

Regulating for innovation: An evolving framework

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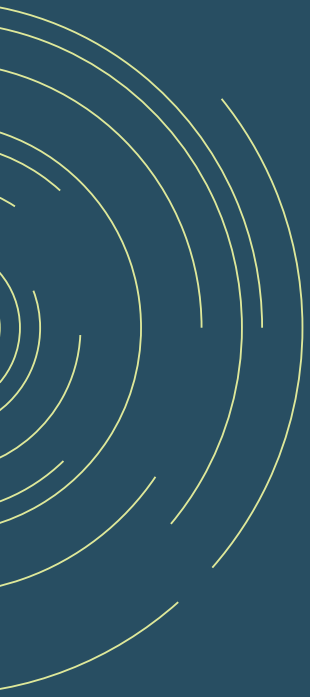


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Introduction

Innovation is changing the financial services landscape. Digital innovation is changing the way financial services are delivered and, indeed, the very nature of financial markets. Innovation has the ability to create opportunities, enhance efficiencies, increase competition, drive scale and improve the reach and value of financial products and services to consumers. Digital innovation is:

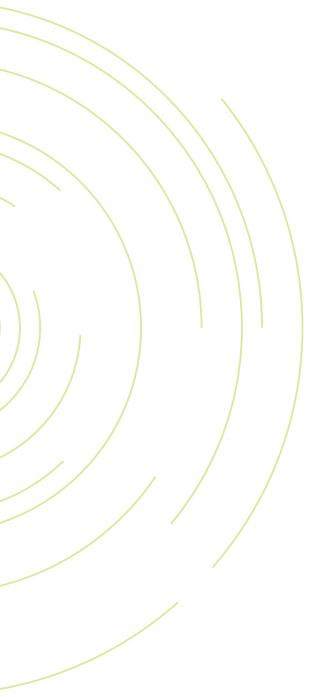
- Enabling increased efficiency, allowing lower-cost products to be financially feasible thereby making it possible for them to serve new target markets.
- Introducing new players functions and new partnerships. Insurtechs¹ have shifted their attention from a focus on mobile network operator (MNO) partnerships to include a focus on digital delivery or online platforms (Cenfri insurtech tracker, report forthcoming).²
- Overturning traditional notions of distribution. Digital platforms³ that match buyers and sellers of goods and services can enable the distribution of insurance products to individuals and small and medium businesses who were traditionally outside the reach of formal financial services (Smit et al., 2019).
- Revolutionising how services are priced and how customers are served. By drawing on new data sources, sensor technology, machine learning and AI, financial-sector players can use technology to differentiate themselves in the market by using their client data to better understand client needs and behaviour and tailoring their products accordingly.

1 Insurtech is “defined as an insurance company, intermediary or insurance value chain segment specialist utilising technology to either compete or provide valued-added benefits to the insurance industry” (Sia Partners, 2016).

2 Cenfri published a report in 2017 on how insurtech is addressing the major challenges in microinsurance in the emerging world. It is based on an underlying insurtech tracker database, which is updated regularly and has shown a remarkable growth in the number of inclusive insurance innovations globally. A forthcoming report provides a summary of the current state of insurtech in emerging markets.

3 insight2impact’s interactive database on Africa’s digital platforms provides a rare insight into the rise of African digital platforms and how they are connecting consumers and providers across Ghana, Kenya, Nigeria, Rwanda, South Africa, Tanzania, Uganda and Zambia. The tool can be used to navigate through various attributes of digital platforms, including the types of products and services offered, and the types of payment methods allowed on each platform.





However, with innovation also comes risk.⁴ For instance, data protection risk can arise when data gathered from clients becomes available to unauthorised parties without the clients' consent. Market conduct risks arise when chatbots sell products to consumers irresponsibly. New business models that are operating in grey areas pose risks to regulators, as this increases the potential for regulatory avoidance or non-compliance, and it poses risks to providers that are faced with operating in an environment of regulatory uncertainty. The risk of partnership failure is also heightened, given the fact that these innovative initiatives are often driven by technical service providers (TSPs) outside the regulated financial service provider (FSP) sphere.⁵ Due to the novel nature of innovation, it is often not fully accommodated in current regulatory frameworks.

