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CASE STUDY

Kenya: A regulatory sandbox for the financial sector

Policy and regulation

New financial products, services and business models based on digital technologies brought new challenges for Kenya's regulators. Risks around cybersecurity, data protection, data standards, service interoperability and intellectual property meant regulators needed a change of approach. So, in 2019 the government launched a regulatory 'sandbox' to test new financial products and services before they enter the market. The sandbox provides evidence for regulators on the risks and opportunities brought by new products and services to inform potential changes to the regulation.

The problem

New financial products, services and business models – based on big data, machine learning, and non-bank entities – brought new challenges for the Capital Markets Authority (CMA) of Kenya. The key challenges were around protecting financial consumers and facilitating their access to international financial markets (but without compromising fintech innovation); maintaining data standards to facilitate interoperability between services and locations (but without compromising privacy and competition); and protecting fintech firms' intellectual property to encourage investment and innovation (but without undermining competition).

Solution

Following a growing trend among financial regulators around the world, in 2019 the CMA Kenya launched a regulatory 'sandbox'. The sandbox helps the CMA to assess and manage emerging risks brought by new financial products and services. It also provides an evidence base to inform potential changes to regulation. The sandbox sits within the government's broader policy objective to facilitate innovation, growth and competition in Kenya's capital markets.

The sandbox concept comes from software development. Software developers create restricted environments to test new code before they deploy to live operating systems. Financial regulators around the world now apply the concept to test new financial products and services before they enter the market. Tests either occur in a real-world environment – with real consumers and other market actors – or in a virtual environment using data modelling. During the tests, the regulators observe the product or service, and in some cases grant it exemption from existing regulation.[1]

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In March 2019 the CMA approved the 'Regulatory Sandbox Policy Guidance Note' and opened the first call for applications to the sandbox.[2] The CMA worked for over a year with industry – particularly with the technology and finance sectors – to design and develop the sandbox. Unlike other regulatory sandboxes – which only admit firms in annual cohorts – the Kenyan CMA accepts applications throughout the year so as to keep up with new fintech innovations. The CMA accepts applications from firms incorporated in Kenya, and those licensed by regulatory partners in the Global Financial Innovation Network – a group of international regulators and central banks – from abroad offering products and services in Kenya. This 'passporting' feature promotes broader international efforts by regulators to nurture innovation and improve regulation. The CMA is clear though that the sandbox is not an incubation centre. The CMA therefore doesn't accept applications for products and services that are not yet at a fully operational level. The CMA does however work with a number of incubators to help firms develop new products.[2]

Firms accepted into the sandbox begin a testing period of up to twelve months. During this period firms test new products and services in a real-world environment under terms agreed with the CMA. Terms include boundaries of operation, which consumer segments to work with, test objectives, performance indicators and customer safeguards. The test period involves iterative feedback loops with regular reporting on outcomes relating to data security and privacy, interoperability and data flows, intellectual property rights and misconduct or fraud.[3] And as capital market participants, firms must still have safeguards to deal with the standard integrity, conduct and protection requirements. A firm may be blocked or suspended from the sandbox if its activities harm customers, investors or the wider public.

Once the test period ends, firms submit a final report detailing key outcomes, incident reports and lessons learned.[3] The CMA either then approves firms to operate in Kenya subject to existing regulation; develops new regulations based on observations made in the test; or denies the firm the right to operate.

Impact

In July 2019 the CMA announced that Innova Limited, a cloud-based data analytics platform for investors, fund managers and banks, Pezesha Africa Limited, a crowd-lending platform that helps investors lend to small and medium enterprises, and a third firm that chose to remain anonymous are the first fintech firms to enter the sandbox. The CMA hopes to admit five fintech firms by 2023.

Risks and lessons

Regular communication between regulators, businesses and consumers is a critical feature of Kenya's sandbox. This ensures everyone's interests are being met, and concerns and risk are dealt with quickly. The sandbox model also ensures that new regulations better protect consumers and markets. By testing new products in live environments, new regulations and guidance are informed by real-world – not hypothetical – operational realities and insights. And while sandboxes are usually associated with startups, they can also be used for large firms to test new products such as when the United Kingdom's regulator used the sandbox for large players like Barclays and HSBC to test new technologies.

But regulatory sandboxes are not without risks. Preparation is key when designing regulatory sandboxes for them to be effective. Industry stakeholders and regulators must have some understanding on how new technologies work, and associated risks even before testing in a live environment to protect consumers and businesses. Having sector-specific regulations, which is typical in Kenya, poses another risk. This can lead to instances where regulations in response to a new technology are introduced in one sector but not all sectors employing the technology. Unless cross-sector regulations are rolled out across all relevant sectors, it will create legal uncertainties for businesses and consumers.

This case study benefited from inputs from Mr. Gitau Mburu.

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Endnotes

1. UNSGSA (2018), *Briefing on Regulatory Sandboxes*. United Nations Secretary-General's Special Advocate for Inclusive Finance for Development.

2. CMA Kenya (2019). *CMA Regulatory Sandbox Ready to Receive Applications*. [online] Capital Markets Authority. Available at: https://cma.or.ke/index.php?option=com_content&view=article&id=531:cma-regulatory-sandbox-ready-to-receive-applications&catid=12:press-center&Itemid=207 [Accessed 11 Nov 2019].

3. CMA Kenya (2019). *Regulatory sandbox policy guidance note-March 2019*. Capital Markets Authority.

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