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Navigating the Regulatory Maze: Balancing Innovation And Compliance For Digital Banks

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Executive Summary

Participants of the "Navigating the regulatory maze: Balancing innovation and compliance for digital banks" roundtable at the Insights Forum 2024, held at the Singapore Fintech Festival, included a mix of regulators and digital banks. They explored the question of balancing innovation with the need for safeguards and compliance in digital banking, as well as how regulators and digital banks can encourage innovation whilst managing risks in the financial sector.

The discussion between digital banks and regulators covered four main themes:

1. **Collaboration in the Financial Ecosystem:** There are challenges in fostering collaboration between traditional banks and digital banks, particularly due to competition concerns. Central banks are seen as key players in driving collaboration through regulatory frameworks and foundational infrastructure. The Philippines, for example, has introduced a digital banking framework to increase competition and encourage new players to enter the market. This allows traditional players to feel confident that new players are properly regulated and have oversight. Regulators acknowledged efforts to foster innovation through a FinTech innovation regulatory framework and proportionality in regulation. Many regulators around the world are aiming to take similar steps. As stated by a participant, ***"We visit innovation hubs within the country and engage the innovators from there, educating them on regulatory requirements but also getting feedback from them on how that would influence what we do as a regulator."***

2. **Financial Literacy and Consumer Education:** Discussants emphasised the importance of educating consumers on digital financial services, ensuring they understand how to use these services safely and benefit from them. Efforts should be made to measure the impact of digital financial inclusion through initiatives like financial health indices.

   Tyme, a digital bank in South Africa, has initiated physical outreach efforts with consumers who may lack full access and understanding of digital banking. As part of its efforts, the bank set up kiosks across the country where consumers can set up a digital banking account and speak to ambassadors on site about issues or concerns, they may have. With this, the bank has been successful in its growth and expansion, since it now has over 10 million users and has approximately US$400 million in deposits in just under 6 years.

   Improved financial literacy will encourage more consumers to choose digital banking as they are more confident of using the digital financial services to their advantage, leading to growth in the industry.

3. **Data Governance and Privacy:** A strong governance framework is essential for managing personal data in the digital ecosystem. This involves clear policies on data ownership, protection, and usage, particularly when it comes to consumer data.

   Data is the key to SME finance and assessing creditworthiness. Banks need innovative ways to collect data, including transaction history, retail partnerships, and digital payments. Digital banking can serve even the poorest segments: for example, AI and alternative data are reshaping SME lending. By analysing consumer behaviour and non-traditional data sources, financial institutions can better assess SME creditworthiness.

   However, a robust data framework is essential to enable the use of AI and digital banking models so that banks can be innovative in their strategies to collect, analyse, and use data responsibly and effectively. As such, it is important for regulators to create frameworks on data sharing which will allow data to be shared between stakeholders in a responsible way. This can be done through the establishment of open banking frameworks by regulators which will foster collaboration between traditional and digital banks and allow consumers to consent to sharing financial data with digital banks and other third-party providers.

4. **Appropriateness and Suitability of Financial Products:** Financial institutions must ensure that products and services are suitable for consumers, aligning with the principles of appropriateness to avoid harm. Financial literacy and consumer protection should be embedded in the operational practices of banks and fintechs.

Introduction

Digital banks face a complex regulatory landscape as they strive to innovate and grow. With an increasing shift towards digitalisation in the financial sector, digital banks are emerging as key players in providing accessible, user-friendly financial services. However, they must navigate a range of regulatory challenges designed for traditional banking institutions, including licensing, compliance with capital requirements, anti-money laundering (AML) protocols, and customer protection.

Regulators are concerned with ensuring that digital banks adhere to robust risk management practices, protect consumer interests, and prevent threats such as cyber-attacks, fraud, and money laundering. Regulators must craft policies that maintain financial stability without stifling technological advancements.

Globally, there has been a rapid rise in consumer demand for digital financial services, which has led many firms to increasingly adopt technologies which facilitate these services. As a result, there has been a growth in the number of licensed digital banks worldwide offering digital financial services from 48 in 2014 to 235 in 2023[2].

Such digital banks are able to effectively adopt technology to facilitate the use of banking services like the transfer of funds online. With the convenience and flexibility offered by such digital financial services, there is potential for digital banks to serve as platforms for promoting financial inclusion in rural or impoverished communities, and to finance the growth of SMEs.

