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Innovate or stagnate: the race to regulate fintech in Asia Pacific

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Financial technology ("fintech") has exploded in recent years, with innovations like blockchain, artificial intelligence and cloud-based software promising to disrupt every financial service from banking and payments to insurance and asset management. Arguably nowhere is the level of competition and innovation more intense than in Asia Pacific: fintech companies in the region received more than 50% of global investment in the sector in the first quarter of 2016, and in the first seven months of the year fintech investment in Asia Pacific exceeded USD9.6 billion – more than double the total for 2015.

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Connell O'Neill, Allen & Overy

This massive tide of investment in such a disruptive industry is a direct challenge to regulators as much as to incumbents. *"Regulatory change is inevitable given the groundswell of fintech investment"*, says Connell O'Neill, an Allen & Overy senior associate in Australia. But the pace of change of the law is far slower than in the technology and in the underlying business models that are driving fintech disruption.

This discrepancy could lead to several possible outcomes. One is that Asia Pacific financial centres lose out to those in other regions on a sector that has the potential to turbocharge innovation and economic growth for many years. Another is for the disruptors to press on anyway and gain such scale that regulators are left scrambling to adjust. A third, preferable, outcome is that regulators, incumbents and innovators recognise that they need to work together – and fairly rapidly – to achieve facilitative legal reform.

Policymakers across Asia Pacific are certainly aware of the challenge and are competing to position their economies as fintech hubs. Several have announced plans to ease regulations in "sandboxes" where innovators can test their services under real market conditions. But the drive to innovate has to be balanced with the need to protect consumers, and new laws inevitably take much longer to roll out than policy initiatives. This has led to a fragmented approach, despite policymakers' best intentions.

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Following China

Australia, Singapore and Hong Kong have all made fintech a policy priority. For Australia, it is a natural fit in the government's National Innovation and Science Agenda, which is aimed in part at promoting the digital economy. Fintech also tallies with Singapore's longstanding bid to position itself as a "smart nation" and as the nexus for South-East Asia's growing demand for financial services. Hong Kong, meanwhile, trades on its role as Asia Pacific's pre-eminent finance hub and gateway to mainland China, Asia Pacific's real fintech powerhouse – and life-size regulatory sandbox.

China is playing in a different league to other markets not just because of the size of its Internet finance industry (estimated recently by consultant McKinsey to be USD1.8 trillion), but also due to its approach to regulation – which it has reformed to accommodate new products and services rolled out at unprecedented scale and speed by the country's tech giants. While other countries may have taken this approach in some sectors, only China has done so in finance.

To take one well-known example, Alibaba's e-commerce payment service Alipay was spun off into a regulated entity (Ant Financial) only after it developed a wildly successful money market fund, Yu'e Bao, which reached 100 million users less than two years after its launch in June 2013. In another, Alibaba, Tencent and insurer Ping An launched Zhong An, the country's first digital-only insurer, in 2013, while the China Insurance Regulatory Commission only clarified regulations on the provision of insurance services without physical branches in 2015.

"This approach is exceptional for Chinese regulators and applies only because of the scale and 'national champion' status of the tech companies concerned," says Jane Jiang, Allen & Overy partner in Beijing. *"Startups or 'business as usual' applicants, particularly foreign companies, cannot expect the same treatment."*

A cautious approach

Elsewhere, authorities have generally been less willing to let the innovation cart drive the regulatory horse.

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Jason Denisenko, Allen & Overy

To be sure, regulators in Australia, Singapore and Hong Kong have worked with incumbents to enable fintech innovation in some areas, such as payments. The Reserve Bank of Australia's New Payments Platform, allowing data-rich and "easily addressed" (eg mobile phone) payments, will launch in 2017; Hong Kong's 2015 Payment Systems and Stored Value Facilities Ordinance opened the way for broader use of such systems beyond the city's Octopus stored-value cards; and the Monetary Authority of Singapore (MAS) recently launched a consultation on establishing an activity-based payments framework. New rules on robo-advice and the provision of cloud-based outsourcing have also been welcomed. But when it comes to other aspects of financial innovation, particularly regarding lending and investing, progress has been slower.

