Decoding Sri Lanka's FinTech Regulatory Sandbox

Key Takeaways

- Primer on FinTech Regulatory Sandbox: Global and Sri Lanka's context
  A sandbox is a safe place to test the viability of innovative products in a controlled environment. An added advantage of a FinTech regulatory sandbox is that a regulator is able to identify regulatory barriers that hinders FinTech initiatives while the innovators can test their product without infringing regulatory controls. UK was the first to initiate the FinTech regulatory sandbox followed by other countries such as Singapore, Malaysia and Jordan. Sri Lanka launched its FinTech regulatory sandbox on the 17th of February 2020.

- Role of FinTech in enabling Financial Inclusion
  The Global Startup Ecosystem Report 2020 (GSER 2020) recognised FinTech in Sri Lanka as a sector showing strong potential. Among the many benefits FinTech can offer to country, it also shows prospects of enhancing financial inclusion. Serving the rural areas in Sri Lanka will also increase the potential customer base for the FinTech industry. Therefore, both FinTech and financial inclusion can go hand-in-hand.

- The FinTech Regulatory Sandbox and its play in nascent FinTech
  A FinTech regulatory sandbox is important for the country since it will identify the impeding regulatory barriers and foster innovation in digital financial services. It can also support financial inclusion through the sandbox's role in harnessing innovation. However, the sandbox is not the only solution but part of a toolset available to the regulator to enable digital financial innovations and improve financial inclusion.

What is a FinTech Regulatory Sandbox?

Sandbox evolved from the children's learning game, vindicating the old "test and learn" approach to foster innovation. According to the UK Financial Conduct Authority (FCA), sandboxes are a safe space in which individuals can test innovative products, services, business models, and delivery mechanisms in a controlled environment.

There are many types of sandboxes available globally with one such type being the regulatory sandbox. A regulatory sandbox apart from its functions as a sandbox, is also a mechanism where the regulator is able to identify regulatory barriers that hinders innovations. UK FCA was the first to introduce a regulatory sandbox in 2016[1] followed by other countries such as Singapore, Malaysia, Indonesia, Jordan and Australia. The Central Bank of Sri Lanka (CBSL) too launched a regulatory sandbox on 17th February 2020[2] with a focus on the country's FinTech industry. This FinTech regulatory sandbox was built in consultation with the Sri Lankan private sector and the general public. The regulatory sandbox models of other countries were also studied in order to develop a suitable regulatory sandbox model for Sri Lanka, taking into account their success factors and challenges faced.

Financial technology (abbreviated to FinTech) is the integration of technology to the financial services offered. However, Sri Lanka is at a very early stage of FinTech development in comparison to other Asian countries such as India, Singapore and Malaysia. The introduced FinTech regulatory sandbox will provide an opportunity for FinTechs to engage in live experiments and, facilitate a test and learn approach without infringing regulatory requirements. Since, focusing on regulatory compliance can drain capital before realising whether an idea could work and be scaled up.

Although, few FinTech initiatives have emerged successful in Sri Lanka, others have failed owing to either the market not being ready to embrace the technology or due to regulatory barriers. Therefore, the FinTech regulatory sandbox is expected to play a pivotal role in bringing in technologies that the market is ready to embrace and identify the existing laws that hinders the development of such technologies.

The CBSL FinTech Regulatory Sandbox

An Overview of the model

Innovators partnering with licensed financial institutions can now apply for the sandbox through the dedicated email address[3] (refer Figure 01) provided by the CBSL. This is on a roll-over basis where applications will be accepted to the sandbox on a continuous basis rather than in group basis (cohorts). However, although both foreign and local players can apply, the sandbox can only be utilized in a situation where there is an absence of similar services or technologies in the domestic financial market. In order to enter the sandbox, an applicant should partner with a CBSL licensed financial institution (unless the applicant is a CBSL licensed financial institution) and, have a solution that is tested in a lab and verified by an independent third-party[4].

