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STIFLING INNOVATION OR ENHANCING RISK MANAGEMENT IN THE FINTECH SPACE:

A REVIEW OF CBN's DRAFT LICENSING REGIME FOR PAYMENT SERVICE PROVIDERS

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Undoubtedly, the Central Bank of Nigeria (CBN) has set a high watermark towards promoting financial inclusion by quantifying the inherent gaps both in terms of infrastructure and delivery channels, identifying the barriers and institutionalising reforms through progressive and proactive regulations. Underpinning these regulations is a definitive and clear strategy to ensure that not only is there robust stakeholder engagement so that all concerns and input are considered before regulations and policies are put in place but also that these regulations assist in driving better access to financial products while improving ease of use thus increasing consumer acceptance.

Since the conception of the National Financial Inclusion Strategy in 2012, CBN has issued a series of regulations and policies on mircobanking, mobile banking, agent banking, transaction switching, electronic payment systems etc. in order to aid inclusion and make the financial service ecosystem more competitive. Even as financial inclusion has improved there is no gainsaying that one critical pillar responsible for this success has been rapid evolution of financial technology (Fintech) within the financial services sector. Now, with the recent issuance of draft regulations by the Central Bank of Nigeria on the new licensing regime for payment service providers, an umbrella term comprising different providers including financial technology companies, genuine concerns have been raised about the implication of these regulations if passed in its current form. At the epicentre of this debate are two central issues; the first is related to the aggregation of singular licences and their categorisation under umbrella licence types and the second, which is more perplexing, is the minimum capital requirements specified for each of license category.

It is against this background that I analyse the draft regulation and interrogate the licensing structure while also sharing my own constructive views on the better way forward.

Understanding the Proposed Licensing Structure

Essentially, the CBN is introducing a 3tier licensing model each with distinct minimum capital requirements, licence fees, renewal fees, license tenors and permissible activities under each licence category. These licence categories are:

a. Super Licence Category:

This licensing category combines five existing licenses comprising switching, payment service solutions providers (PSSP), payment terminal service providers (PTSP), Non-bank Merchant Acquiring and Super Agency thus allowing the Super Licensee to render permissible activities along each and any of those existing licence categories. A licensee under this category must have a minimum shareholder fund of N5billion, pay licensing fees of N2million, pay renewal fees of N1million with the licence having a tenor of 3 years.

b. Standard Licence Category:

Under these category three existing licences are combined ranging from mobile money operators (MMO), Super Agency and Non-bank Merchant Acquiring hence a Standard Licensee can perform permissible activities along each and any of those existing licence categories. Holders of this licence must have a minimum shareholder fund of N3 billion, pay licensing fees of N1 million, pay renewal fees of N 500,000 with the licence having a tenor of 3 years.

c. Basic Licence Category:

This licence category allows the holder to render permissible activities across three existing licence categories namely Super Agency, PSSP, and PTSP. Holders of this licence must pay licensing fees of N2million, pay renewal fees of N1million with the licence category having a tenor of 3 years. However, unlike the other previous categories each existing licence category attracts individual minimum capital requirements hence Super Agency businesses would require a minimum capital of N50m while PSSPs and PTSPs require a minimum of N100million individually.

According to the draft regulations, once the new licence regime is implemented, licence holders would be expected to notify CBN before starting any activity under its license category. This means if a Super Licence holder for instance was only undertaking switching and non-bank acquiring services it would need to inform the CBN if it wanted to commence PSSP operations.

Now having read the draft regulations, the obvious question is why is the CBN at this critical juncture coming up with these regulations and what does it seek to achieve? Are its motives altruistic or is this a more strategic subterfuge by some vested interests especially coming at a time when the acceptance of Fintech products by those underserved by mainstream financial institutions in reaching has grown exponentially.

The preface to the draft regulations reveals that it is CBN's 'belief that the proposed structure, if implemented, will properly position the Bank to adequately address the emerging issues of Fintech with respects to **cyber risks, risk management framework, capital adequacy, better focused regulation and oversight operations**.' Juxtaposing this intent against the proposed licensing structure one needs to interrogate whether the new structure can indeed achieve this intent.