Each jurisdiction has been eager to be seen as consultative: the Australian Securities and Investments Commission (ASIC) set up an Innovation Hub in 2015, which offers informal guidance on regulatory issues, while MAS recently opened a "Looking Glass" fintech innovation lab, in part to provide consultations for start-ups. In March 2016 the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) set up, respectively, the Fintech Facilitation Office (to facilitate the development of fintech in Hong Kong), and a Fintech Contact Point (to provide guidance on applicable regulation, and including the Fintech Advisory Group), while its insurance regulator set up a Fintech Liaison Team in June.

Even so, the default approach has tended to be one of caution. In March 2016, for instance, ASIC clarified that peer-to-peer lenders in Australia would be regulated like collective investment schemes, forcing the "square peg" of P2P lending into the "round hole" of strict asset management regulation.

The risk with this tactic is that as in China, fintech disruptors will force the issue and achieve widespread success before the watchdogs have grasped the implications.

"If the regulators don't determine their approach quickly and put in place facilitative law reform, they run the risk of losing control of this agenda," says Jason Denisenko, an Allen & Overy partner in Australia. *"Then the next disruptor in the fintech space will come along and dictate the terms on which they would do business, and they will scramble to plug the gaps."*

Sandboxes: much impact in reality?

In an effort to increase the spirit of openness and interaction, Australia, Singapore and Hong Kong have announced regulatory sandboxes. First tried by the UK's Financial Conduct Authority, these aim to make innovation easier by allowing innovators to test products and services in real markets without all the usual red tape (for example, the need for a licence). Australia announced sandbox plans in June this year, while Hong Kong did so in September. Singapore recently issued final sandbox regulations in November.

Despite the fanfare, the sandboxes are arguably less ambitious than they appear, and many questions attend their application in practice. Australia's is limited to certain simple products, excluding superannuation or insurance, and will apply only for six months; start-ups will also need "sponsorship" from an ASIC-approved organisation. Hong Kong's is open only to existing banks authorised by the HKMA. Singapore's promises a potentially wide range of exemptions from licensing requirements but these will be applied only on a case-by-case basis.

Moreover, questions remain about how fintech services delivered within the sandbox might then transition to a conventional regulatory environment. And there is little clarity on whether takeaways from trials within the sandboxes might feed back into the process of drafting legislation. This could be vital in areas for which rules don't currently exist, such as how to regulate decentralised technologies like blockchain, and also in areas such as payments, where regulators lag behind current business realities.

"Sandboxes are positive initiatives but they need to be facilitative and broadly crafted to ensure jurisdictions can obtain the maximum benefit of people coming up with great ideas that can be tested," says Denisenko.

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Jane Jiang, Allen & Overy

Keeping up with the disruptors

Regulators have good reasons to be cautious. Hong Kong has arguably been slower than Australia and Singapore in recognising the transformational potential of fintech, but it has also perhaps been dissuaded from going too fast by what is happening in China. Following the collapse of several businesses that looked suspiciously like Ponzi schemes, mainland regulators have cracked down on P2P lending, putting on ice what was until recently the fastest-growing segment of Internet finance.

"P2P is a negative example," Jiang says. *"If fintechs now go to China's regulators and say 'let us innovate' they will say, 'Look at P2P. We let you innovate and what we ended up with is not pretty."* Singapore has facilitated P2P intermediaries whilst trying to bring them within the regulatory perimeter (eg crowdlending platforms).