Applicants to the Sandbox will be informed whether the application has met eligibility criteria by the CBSL within 15 working days of submitting the application. After which, the Financial Technology Advancement Committee (FTAC) that is headed by a Deputy Governor of the CBSL will approve it,

[1] World-First Regulatory Sandbox Open for Play in the UK: https://www.lw.com/thoughtLeadership/LW-world-first-regulatory-sandbox-open-for-play-in-UK

[2] For more details refer: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/about/20200214-FinTech-Regulatory-Sandbox-of-CBSL-Framework-e.pdf

[3] Application Form can be accessed at:https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/about/20200214-FinTech-Regulatory-Sandbox-of-CBSL-Framework-application-e.docx

[4] An individual or entity, registered in Sri Lanka, independent of the Applicant or partnering Financial Institution, having experience in providing systems auditing or validation services for products or services in the Financial Technology sector and being acceptable to the Central Bank of Sri Lanka.

within another 30 working days. In a situation where the application is rejected, the applicant is eligible to re-apply after a cooling period of 6 months and after meeting criteria. (Refer Annexure 2 for the step by step process/ stages of the regulatory sandbox).

Figure 01: Eligibility Criteria, Testing period[5] and Dedicated Communication Lines

Product Eligibilty	Testing Period	Dedicated Communication lines
• New and Innovative • Tested • Beneficial	• 9 months and optional additional 3 months	• Email - sandbox@cbsl.lk • Telephone - 0112477542

If the solution proposed by the applicant requires any relaxations of regulation[6] issued by the Financial Intelligence Unit (FIU) of CBSL and a relaxation in the Customer Due Diligence (CDD) rules, then an addendum to the application will be provided to the applicant to be filled and sent across. This will be assessed by the FIU to approve the required relaxation.

The relaxation of rules will end once the testing period is over. However, CBSL may relax a regulation that is hindering the product from being released to the market based on the progress and success of the product/solution while in the sandbox. In a situation where a product successfully exit from the sandbox and enters an undefined area then introduction of new regulations can be considered.

Benefits

Participating in a regulatory sandbox can potentially convince investors who have been reluctant to invest earlier, in the context that they are working on both regulatory obligations and product innovations. A recent Deloitte survey conducted on current and past participants of the FCA's sandbox found that most innovators see it as a "badge of honour" and believed that acceptance into the sandbox increased their credibility with both their customers and investors.

Individuals also get the opportunity to work with regulators while testing their products or services. Regulators, on the other hand, can develop more appropriate regulatory policies since they have greater visibility into new innovations.

Customers too get better protection, since products are tested in a controlled environment before official rollouts and since regulatory bodies are able to implement more focused policies.

Factors to consider for Sri Lanka

According to research by the Consultative Group to Assist the Poor (CGAP), a regulatory sandbox requires adequate resources (staff and funding) to operate. However, CGAP has observed that often times regulators put sandbox responsibilities at the top of their staff's existing work, instead of hiring

[5] An additional 3 months can be requested by CBSL if the 9 month testing period is not sufficient
[6]CBSL will consider the temporary relaxing of directions, regulations, circulars, guidelines and rules issued by CBSL. However, Acts of Parliament will not be relaxed in this Sandbox.

dedicated staff. This results in further stretching of capacity and may have a negative impact on other areas of regulator's responsibilities such as regulation, monitoring and supervision.

There is a growing tendency for financial services or products being interlinked with various sectors such as Insurance and Telecommunication. Therefore, establishment of a regulatory sandbox by one authority as opposed to multiple may disadvantage innovators in other areas such as Insurance. A coordination mechanism can remedy such situations by benefitting all the interlinked sectors.

FinTech Ecosystem and its Role in Financial Inclusion

Sri Lanka's regulatory sandbox was established with a focus to develop the FinTech industry due to the many benefits FinTech can offer to the country. It has the ability to move the country towards a less-cash society and also improve financial inclusion. The Global Startup Ecosystem Report 2020 (GSER 2020) too recognised FinTech as a sector with strong potential to grow in Sri Lanka. This was owing to initiatives such as the regulatory sandbox, the launch of HatchX, a FinTech Accelerator[7] and other noteworthy startups such as Payhere and Helios present in the ecosystem.