Balancing benefits and risks. Given that innovation brings with it both benefits and risks, it is the regulator's role to proactively consider the trade-offs between the two: On the one hand, the benefits from innovation create an imperative for the regulator to ensure that both the regulatory framework and its actions in regulating do not hamper innovation but rather promote or facilitate it. On the other hand, the regulator has a duty to protect consumers against any risks arising from innovation. The regulator is faced with balancing its mandate to develop the market with its mandate to protect consumers.

Multiple possible approaches to innovation. There are various approaches and levels at which innovation can be facilitated. These approaches are driven at either the policy level or the regulatory level, and they address either innovation broadly or specific risks that emanate from specific innovations. It is the focus of this note to unpack the different approaches and tools to help regulators navigate the decisions they face.

Market context determines need. The market context will determine whether the regulator is confronted with the need to respond to innovative developments. Are there innovative developments – or can such developments be foreseen – that do not fit neatly within the existing regulatory framework or supervisory system? Equally importantly, does the supervisory authority have the willingness to support innovation?

These topics and trends apply across the financial sector. Thus this framework, although originally developed and tested in the context of insurance, is applicable to all financial sector regulators – providing steps and potential tools to consider, and to help guide decision-making.



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- 4 The International Association of Insurance Supervisors (IAIS) identifies six primary risks arising from innovation in the "Use of Digital Technology in Inclusive Insurance" Application Paper (2018): client value risks, systems or operational risks, marketing risks, legal risks, systemic risks, regulatory avoidance risks, and data and technology risks.
 - 5 EcoLife was a product that was sold and marketed as part of an airtime package, with free life cover as an additional benefit. By June 2011 (seven months after its launch), it had reached approximately 20% of the Zimbabwean adult population. A tripartite partnership between EcoNet (a Zimbabwean MNO), First Mutual Life (FML) (a Zimbabwean insurer) and Trustco (a Namibian-based TSP) made the provision of EcoLife possible. Before launching EcoLife, EcoNet and FML sought IPEC's approval. The regulator required that EcoNet formally register as FML's agent and reviewed the agreement between EcoNet and FML, but it did not review the tripartite agreement. In June 2011, following a royalties-related dispute between Trustco and EcoNet that resulted in the suspension of the service, all EcoNet subscribers lost their EcoLife cover overnight. Upon cancellation, 62% of EcoLife customers were not notified about its cancellation. Demand-side research indicated that 63% of sampled consumers ruled out the use of similar products in future, and 42% were dissatisfied with insurance. This illustrates the significant reputational risk for the insurance sector associated with such a suspension.

