with technologies** to improve governance and consumer outcomes in markets. For example, CBDC and digital currencies can increase the transparency of supply chains, distributed ledger technology can enable tailored data privacy regulation at scale, AI can help to simulate consumer outcomes and risks, and digital platforms can support the aggregation and productivity of value chains.

Leveraging tech for Anti-Money Laundering and Combating the Financing of Terrorism (AML-CFT)

AUSTRAC is the Australian agency responsible for detecting, deterring and disrupting criminal abuse of the financial system. As criminals have become more sophisticated and developed new ways to target the vulnerable, AUSTRAC has needed to keep up. It has done this through a novel approach to AML-CFT monitoring. Traditionally, banks were asked to monitor their data and report suspicious activity to AUSTRAC, which often entailed a substantial compliance burden. Instead, AUSTRAC now uses privacy preserving software to directly access banks' data and then use sophisticated modelling and predictive analysis tools in combination with other data sources to identify potential criminal activity. By using AI, the authorities can detect suspicious activity before the bank even notices.

> You need to embrace **privacy regulation as an enabler of innovation**, not a hindrance.
>
> – Convening participant

5. Data governance is at the heart of the nexus

The discussions around governance and DFS as it relates to AI, cybersecurity, CBDC and transparent supply chains all in some way deal with data governance. To govern DFS in a way that protects customers and fosters innovation, policymakers must have guiding principles on data privacy, protection and use. Thus, effective data governance is the foundation for effectively leveraging new technologies to contribute to the SDGs. Many emerging economies still lack comprehensive data governance frameworks. Where frameworks have been adopted, they are often modelled on foreign regulation (notably GDPR) rather than tailored to the local context.

Governance needs at the nexus

What is needed to make the most of the opportunities presented by DFS while effectively managing the potential downsides?

1. An omnibus framework

Even though the New Nexus series topics focus on tech, what is ultimately at stake are the basics of market conduct and data governance. All the topic areas also require cross-cutting infrastructure such as digital identity and open data to unlock the opportunities and manage the risks. Thus, there is a need for **foundational regulation or systems** to form the backbone for responsible digital innovation. This would include a cross-institutional **market conduct framework**, as well as a cross-cutting **data governance** framework. In parallel, a secure **digital identity system** is needed. Establishing an omnibus framework that will cover all the foundational elements is a complex task that cuts across sectors and requires the dynamic management of often competing priorities. It is a long-term undertaking rather than a quick win.

> "It is important to note that with privacy, we may find it helpful to think about privacy of what and privacy from whom. **Distributed ledger technology can manage that distinction and we might find it gives us more room to find the perfect privacy fit in these solutions** – because I doubt they'll be the same."
>
> – Convening participant

2. Policy leadership for a coordinated approach

Implementing the cross-cutting frameworks referred to above requires **coordination** across government, including the ICT ministry, financial sector regulators, the ministry in charge of identity systems and government's umbrella economic planning and development functions.

Policy leadership is needed to set the tone for effective coordination. Thus, there is a strong leadership role for the ministry of finance, the office of the president or another central policy node responsible for a country's digital strategy to "hold" the dialogue at the broad agenda level and represent a master view on governance that connects the dots across the various interconnected fields.

> "When thinking about digital currencies and digitalising the economy, it needs to start at the policy level, then the design considerations will flow from that."
>
> – Convening participant

A coordinated data governance framework: the case of Rwanda

The Rwanda Utilities Regulatory Authority (RURA) followed a public consultation process to draft a law on data protection whereby it reinterpreted GDPR for the local context. It realised early on that, as this is such a cross-cutting topic, coordination between ministries would be essential. It made use of existing coordination structures in government (such as a payments council that coordinates on all matters relevant to digital payments); and it engaged relevant regulators to agree that the tone for data protection would be set by the central law, with each regulator then aligning sector-specific regulations with the law.

3. Striking the right balance

Facilitating innovation while effectively managing risks requires governance frameworks to strike the balance at two levels:

- At the global–local level, there is a need to draw learnings from ground broken in the global space, while keeping the developing country context front and centre. There is also a need to take learnings from the developing country context into the global dialogue, and to find ways for cross-border coordination where the operations of big tech players (currently originating outside of most developing countries, while operating within them) are concerned.
- At the local level, each responsible regulator faces a need to strike the balance between over- or under-regulation to effectively regulate and promote responsible innovation. Across the world, sandboxes are gaining prominence, but they are not a panacea. A broad-based approach, encompassing traditional regulatory and supervisory tools as well as proactive market engagement, is needed to test and learn from new technologies.