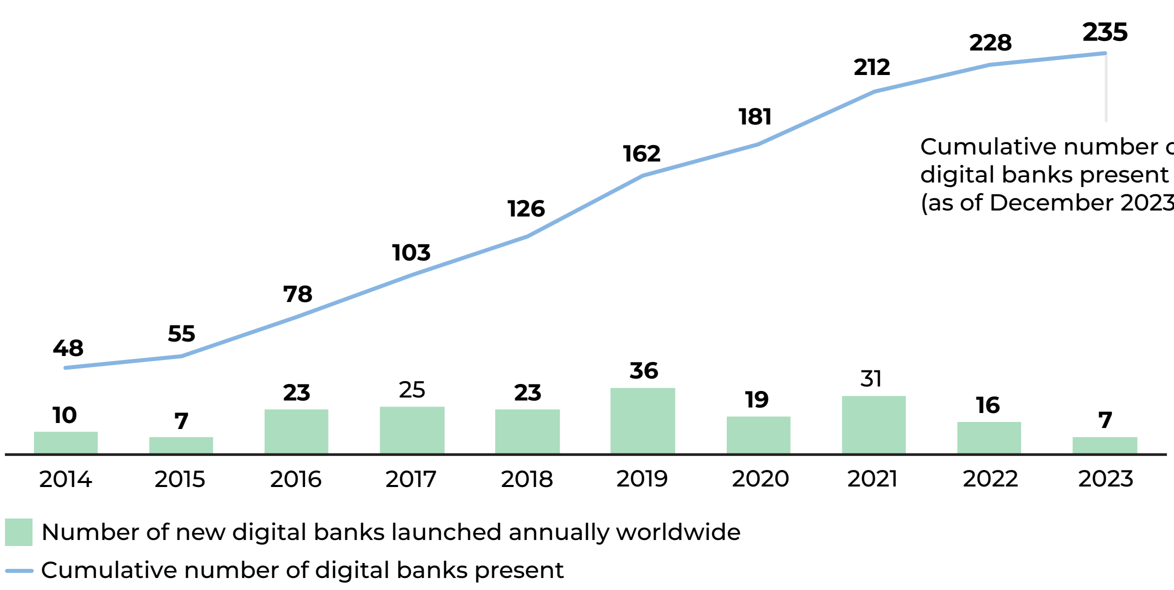
At the same time, there are risks associated with the use of digital financial services and regulation is needed to prevent the exploitation of these services for harm. Across the world, regulators have adopted measures to regulate digital banks, though these measures may differ across countries and are catered to the specific needs of the market in each country.

However, a critical issue in the regulation of such digital banks is the need to balance the protection of consumers and financial systems with the provision of the space required for digital banks to pursue innovation and to expand. Over-regulation can stifle innovation and growth, while under-regulation can leave consumers vulnerable to the risks associated with the use of digital financial services.

Due to the rapidly changing landscape in the digital banking industry, regulators must respond quickly and revise or adopt regulations that are sustainable in the long-term. Failure to do so can drive new entrants out of the digital banking market and stifle the growth of existing digital banks in a country.

Given the large potential for increased financial inclusion globally with the adoption of digital financial services, it is important that regulators support the growth of digital banks in a sustainable way. With this, the full potential of digital banks in uplifting underserved communities can be realised.

Figure 1: Number of new digital banks launched worldwide



Source: Oliver Wyman

Discussion

The Global Context:

Representatives from the International Finance Corporation (IFC) set the scene with the global context and a focus on SMEs and how digital banks have plugged some gaps that traditional banks have been challenged with:

1. The State of Financial Inclusion and Persistent Gaps

Financial inclusion remains an unmet Sustainable Development Goal (SDG) despite progress. Advances in access have been driven by technology, including mobile and digital networks. According to a 2019 report, the IFC estimates a $5.7 trillion MSME financing gap, meaning demand still outstrips supply. The Philippines representative emphasised that SME registration remained low due to complex permit requirements and limited SME lending. Similarly, the Namibian participant stressed that reaching the rural and informal economies remained challenging due to high digital banking costs.

2. The Role of Digital Finance in Expanding Access

Digital financial services are key to reaching underserved segments like MSMEs and women entrepreneurs. Traditional financial services have struggled with these groups due to high operational costs and perceived higher risks. Traditional banks have also lagged in innovation due to legacy infrastructure.

The IFC has supported digital financial services through lending to fintechs, digital banks, and DFS providers. In addition, the IFC offers risk mitigation tools, such as guarantees and first-loss facilities, to encourage lending.