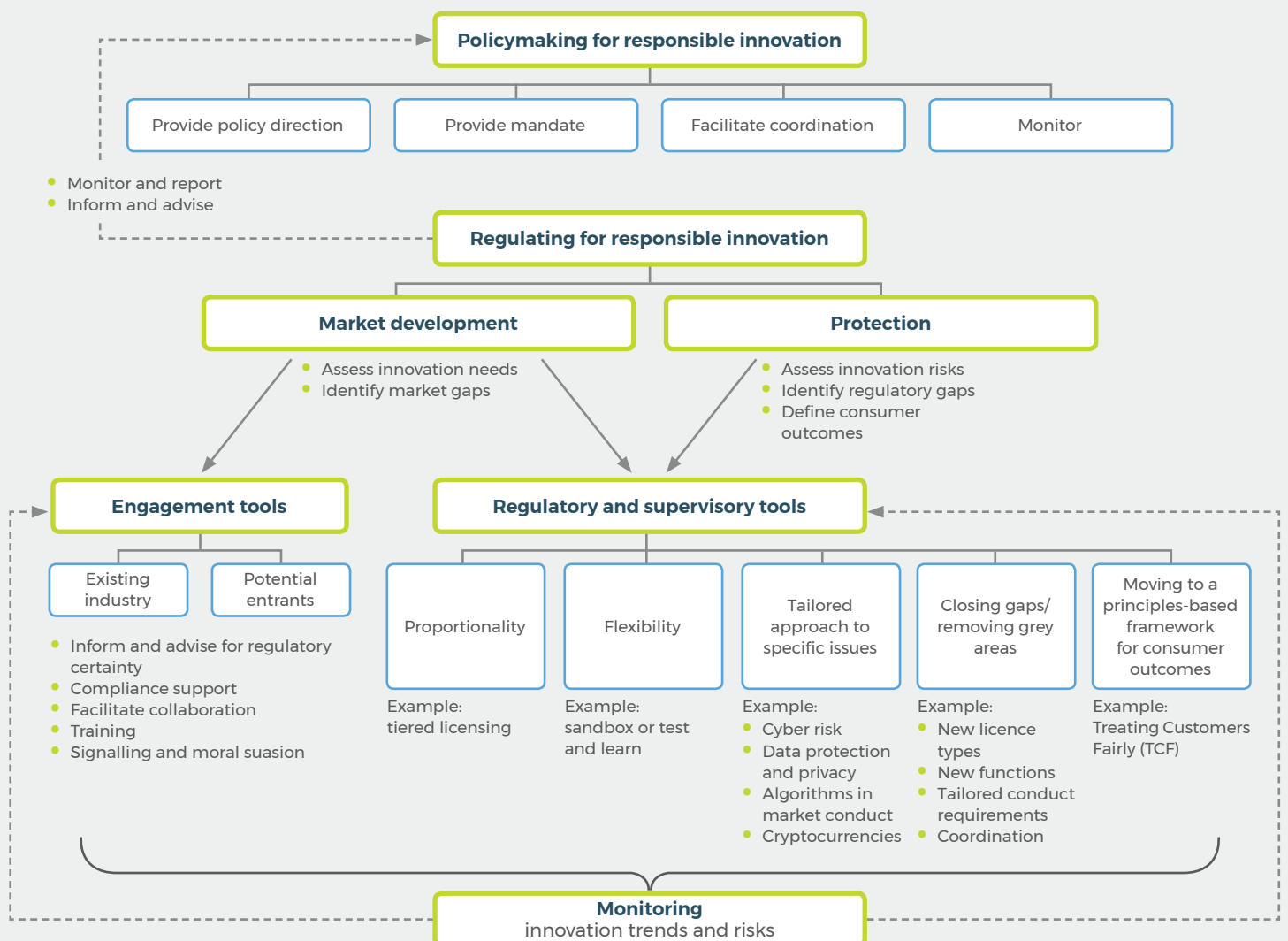
2 How to regulate for innovation

2.1. Introduction

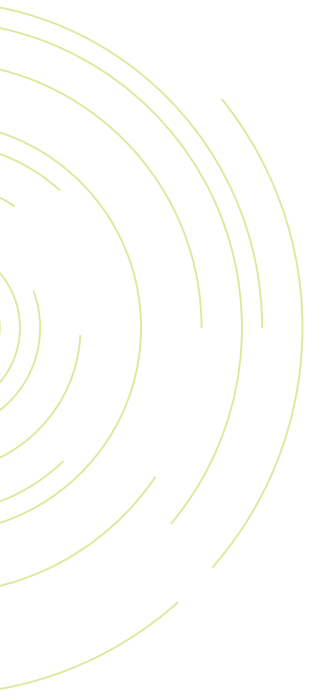
Background to how the framework evolved. This framework has been developed and shaped by a number of projects and engagements. It stems from a few years of research followed by technical assistance provided to regulators on the question of how to regulate for responsible innovation. Initially, we tested the framework with insurance regulators, but we have realised that it has broader applicability across the financial sector.

The regulating-for-innovation framework. The framework serves as a toolkit for regulators for how they can better encourage and facilitate innovation in their markets while protecting consumers, thereby fulfilling both market-development and consumer-protection mandates. It depicts the two components of regulating for innovation: one addressing the role of the policymaker, the other addressing the role of the regulator. The subsections below unpack these components.

The Regulating for Innovation Framework



Source: Authors' own (2019)



The role of the policymaker in regulating for innovation is often overlooked, and our research has shown the implications of a missing policymaker on market innovation. The decision-maker responsible for financial-sector policy should not only be privy to innovation discussions but be a key actor in driving innovation.

2.2. Policymaking for responsible innovation

The path to facilitating and encouraging innovation starts at the policy level. Policy leadership is key to unlocking the role of the regulator in regulating for innovation. The policymaker has various roles:

- **Provide policy direction.** The policymaker is in a position to target and prioritise innovation by means of clearly articulated innovation objectives, presenting the regulator with a clear vision for change.
- **Provide a mandate.** A mandate determines the type of activities a regulator can engage in and when it can intervene. To support innovation, the regulator needs an explicit mandate, bestowed on it by legislation or via its board, for market development or the promotion of competition. Increasingly, the legal mandates of financial regulators extend beyond a narrow focus on regulation and supervision. By providing the regulator with a clear and explicit market-development mandate, the policymaker is capacitating the regulator to encourage and facilitate innovation.
- **Facilitate coordination.** Innovative developments often cut across or fall between the mandates of multiple regulators, and thus coordination among regulatory bodies is crucial. It is a core role of the policymaker to implement coordination mechanisms to ensure a clear understanding of roles between the policymaker and regulator, and between all other official decision-makers. Observed approaches include: memorandums of understanding (MoUs) between regulators, mandate-limited application of tools, an innovation coordination body or overarching innovation framework.
- **Monitor.** The role of monitoring lies with both policymaker and regulator, but it is the responsibility of the policymaker to identify appropriate indicators that effectively track progress towards policy objectives. Furthermore, monitoring is required at the policy level across regulatory silos. It is the joint responsibility of the two decision-makers to ensure the consistent, effective and efficient data collection for monitoring purposes to track progress. As indicated by the arrow going up from regulating to policymaking in the framework, the regulator's responsibility is to provide feedback to the policymaker by means of monitoring and reporting the progress, observed trends, and impact of innovation, as well as to inform and advise the policymaker based on its learnings and experiences.



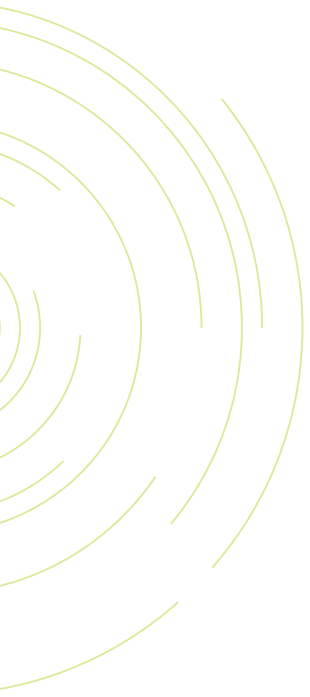
Policy leadership is key to unlocking the role of the regulator in regulating for innovation.



2.3. Regulating for responsible innovation

With clear and visible policy leadership, and equipped with a market-development mandate, the regulator is capacitated to deliver on policy objectives. However, even if the regulator is not guided by policy direction but has a mandate to develop the market, it is able to use its discretion to facilitate and encourage innovation.

Range of tools to achieve a balance. There is a range of tools available to the regulator to encourage responsible innovation in its market that, when



employed, can achieve the balancing act as depicted by the balance scale in the framework. The regulator needs to decide what tools to use, as not all of them will apply or be appropriate in every context. The tools available to the regulator fall into two categories: regulatory and engagement. While regulatory tools entail adjustments to regulatory instruments and supervisory processes, engagement tools include proactive engagement with, and signalling to, industry. The latter tools, although not considered as part of the traditional regulator's toolbox, are vital to addressing barriers to innovation that either do not stem from legislation or do not require legislative amendment to be implemented. It is vital to consider a combination of both regulatory and engagement tools in any regulating-for-innovation strategy. The framework is essentially a decision guide for which tools to apply and how they relate to one another.

Two key components of a financial regulator's mandate are its functions to develop the market and its functions to protect consumers. Engagement tools (on the left-hand side of the framework) are used to advance market development, while regulatory tools (in the middle and on the right) have a dual market-development and consumer-protection function.

Under the market development function of the regulator:

Proactive engagement. Proactive communication with industry is an accessible tool that wields significant power and can have far-reaching impact. Two-way engagement is vital because the regulator may not have a full view of industry's evolving needs; and it is, therefore, important for industry to be able to provide feedback to the regulator as well as vice versa. It is important that the regulator targets its engagement, encouragement and support not only at existing market incumbents but also at potential market entrants who may be the source of future innovations. Typical tools include convening current and potential players on innovation-related topics, clarifying uncertainties regarding regulatory requirements or supervisory processes, or simply signalling to the market the importance of innovation. Other proactive engagement tools include:

- Facilitating collaboration
- Training
- Informing and advising
- Compliance support
- Funding support