FinTech enhances the services offered to consumers, lowers cost, provides ease and convenience, saves time and effort and, fights fraud by leveraging information about payment history to flag transactions that are outside the accepted standards.

Pandemic such as COVID -19 are also testimony that adoption of FinTech is imperative for the country's growth. Since these pandemics limits the movement of people and, companies and institutions find it difficult to engage in financial activities such as collecting dues from customers. Resulting in increased Non Performing Loans (NPLs).

FinTech also has the potential to benefit underserved individuals and communities and, improve financial inclusion in the country. Serving the rural area in Sri Lanka will also increase the potential customer base for the FinTech industry as well. Therefore, both FinTech and financial inclusion can go hand-in-hand. However, FinTech is still at a very early stage in Sri Lanka and there is much potential to expand financial inclusion as well[8].

Section below sets out the causes for the slow growth in FinTech and financial inclusion identified through Key Informant Interviews (refer Annexure 1) and research conducted.

A. Lack of a Customer Identification Mechanism

Financial services require accurate identification of customers in order to detect fraud. The inability of financial institutions to verify prospective clients often leads to financial exclusion. Therefore, customer identification is a first step towards promoting financial inclusion.

Countries such as India addressed this issue by introducing the Aadhaar digital ID which was used for e-Know Your Customer (KYC) purposes as well. In Sri Lanka too, similar initiatives are being developed – Digital ID and shared KYC – to solve the issue of digital onboarding of customers.

[7]Sri Lanka's first FinTech accelerator as well as the first virtual accelerator in South Asia.
[8]The National Financial Inclusion Survey 2018/2019 highlighted that despite a high level of bank account ownership among both men and women in Sri Lanka, the use of formal financial products remains low.

However, these initiatives should be fast tracked in order to reap the benefits of FinTech and financial inclusion.

Digital payment mechanisms also serve as great means of generating data, which financial institutions can use to assess creditworthiness without requiring long histories, identity, or even collateral.

B. Impediments in Regulatory and Legal Environment

Supportive regulations and legislations will increase the digital financial innovations and as well as increase trust among consumers while complementing financial inclusion. A clear legal and regulatory framework is needed to allow for new technologies, while also addressing the risks that arise from innovation to protect all stakeholders. The recently launched FinTech regulatory sandbox aims to address this concern by working with the innovators and having greater visibility into new innovations in order to develop supportive regulatory policies.

C. Lack of Coordination and Communication Among Various Stakeholders

Collaboration between different organisations is imperative rather than the individual organisations working in silos. Coordination and communication between various organisations such as CBSL and Information and Communication Technology Agency (ICTA) were identified by Industry experts as key since it will enable fast and coherent digital interventions in the financial sector as well as improve financial inclusion in the country.

Industry experts also identified the need to implement a mechanism to have a continuous dialogue between startups, CBSL and banks to act as platform to raise concerns on the FinTech developments and implement solutions that are in concurrence with all the stakeholders. In this context, a joint steering or advisory committee with the participation of startups, banks and CBSL could be formulated to ensure that the sandbox is utilised.

D. Low levels of Financial Literacy

Enhancing financial literacy and developing the financial capability will improve financial inclusion and increase the adoption of FinTech. The National Financial Inclusion Survey 2018/19 revealed that about 56% of Sri Lankans did not compare the interest rates with other providers and did not appreciate the need to do so, proving the need for financial literacy. Therefore, enhancing financially literacy will allow individuals to make better investment decisions which will have wider economic benefits. Financial literacy is also imperative given Sri Lanka's rapidly aging populations, to enable a sustainable flow of income right throughout an individual's life span.

E. Lack of Digital Inclusion

Digital inclusion encompasses digital skills, connectivity and accessibility. Measures to improve the accessibility of fast and affordable broadband internet service, availability of internet enabled devices that meet the needs of the user[9] and, improving the digital literacy through training programmes and platforms to provide technical support/clarifications will bridge the digital divide

[9] According to the National Financial Inclusion Survey 2018/2019, feature phones were the popular choice (61%) when compared to smartphones which limits the uptake of FinTech.

in Sri Lanka. This in return will also increase the adoption of FinTech as well as enhance digital financial inclusion.