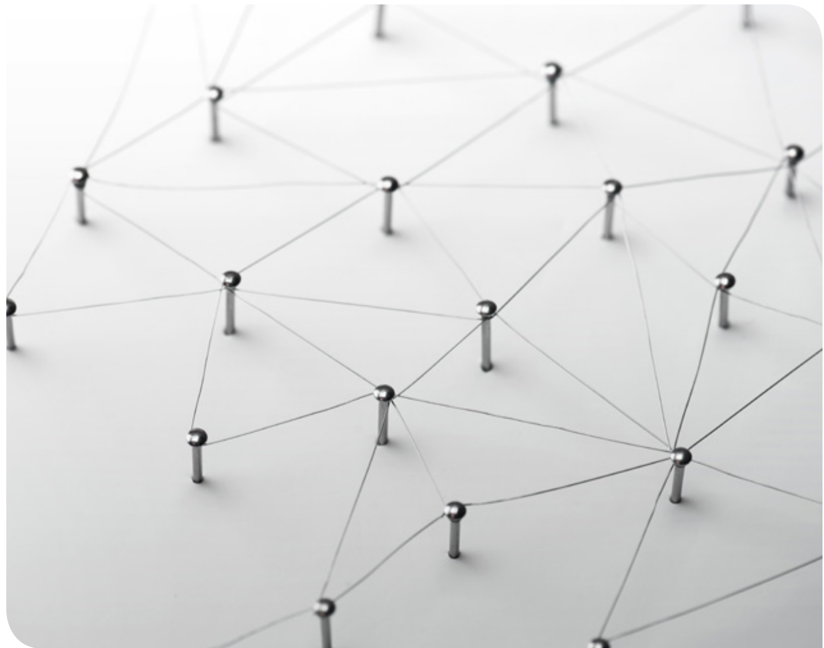
China is also a walled garden when it comes to fintech innovation, albeit a massive one. Australia and Singapore, by contrast, have recognised the industry's potential to cross national borders, entering into "bridge" agreements with each other (in June), and the UK (earlier in the year), to share best practices and learning on fintech regulation. The MAS' Chief Fintech Officer has also indicated that a major priority for 2017 will be to help Singapore fintechs develop in markets abroad.

Again, these agreements are currently of more symbolic than practical value: they do not contain formal passporting clauses that would allow entities regulated in one jurisdiction to deliver services in another without obtaining local clearance. But they may one day morph into such arrangements, positioning Australia and Singapore well to serve as Asia's regional fintech hubs.

Calling for a unified approach

"We might get some law reform over the next couple of years, but fintech disruptors could have developed a whole new business in a matter of months."

Connell O'Neill, Allen & Overy



So far, most of the regulatory initiatives rolled out in Asia Pacific financial hubs are at nascent stages, albeit steps in the right direction. The need for substantive law reform is increasingly urgent.

However, it is not all down to the authorities. More than ever, the onus is on industry incumbents – banks, insurers, asset managers and others – to help the industry devise suitable legislation. They have already done so in the payments field, and are starting to do so in blockchain, but will have to use their strengths in other areas too. *"Banks and financial institutions are in a better position to drive regulation, since they have the funds, they know the sector and they already have ongoing dialogue with regulators,"* says O'Neill.

Also, it will be a matter of self-preservation for them to get on the right side of the fintech revolution. *"We don't know whether today's financial institutions will be tomorrow's dinosaurs,"* says Denisenko.

For regulators, given the potential range of applications and the breadth of issues that are involved – from securities, banking and insurance standards to cybersecurity and data protection laws – the next required step is a holistic regulatory approach incorporating all these fields. *"Fintech is a cross-industry business, it doesn't fit neatly into silos,"* warns Jiang. *"With the current very siloed way of thinking, regulators will always find it difficult to come up with the appropriate framework."*

If Asia Pacific is to sustain its leading position in fintech, it will rapidly have to change its approach. *"Regulators like to be seen as facilitating innovation, but they are not keeping up with the pace of technology change,"* says O'Neill. *"We might get some law reform over the next couple of years, but fintech disruptors could have developed a whole new business in a matter of months."*

For more information, please contact your usual contact at Allen & Overy or a member of our core Asia Pacific Fintech team that contributed to this piece:

Connell O'Neill
Senior Associate, Sydney
Tel +61 2 9373 7790
connell.oneill@allenovery.com

Jane Jiang
Partner, Shanghai
Tel +86 21 2036 7018
jane.jiang@allenovery.com

Benjamin Crawford
Of Counsel, Hong Kong
Tel +852 2974 7246
benjamin.crawford@allenovery.com

Charlotte Robins
Partner, Hong Kong
Tel +852 2974 6986
charlotte.robins@allenovery.com

Jason Denisenko
Partner, Sydney
Tel +61 2 9373 7809
jason.denisenko@allenovery.com

Lian Chuan Yeoh
Counsel, Singapore
Tel +65 6671 6075
lianchuan.yeoh@allenovery.com

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