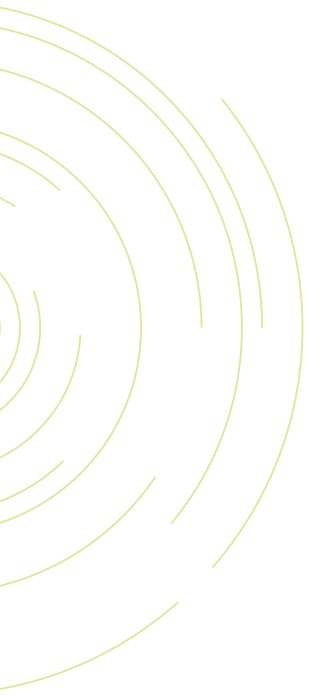
Proportionality. The proportionality principle often forms the basis for tiered regulatory requirements or licences. It involves adapting specific supervisory requirements so that they align with the "nature, scale and complexity of risks posed" (IAIS, 2012). It has been implemented by financial-sector regulators in numerous jurisdictions and forms the foundation for any regulating-for-innovation approach. Proportionality entails setting requirements in line with the level of risk posed. Examples include:

- Tiered licensing in terms of which entities are subject to different prudential and reporting requirements based on the activities in which they are permitted to engage, such as microinsurance licences
- Proportionate measures such as different agent-qualification requirements for simplified products or for products sold through certain channels, or tiered know-your-customer (KYC) requirements in line with transaction limits
- Dedicated frameworks – a carved-out regulatory space providing a specific dispensation for a specific type of player or structure that is relevant from an innovation point of view (cell captives, for example)



Engagement tools are used to advance market development, while regulatory tools have a dual market-development and consumer-protection function.

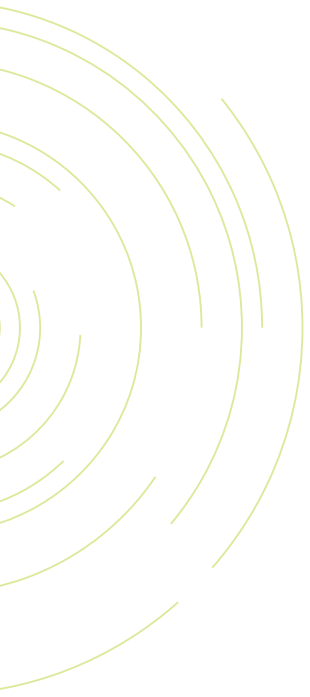




Flexibility (licensing and product approval). Apart from the general principle of proportionality, there are a number of tools that the regulator can use to exercise flexibility. The principle of flexibility concerns different approaches to allow new products, services and business models meeting market needs to be introduced into the market – ideally “under carefully controlled conditions” (AFI, 2011). It is different from other regulatory tools in that it does not make any changes to regulation, but it is an exercise of the regulatory authority’s discretion within the parameters of the existing regulatory framework. The regulatory architecture will determine whether a regulator has the discretion to make certain interventions beyond that which is already included expressly in legislation. Given the fluid nature of innovation, some level of discretion will be important to ensure flexibility to respond to unforeseen developments. It gives regulators an opportunity to learn from the risks related to innovation, enabling them to tailor subsequent regulation accordingly. We see two main examples of how flexibility is applied to promote innovation in the financial sector:

- **The first is the so-called regulatory sandbox.** A sandbox is essentially a controlled environment where innovators are given an opportunity to test their products without having to comply fully with regulations while regulators keep a close eye on, and learn from, the impact of those products on the market and consumers. Sandboxes can manifest in different forms but are typically structured almost like a competition, with eligibility criteria and applicants for entry. Each firm or venture that applies to enter the sandbox and meets the eligibility criteria is then assessed on its own merits, so that the regulator may tailor and implement safeguards accordingly (Beyers et al., 2018).
- **The second is the broader “test-and-learn” approach.** This approach has been applied for a number of years and comprises tools that go beyond a strict sandbox definition, for example, applying a letter of no objection, with safeguards, or leveraging discretion in the product-approval process. In practice, test-and-learn is often used as an alternative way of allowing players that do not fall within the current regulatory framework into the market on a permanent or semi-permanent basis. The letter of no objection issued by the regulator thus becomes the permanent regulatory dispensation for these players. In contrast, generally, sandboxes specify the concessions as temporary or specify that the sandbox applies to pilots only, before the fully fledged launch.