Is the Regulatory Sandbox the Right Model for Sri Lanka?

A regulatory sandbox is important for the country since it will identify the impeding regulatory barriers and foster innovation in digital financial services. It can also support financial inclusion through the sandbox's role in harnessing innovation. However, in our discussion with various stakeholders it was emphasised that the lack of awareness on the benefits of the regulatory sandbox is deterring the industry from reaping the sandbox's full potential. Therefore, carrying out awareness campaigns on the regulatory sandbox and its benefits is imperative for the successful implementation of the sandbox.

Further, a regulatory sandbox is not the only solution but part of a toolset available to the regulator to facilitate innovation. Below sets out few other tools used by regulators around the globe to support the development of FinTech and also to improve the financial sector.

Thematic Sandboxes

Unlike general purpose sandboxes, thematic sandboxes are designed for a specific context and with a clear set of policy objectives. This is usually done by limiting admission to applicants that are developing specific types of technologies, products or business models that will achieve the identified policy objective.

Although, general purpose sandboxes are a popular option and relatively easier to launch, thematic sandboxes require regulatory authorities to set a clear frame of objectives prior to their implementation. Therefore, when implementing a thematic sandbox careful attention should be paid during the planning stage. This may help to ensure the sandbox aligns with existing issues that need to be addressed and so that it does not ultimately lead to a resource-intensive distraction.

Eg: Bank of Sierra Leone (BSL) introduced a thematic sandbox in 2018 where in its evaluation criteria, it required applicants to demonstrate how the proposed innovation can advance the country's national financial inclusion strategy (NFIS).

Innovation Hub

Innovation hub can take various forms depending on the mandate of the regulatory authority. However, it is usually a dedicated point of contact for individuals to raise inquiries on FinTechs. This includes discussing FinTech related issues and receiving non-binding guidance on areas such as licensing or registration requirements and, regulatory and supervisory expectations of the regulator on FinTechs.

Eg: Australian Securities and Investments Commission (ASIC) set up an Innovation Hub in 2015 to assist FinTech start-ups navigate the regulatory system and laws. This included providing informal guidance from senior regulatory advisers about the overarching regulatory framework and questions relating to ASIC's relief powers.

Regulatory Accelerators or RegTech Labs

Regulatory accelerators enable partnership arrangements between innovators and regulatory authority where the innovators understand the regulator's needs, and the regulator understands emerging technology. However, a regulatory accelerator should not be confused with an industry accelerator where an industry accelerator usually helps innovators define and build initial products and, identify potential consumers and investors.

Eg: The Bank of England launched a FinTech Accelerator in June 2016 to help it harness FinTech innovations for central banking purposes. It worked with small cohorts of successful applicants on short Proofs of Concept (PoC) in priority areas such as cyber-resilience, desensitization of data and the capability of distributed ledger technology

Note: refer Annexure 3 for a list of selected countries with the above mentioned innovation facilitators.