4. An approach centred on principles, outcomes and collaboration

Striking the balance requires a focus on **principles and outcomes**, and the governance of the process to deliver such outcomes, rather than setting up strict rules for specific technology. A sustainable digital economy will inherently require flexible and **adaptive governance** approaches that allow stakeholders in industry, government and society to iteratively adjust their best practices and codes of conduct to derive the benefits of digitalisation without incurring unnecessary or unacceptable risks or losses.

To do this, it is necessary to **assess outcomes**, processes and risks, rather than try to measure tick-box compliance to rules. There also needs to be safe and responsible **data sharing**, locally as well as across borders.

Policymakers, regulators and the private sector need to work together in a **multistakeholder collaborative governance approach**, based on partnership rather than rules-based compliance. This means crowding in of the market in co-regulation or self-regulation, using moral suasion and leveraging industry associations. Collaborative governance is only possible in a **relationship of trust**. It requires constant regulator-market interaction, with small working groups characterised by dynamism and active listening.

> We have to go beyond compliance and towards collaboration and **continuous improvement**. From the regulatory perspective, collaboration is critical.
>
> – Convening participant

Singapore's Veritas initiative

The Monetary Authority of Singapore (MAS) has an explicit objective to facilitate innovation. In pursuit of this mandate, it embarked on a process to revisit how it regulates, not by top-down rules, but in a collaborative way. Following intensive public consultation, MAS in 2016 issued the Principles to Promote Fairness, Ethics, Accountability and Transparency (FEAT) for AI. As part of the work to translate these principles into practice, MAS launched the Veritas initiative, a multi-stakeholder initiative to develop open-source code for algorithmic credit scoring whereby financial institutions can measure the risk of discrimination. Furthermore, it adopted a voluntary model for open banking. Thanks to industry buy-in generated through the collaborative approach, the result was the creation of the largest marketplace for open APIs in the world.

> When dealing with a person, a consumer may have some inkling if they're being discriminated against, but **when the decision is algorithm-based**, consumers won't know that they're wrongly excluded. Surfacing harms is an evidence gap.
>
> – Convening participant

It is also important to bring the **perspective of the end-user** to the table and to ensure that all decisions are designed with their needs and outcomes in mind. In the emerging market context, where not everybody has a smartphone or an ID, or the digital wherewithal to protect their data, understanding the implications of digital innovation creates a need to survey consumers, do rapid testing of consumer perceptions and experiences, or directly incorporate consumer representatives as part of the collaborative governance approach.

What can development partners do?

Development partners can play a key support role to realise these governance needs, and they can do so at a global, regional and local level.

At the **global** level, development partners can:

- **Represent the emerging market voice in the global dialogue** by testing new paradigms for regulation, advocating at a global level for the need for more nuanced regulation based on the level of development, and documenting the potential unintended negative consequences of copy-and-paste regulation.
- **Provide guidance to emerging market regulators for implementing global standards, as well as on frameworks for regulating for innovation,** by documenting successful case studies of implementation and translating standards and best practices into toolkits or decision trees for regulators.
- **Support knowledge exchange across regulators** by creating forums for discussion, facilitating exchanges between regulatory peers or cross-country working groups or communities.
- **Hold the cross-cutting narrative** across different topics in the nexus between DFS innovation, governance and sustainable development – as the New Nexus series aimed to do as first step.
- **Support the development of improved measurement indicators** that speak to an outcomes or principles-based framework, rather than a rules-based framework.

At the **regional** level, there is scope to host regional convenings on key topics and to support **regional harmonisation** of approaches and principles to avoid fragmentation and promote the sharing of learning and best practices.

At the **country** level, there is a need to support discrete national priorities, namely:

- **Infrastructure-building**, by establishing a digital identity system. This is an immediate priority, as it provides the backbone for innovation.
- **Technical assistance** for the development of an omnibus regulatory framework (and regulator) on data governance, cybersecurity and for supporting responsible innovation.