Tailored approach to specific issues. There are new and different risks that arise from the introduction of new technologies. It is the role of the regulator to identify these risks and formulate an appropriate regulatory response. Thus, over and above putting into place a broader or overarching regulating-for-innovation approach, it is necessary to regulate for the specific risks that emanate from specific innovations. For example, data protection and privacy risks have proliferated from the increased collection, storage and use of consumer data (Gray et al., 2018). It is up to the regulator to protect consumers from these risks, which may have severe consequences such as exclusion. However, given that the financial-sector regulator is not the data-protection authority, its role will depend on the legislative context of data protection in its country:

- If a data authority has been established and there is an overarching data-protection framework, the regulator can choose either to shape the application of the data-protection policy to the financial sector or to delegate the regulation of consumer-data risks to the data authority.
- If there is no data authority and no overarching regulation, the regulator can choose either to actively create the data-regulation approach for the financial sector or to take the risk of not developing a data-regulation approach, leaving the sector without a specified legislative approach to consumer protection and privacy.

The strategies and tools employed to achieve this objective must, therefore, be tailored according to the overall legislative approach to data protection in the specific jurisdiction and must be aligned with the regulator's mandate and market context.



It is vital for these regulators to communicate and coordinate effectively to avoid regulatory uncertainty.

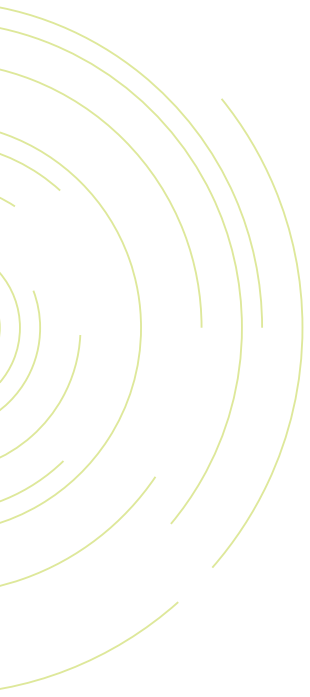


Removing grey areas. New business models that are operating in grey areas pose risks to regulators, as this increases the potential for regulatory avoidance or non-compliance, and it poses risks to providers that are faced with operating in an environment of regulatory uncertainty. It is suboptimal to regulate, for example, a non-broker under a brokerage licence – it means that the entity is complying with irrelevant requirements and, from the regulator's perspective, that there may not be a full set of appropriate compliance requirements in place for the entity's operations. To close gaps and remove or reduce grey areas, regulators could consider introducing the following:

- New licence types
- New functions
- Tailored conduct requirements

Additionally, communication and coordination between financial-sector regulators and other regulators are fundamental to removing grey areas. Innovation often cuts across the jurisdictions of multiple regulators. For example, mobile insurance involves not only the insurance regulator but also the telecommunications authority and the payments regulator. It is thus vital for these regulators to communicate and coordinate effectively to avoid regulatory uncertainty.

Following from the middle to the bottom right-hand side of the framework, regulatory tools also come into play at the other end of the balancing act, namely the function of a regulator's mandate relating to consumer protection and the soundness of the market. In the same way it is important for regulators to understand innovation gaps and the tools they can apply to promote innovation, it is also vital that regulators understand risks and what tools to apply to manage risks. The assessment of risk and a risk-based approach to supervision form part of the toolkit, as would be crafting a regulatory framework for tailored responses to specific issues identified.



Under the consumer-protection function of the regulator:

Expanded consumer-protection mandate. It is becoming increasingly commonplace for regulators to look beyond tools that respond to bad practices (such as consumer-protection tools, disclosure requirements, fit and proper requirements, and governance requirements) to also consider the consumer outcomes that they want to achieve. Regulating for consumer outcomes requires a principles-based rather than a rules-based approach. Treating Customers Fairly (TCF) is an example of a principles-based framework to regulate for consumer outcomes.

Many financial-sector regulators across a number of jurisdictions have implemented elements of TCF under their consumer-protection mandates. The regulator's consumer-protection function has developed to include regulating for positive consumer outcomes. In partnership with CGAP, Cenfri identified in recent research six core outcomes in financial-services engagements, namely:

- **Suitability:** I have access to good-quality services that are affordable and appropriate to my needs and situation.
- **Choice:** I can make an informed choice from among a range of products, services and providers based on appropriate and sufficient information and advice that are provided in a transparent and easy-to-understand way.
- **Safety and security:** My money and information are kept safe, and the provider respects my privacy and gives me control over my data.
- **Fairness and respect:** I am treated with respect throughout my interaction with the provider, even when my situation changes, and I can count on the provider paying due regard to my interests.
- **Voice:** I can communicate with the provider through a channel of my choice and get my problems resolved quickly with minimal cost to me.
- **Meets purpose:** By having access to and using products designed and delivered in this way and getting the service I need, I am in a better position to increase control over my financial life, to manage a shock, or to attain other goals.