3. The Need for Consumer Protection and Regulatory Guardrails

Digital finance presents risks, including over-indebtedness, financial exploitation, and aggressive recovery mechanisms. The financial ecosystem must serve the majority and do more good than harm.

The key challenge is finding the right balance between regulation and innovation to avoid stifling new solutions. The IFC focuses on principles-based safeguards, including:

- Anti-Money Laundering (AML) & Countering the Financing of Terrorism (CFT).
- Financial consumer protection
- Cybersecurity measures.

As a participant noted, ***"The system has to, as an ecosystem, evolve and serve the majority. And it has to do more good than harm. So, you do need those safeguards and those guardrails to be put in place. But what is the right level of guardrails and safeguards that doesn't stifle innovation and doesn't kill that outreach element before you get to where you need to go?"***

4. Liquidity, Market Dynamics, and the Role of Digital Financial Institutions (DFI)

Each market needs tailored approaches. Banks still hold the majority of liquidity and control its flow, even to digital players. DFIs must facilitate local currency liquidity from formal financial institutions to fintechs and alternative financial providers. Whilst some capital markets solutions exist, they remain limited. A mix of innovation, risk-taking, and regulatory safeguards is essential for financial inclusion to scale. It was emphasised that while digital finance is key to closing the MSME financing gap, it must be coupled with strong consumer protections and liquidity strategies. The importance of regulatory flexibility to allow innovation while maintaining trust and financial stability was highly stressed.

Key challenges for digital banks

1. Collaboration with Traditional Banks

Digital banks face resistance from traditional banks, which are often reluctant to collaborate, particularly with fintech companies. This lack of cooperation creates barriers to innovation and limits the growth of the digital banking ecosystem. Fintech companies face challenges in transitioning to digital banks due to cultural and compliance issues, but it was highlighted that there are opportunities for collaboration between fintech companies, regulators, and traditional banks to build utilities like credit bureaus and property rights systems to enhance financial inclusion.

The importance of open finance and consumer data sharing to empower consumers and enhance banking services was seen as an enabler for the growth of digital banks. There was a call for central banks to foster collaboration, particularly among banks and fintech companies, and build foundational infrastructure like shared utilities and public digital infrastructure to support financial inclusion.

2. Consumer Trust and Education

Despite advancements in digital financial services, there is a need for greater financial literacy among consumers to ensure they can safely use these services. Education on fraud prevention, understanding services, and digital security is critical for fostering trust and adoption. The conversation focused on financial literacy, collaboration, and data governance. Progress in digital financial services has improved, particularly through government-led efforts in consumer financial literacy and digital safety. The Central Bank of the Philippines, for example, has implemented initiatives that ensure consumers are educated on using digital financial services safely and are included in the digital ecosystem. The government also tracks financial health to measure the actual impact of digital services on consumers lives. The importance of customer partnerships was highlighted as key to ensuring that that consumers understand and benefit from digital services.

Financial literacy was seen to be closely tied to data governance. Strong governance around data, particularly when sharing personal information, is key to gaining trust. Participants underlined the importance of appropriateness and suitability in financial services, which ensures that consumers are not harmed by financial products. Financial literacy and education efforts, therefore, should be embedded in the way financial institutions operate to ensure that customers understand the impact of the services they use.

This is reflected in a comment made by a participant, ***"At the end of the day, our business is not really a business of providing money. I think our business is a business of providing trust and we are only as strong as our weakest link so there is a need to make the whole ecosystem stronger."***

3. Regulatory and Governance Frameworks

Digital banks are navigating complex regulatory environments. There is a need for stronger governance around data management, especially in terms of data privacy, ownership, and sharing, to protect consumers and ensure that services remain compliant with laws. One size does not fit all: Digital banking must adapt to market conditions.

For instance, India has yet to issue regulatory licenses for digital-only banks, given the market and experience of regulators, who explained that even payment banks have struggled to become profitable due to high costs and liquidity constraints. The importance of physical banking in a large, diverse country like India remains, and physical banking infrastructure is critical for reaching digitally excluded populations. India regulator has taken a cautious approach by not issuing digital-only licenses, reflecting concerns about long-term sustainability and fair competition.

A participant stated that, ***"One solution does not fit every market size, every market type. You've got to look at what are the current market dynamics, what is working, what is not working, where are the safeguards correctly deployed, and where they are not correctly deployed."***

4. Appropriateness of Products

Digital banks must ensure that their offerings are suitable for consumers, particularly in emerging markets. They need to ensure that products are aligned with consumer needs, and financial literacy is embedded in the way these services are designed and delivered to avoid potential harm. As technology evolves, products must be considered within a sustainable financial ecosystem that balances digital innovation with the needs of underserved communities.