> **AI's contribution to the SDGs depends on us:** working together, mitigating and managing those risks.
>
> – Convening participant

- **Establishing collaborative regulatory approaches:** Help to set up coordination mechanisms between relevant spheres in government, and advocate for the role of the policymaker in holding the big-picture view from which coordination cascades into different departments. Also, advocate for governments to work with industry towards the achievement of positive outcomes.
- **Leveraging technology for governance:** Consider where technology can be deployed to help regulators and supervisors in measuring outcomes, and provide technical assistance to pilot this.
- **Giving the consumer a voice:** Measure the customer experience and customer outcomes to help inform governance approaches. This includes using tech to simulate customer harms and building outcomes indicators, working with others that are already active in this space.
- **Conducting education and capacity-building initiatives** to support regulators and policymakers, as well as consumers, in navigating DFS. Build regulatory capacity on core topics such as data governance and digital currencies.

Embed specific actions in a holistic digital strategy. To navigate the various priorities as outlined above, governments require support to define an overarching DFS governance and innovation facilitation strategy. Such a strategy would set priorities for different timeframes. For example, infrastructure development may be an immediate priority, while in parallel moving towards outcomes-based co-regulatory approaches in the medium term and putting in place the necessary omnibus regulatory framework as a longer-term objective. There is a clear role for development partners to help define the priorities and sequencing, and to provide technical assistance for the implementation of the strategy.

> Regulators don't know what they don't know and don't want to publicly say it. Capacity-building is key and **you need a safe space for regulators to share learnings and questions with their peers**.
>
> – Convening participant

Filling evidence gaps

Finally, development partners have an important role to build knowledge on core topics that will help to advance the governance agenda at the nexus with DFS and sustainable development. Key research needs identified include:

- What existing coordination governance models exist that we can learn from and scale up in emerging economies?
- What are the key policies from global jurisdictions such as the USA, EU and China relevant to DFS governance in emerging economies? What are the best entry points for emerging economy regulators to ensure their voice in these policy discussions?
- How can regulators test innovations in their market and what support do they need?
- How best to measure consumer outcomes and what are the options for making the consumer voice heard in governance models?
- What are the technological applications that could support outcomes-based governance? And what skills do regulators need to apply these technologies?
- What data governance solutions in emerging economies go beyond copy-and-paste regulation? What opportunities are these solutions creating? What risks are being introduced?

> **If we don't understand something, how do we regulate it?** In the private sector, just now, are we discovering the potential and possibilities of AI. We haven't even started scratching the surface from an AI perspective, then what are we regulating?
>
> – Convening participant

Conclusion

This note examined the key question of how governance models should evolve for digital financial services to contribute positively to the sustainable development goals. This question has a cross-jurisdictional element, as well as a national element. It talks to a broader, collaborative view of governance, where there is shared accountability across different types of regulators and where incumbents as well as new types of market players are made part of the solution. Rather than just seeing it as the subject of regulation, the question also talks to a focus on outcomes (rather than an attempt to regulate innovations on a rules basis) and a focus on leveraging technology to aid supervision.

As the quest for fit-for-context, collaborative approaches continues, the development community has an important role to facilitate dialogue between policymakers, regulators and market players, at the global level as well as national level, to cut to the core of the nexus between governance, DFS and sustainable development.

Visit the New Nexus page to further explore these topics.

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About Cenfri
Cenfri is an independent African economic impact agency based in Cape Town. We work to boost economic growth and increase sustainable development in emerging and developing markets. We collaborate with partners to deliver impact through research, capacity-building, convening and innovation support in four focus areas: financial sector innovation, integrity, resilience, and inclusive digital transformation. Our core focus is to understand consumer needs and market constraints to generate insights that can inform policymakers, market players and development partners who seek to unlock development outcomes through sustainable finance and digital inclusion.

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EMSD is a global programme of the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, commissioned in 2014 by the German Federal Ministry for Economic Cooperation and Development (BMZ). To this end, EMSD convenes change agents from think tanks as well as the public, private and financial sectors in multi-stakeholder dialogues around three core topics: (1) "Sustainable Infrastructure", (2) "Sustainable Finance" and (3) "Digital Solutions for Sustainability". To ensure lasting impact, EMSD and its partners disseminate ideas across global policy fora such as the G20 engagement groups and scale innovative approaches across GIZ's global network.

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