Understanding the customer outcome from an engagement with a market player, better equips the regulator to tailor its regulatory responses for better outcomes.



Positive customer outcomes are a natural progression – the next evolution of consumer protection – and a vital consideration in any regulating-for-innovation approach. Whereas protecting consumers may focus a regulator's attention only on the risks, customer outcomes force a regulator to explicitly consider the benefits and risks of a product. Understanding the customer outcome from an engagement with a market player, better equips the regulator to tailor its regulatory responses for better outcomes. Customer outcomes ties in with flexible and fit-for-purpose regulation. Implementing TCF principles in market-conduct guidelines, for example, is a way in which to regulate in a flexible manner that is conducive to innovators and technology, and that allows the consumer to benefit without posing additional risks.

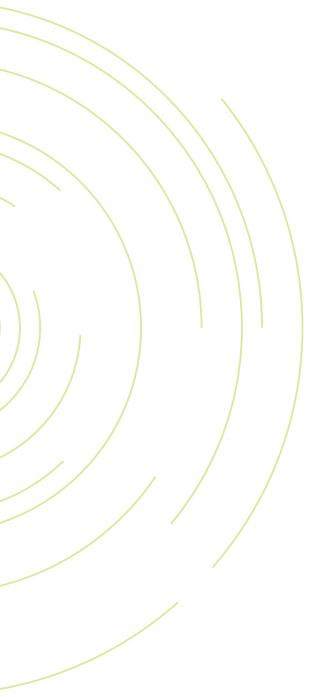
3 Conclusion

Equipping regulators to regulate for innovation. This focus note aims to equip regulators with a decision framework that illustrates the available tools required to regulate for responsible innovation. A range of tools exists to give effect to both the market-development and protection functions of a regulator’s mandate by facilitating and encouraging innovation while protecting the market and consumers. Regulators can use the framework to help navigate their role and guide their decisions in regulating for innovation. A key takeaway is that engagement tools wield significant power and should not be overlooked. Proactive engagement and encouragement may be as impactful as, if not more impactful than, effecting legislative amendments.

Implementation requirements. Although it is possible to regulate for innovation without one, a market-development mandate capacitates the regulator – unlocking its full potential to embrace and facilitate market innovation. Given that innovation is often not confined to a specific sector, and thus may cut across several sectors and the regulatory authorities that govern them, coordination is critical to ensure that regulatory grey areas be kept to a minimum. In the absence of effective coordination, the innovator may be deterred by considerable regulatory uncertainty, robbing the sector and its consumers of the benefits that it would have brought had it been accommodated. Finally, a successful approach to regulating for innovation ultimately depends on the commitment of the regulator to see the process through, to monitor trends and progress, and to adapt the approach as and where required.

An evolving framework. This framework represents our contribution to the discourse thus far, to illustrate that regulating for innovation extends beyond sandboxes and regtech – that an understanding of the bigger picture, and how everything fits together, is required. It is intended that the regulating-for-innovation framework remains a “living” framework that will develop and evolve with each update. Despite its genesis in insurance, the regulating-for-innovation framework is applicable to and cuts across the financial sector. It is thus useful to decision-makers across the sector, regardless of the jurisdiction’s division of roles, or the regulatory and supervisory model in place. Future plans include the implementation of the framework with regulators spanning the financial sector in multiple jurisdictions and improving the framework with each learning.





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About Cenfri

Cenfri is a global think tank and non-profit enterprise that bridges the gap between insights and impact in the financial sector. Cenfri's people are driven by a vision of a world where all people live their financial lives optimally to enhance welfare and grow the economy. Its core focus is on generating insights that can inform policymakers, market players and donors seeking to unlock development outcomes through inclusive financial services and the financial sector more broadly.

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FSD Africa is a non-profit company that aims to increase prosperity, create jobs and reduce poverty by bringing about a transformation in financial markets in sub-Saharan Africa (SSA) and in the economies they serve. It provides know-how and capital to champions of change whose ideas, influence and actions will make finance more useful to African businesses and households. It is funded by the UK Aid from the UK Government. FSD Africa also provides technical and operational support to a family of 10 financial market development agencies or "FSDs" across SSA called the FSD Network.