Key challenges for regulators

1. Balancing Oversight and Flexibility

Regulators face the challenge of providing effective oversight while maintaining flexibility to foster innovation. Finding the right balance between enforcing regulations and allowing the market to evolve, particularly in the fintech and digital banking sectors, is complex.

2. Encouraging Collaboration

Regulators struggle to facilitate collaboration between traditional banks, fintech companies, and other market participants. Many banks are reluctant to share resources or cooperate, making it difficult to build a unified, interoperable financial ecosystem.

3. Regulatory Frameworks for Emerging Technologies

Regulators must develop adaptable frameworks that cater to emerging technologies such as digital-only banks, cryptocurrencies, and new fintech services. This requires staying ahead of technological trends and anticipating risks, particularly consumer protection, without stifling innovation.

4. Ensuring Consumer Protection and Financial Literacy

Regulators must ensure that consumers are well-protected in a rapidly evolving digital financial space. This includes addressing issues such as fraud prevention, cybersecurity, and promoting digital literacy to ensure users understand and safely engage with new services. Partnerships between digital banks and regulators can collaborate to develop means of educating consumers in financial literacy. Consumer education can take place through financial literacy workshops organised by digital banks and regulators or through the use of digital platforms like social media or websites to convey information on financial literacy to consumers.

5. Data Governance

As data governance becomes more critical, regulators face the challenge of ensuring that personal data is protected, properly managed, and used appropriately. This requires establishing clear rules around data ownership, sharing, and privacy, particularly as digital financial services rely heavily on data to operate.

Discussed solutions

1. Creating Clear and Adaptive Regulatory Frameworks

Regulators should develop clear, flexible frameworks that can evolve with technological advancements. By introducing proportional regulation that considers the size, complexity, and risk profile of banks, regulators can encourage innovation while ensuring stability and compliance.

2. Promoting Collaborative Platforms and Engagement

Regulators can establish platforms that encourage ongoing dialogue and collaboration between banks, fintech companies, and regulators, where feedback and concerns are shared, and where regulatory challenges can be addressed in a constructive manner.

3. Implementing Regulatory Sandboxes

Regulatory sandboxes allow banks and fintech companies to experiment with new products and services in a controlled environment, under the oversight of regulators. This provides a safe space to test ideas, mitigate risks, and adjust regulations based on real-world outcomes and bridge the trust gap between banks and regulators.

4. Shared Infrastructure and Utilities

Encouraging the development of shared infrastructure such as credit bureaus, digital payment platforms, and data-sharing frameworks can facilitate collaboration. By establishing public digital utilities, banks can reduce operational costs and improve interoperability, which can lead to greater trust and cooperation.

5. Encouraging Data Governance and Consumer Protection

Regulators and banks can collaborate to establish strong data governance policies that ensure consumer data is protected while enabling innovation. Transparent rules on data ownership, privacy, and consent can address concerns from both banks and consumers, creating a safer and more reliable digital financial environment.

6. Building Capacity and Financial Literacy

Regulators and banks can jointly support initiatives to improve financial literacy, ensuring consumers understand the services they are using and can make informed decisions. By investing in consumer education, both entities can ensure digital inclusion is achieved while protecting consumers from fraud and scams.

By implementing these solutions, regulators and banks can create a more conducive environment for innovation, reduce friction, and ultimately work towards a more inclusive and robust financial ecosystem.

Conclusion

The core business of banking is trust. The financial sector is ultimately not just about providing money but about ensuring trust. The industry is only as strong as its weakest link, so all players (banks, fintech companies, digital banks, and regulators) must work together to strengthen the financial ecosystem. Trust is the foundation of finance: ensuring strong security, compliance, and consumer protection is essential for building a resilient financial system.

Find the middle ground: regulators must enable innovation without excessive restrictions, while digital banks must perform due compliance and risk management checks while pursuing the development of innovative products and services.

Banks must evolve to serve SMEs. A traditional banking approach does not work for SMEs, and digital solutions and a tech savvy mindset are necessary.

Regulatory harmonization is crucial: Fragmented, unpredictable regulations create compliance burdens and can stifle innovation.

Regulators must adopt a long-term, consistent approach, and digital banks must balance innovation with responsibility. The financial industry can only thrive if all stakeholders collaborate to strengthen the ecosystem.

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