Analysing the Issues

While the draft regulations essentially only introduce 2 new concepts, the reality is that those concepts have seismic implications on Payment Service Providers and below we discuss those concepts, the inherent issues and whether on a scale these concepts do align with the indices CBN set for itself in the preface to the draft regulations.

a. Consolidation of Existing Licences:

On the face of it the obvious implication for the consolidation of licences is that licence holders can now offer a wider range of services. However, it is difficult to see how this consolidation achieves any of the objectives of CBN i.e. risk management, cyber risk mitigation, capital adequacy etc and even more worrying is that the draft regulations is short on details as to how existing licence holders will evolve into this new licensing arrangement. Is it a compulsory or voluntary evolution? Would they have to use an holdco model? Also, why do licence holders need to inform CBN again when they want to commence operations for an activity they are already licenced to undertake.

b. Minimum Shareholder Funds:

This is the real elephant in the room. Now to my mind the most critical reason for insisting on a minimum capital requirement in any regulated business is to achieve two functions. One is to mitigate risk such as market risk, credit risk, operational risk, liquidity risk while the other is to ensure that the entity has capacity to undertake the business. If we dissect the digital financial services ecosystem from a risk perspective, it is clear that only Payment Service Providers with settlement obligations carry an inherent credit risk (i.e. the risk that counterparty will fail to meet its obligations in accordance with agreed terms) and the players that fall within this bracket are Switching Companies, MMOs, Non-bank Acquiring

Acquiring and Super Agents. Not that these Service Providers are immune from those other risks, it's that given the nature and scale of their business those risks can be and indeed have already been addressed by other means from a regulatory perspective (the plethora of regulations and circulars on the activities of each of these service providers shows that there are robust provisions on risk management).

Also, a review of the existing regulations on each of these settlement PSPs reveals that each already has a minimum capital requirement. Therefore, other than the increased capital requirements by virtue of the consolidated licensing structure, the only new introduction in this draft regulation is the capital requirements for PSSPs and PTSPs. Now interestingly, it is within this segment that a lot of fintech start-ups have emerged over the past 5 years with superior and innovative products in relation to payment solutions applications, processing gateways and portals and payment terminal applications development. These subset of PSSPs and PTSPs are the ones at real risk of extinction with the introduction of this minimum capital requirements.

As previously stated, this draft regulation is short on details hence the composition of this minimum shareholder funds is unclear i.e. is this paid-up capital or authorised capital? How will this be monitored? and will there be any filing requirements? Are there any penalties if one falls below the minimum during the licence period? and what is the cure period? etc. While it is clear that the capital adequacy concerns should only be limited to PSPS with settlement obligations hence increasing the minimum shareholder funds may be justified for those undertaking those aggregated services, it is difficult to see how this new regulation addresses issues of cyber-crime or risk management framework or why capital adequacy is a concern for those PSPs without any settlement obligations i.e. PSSPs and PTSPs.

What is the Way Forward?

Fortunately, this new licensing structure was released under a draft regulation and the supposition therefore is that all stakeholders would have already engaged CBN on their views and concerns within the review window indicated in the draft regulations. Let me however take the benefit of highlighting my own succinct remedies to some of the anomalies identified in this draft regulation:

a. Generally, there should be greater detail on how PSPs can evolve into this new licensing categories and a confirmation as to whether CBN is discontinuing the existing license regime and if so, what the transition period would be.

b. The CBN should take a critical review of the minimum capital requirements for PSSPs and PTSPs in order to ensure that they are not inadvertently stifling innovation through this new regime. Everything must be done to protect and preserve the Fintech Startups space not only because of their importance to achieving financial inclusion both also because of the huge economic potential they present. My view is that the minimum capital requirements should only apply to those PSPs with settlement obligations while no capital requirements should be imposed on the others or at best, they are required only to maintain a nominal capital amount e.g. N5million or N10million but this should be limited to authorised share capital.

c. In terms of the financial technology space, CBN's focus should rather be on improving ease of use of these fintech products by increasing the technical requirements and specifications, preserving the integrity of customer information by ensuring enhanced cyber security architecture utilised (which interestingly was the basis of the cyber levy imposed by CBN on all MMOs and other PSPs) and maybe coercing these players to a minimum corporate governance requirement in order to institutionalize best practices on them at an early stage.

d. Finally, CBN should be weary of overregulating this space because it may prove counterproductive and make it challenging for Fintechs to develop and implement the latest innovation. It is essential that the regulator maintain an equilibrium between customer protection and creating an environment that supports innovation. Therefore, to my mind it is about time that CBN sets up a regulatory sandbox for players Fintech thus creating a 'framework to allow small-scale, live testing of innovations by private firms in a controlled environment (operating under a special exemption, allowance, or other limited, time-bound exception)'.

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