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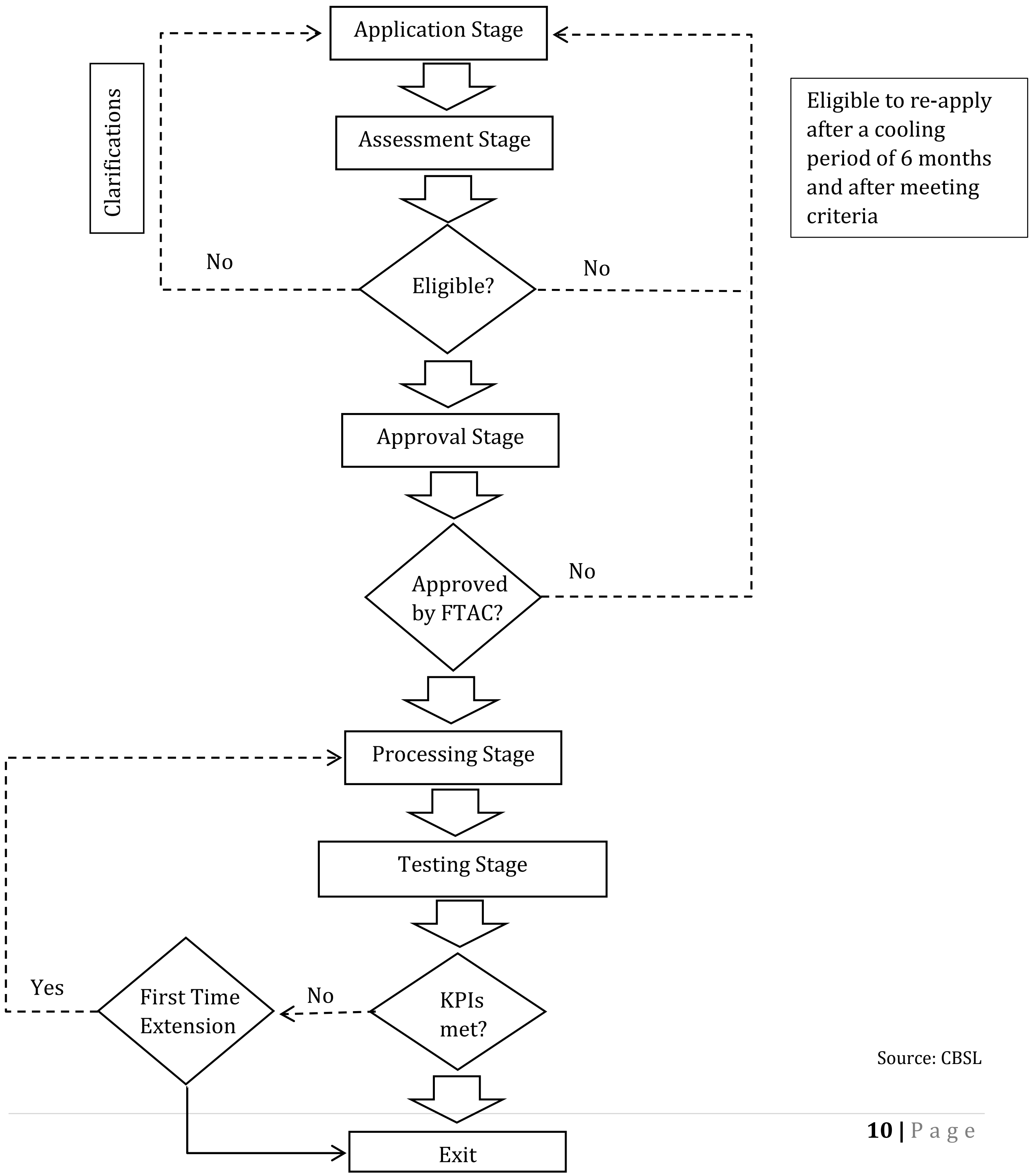
Annexure 1

List of Key Informant Interviewees

1. Mr Rajendra Theagarajah, Immediate Past Chairman, The Ceylon Chamber of Commerce
2. Mr Supun Weerasinghe, Chief Executive Officer, Dialog Axiata PLC
3. Ms Renuka Fernando, Chairperson, Dialog Finance PLC
4. Mr Rohan Wijewardane, Additional Director, Payments and Settlements Department, Central Bank of Sri Lanka
5. Ms Rushika Kumarasamy, Senior Assistant Director, Payments and Settlements Department, Central Bank of Sri Lanka
6. Mr Jeevan Gnanam, Executive Director, St. Anthony's Industries Group / Co-Founder, Hatch Works

Annexure 2

Stages of the CBSL FinTech Regulatory Sandbox



Source: CBSL

Annexure 3

List of Selected Countries with Innovation Facilitators

Country	Thematic Sandbox	Innovation Hub	Regulatory Accelerators or RegTech Labs
Thailand	✓	✓	✓
Singapore	-	✓	✓
Japan	✓	✓	✓
Malaysia	✓	✓	-
Sierra Leone	✓	-	-
Abu Dhabi (UAE)	✓	✓	-
Australia	-	✓	✓
UK	-	✓	✓
India	✓	-	✓

Source: World Bank, CGAP

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