

## Distributed Ledger Technology: a South African financial services perspective

The advent of Distributed Ledger Technology (DLT) has caught the attention of the global financial services industry, with many labelling it a technological revolution that is set to disrupt the financial services infrastructure. DLT is a type of digital ledger or database that is used for the recording, safe keeping and decentralised sharing of data relating to the ownership and possession of a wide range of assets. It uses consensus-based cryptographic methods to record and distribute information among participants of that ledger without the need for a middleman to facilitate this. Blockchain is an example of a very popular and well-known form of DLT.

There is no doubting that DLT, and generally financial technology (fintech), has huge potential to challenge and impact conventional ways of rendering financial services and possibly even extending services to new consumers. However, very limited actual 'use cases' have been introduced to demonstrate how DLT can help expedite financial inclusion. At present, most use cases pertain to how DLT can improve the efficiency of existing methods in order to make them more cost-effective and secure. These use cases have been, for example, on how blockchain can help reduce costs and improve payment settlement times in the deposit and peer-to-peer payment environments, and how it can help enhance data protection and data sharing between consumers, regulated institutions and regulators. Yet use cases are still lacking on how blockchain can be more effective than existing methods in expediting economic participation and use of financial services by unbanked people.

### Obvious challenges

Perhaps one of the biggest challenges in achieving financial inclusion through DLT is that current DLT (blockchain) based products and services are aimed at improving existing methods of rendering financial services. In other words, the current use cases do not seem to introduce any new services that would be useful in the daily transactions that unbanked people ordinarily undertake.

It may be argued, however, that DLT is not meant to expedite financial inclusion directly by developing new products or services but rather indirectly through the introduction of cheaper and more efficient methods of rendering existing financial services and products, which in turn makes it easier for service providers to extend these services to new markets.

Another challenge is consumer education and awareness. Regulators will always want to be comfortable that the most vulnerable members of society know about and understand new products and services well enough to use them for basic transactions without their protection as consumers being compromised. The difficulty is determining who is better placed to lead this initiative - the service providers or regulators - while also ensuring that consumers do not bear the costs.

Despite these challenges, there is general industry consensus that with appropriate regulatory supervision, DLT-based products and services hold huge potential to improve financial inclusion - whether directly by developing new use cases or indirectly by making conventional methods cheaper and more efficient and thus more accessible to underbanked people.

### Regulatory buy-in and the way forward

Financial services industry participants have also taken comfort from the fact that South African regulators are actively engaged in the conversation and creative process around fintech. This eases some concerns about a potential disjoint between fintech innovation and regulation.

In most cases there may not even be a need to drastically reform legislation to cater for new product innovations such as DLT. South African financial services legislation is largely sufficient to regulate DLT-based services and products, albeit in a fragmented manner. Consider the insurance landscape, for example. The insurance Acts already have broad deeming provisions that allow the regulator to deem a person's conduct as insurance business conducted in South Africa and therefore requiring licensing by the insurance registrars.

The same can also be said for legislation regulating the credit lending environment. As with the insurance Acts, the National Credit Act 34 of 2005 (NCA) applies to credit transactions having an effect within South Africa. Because the NCA is activities-based and not entity-based, it means that provided a credit transaction has an effect within South Africa, it may be regulated by the NCA regardless of the medium used to provide that credit. However, this does not mean that the need for some level of regulatory reform is completely negated in other areas.

Regulatory reform will likely be required if, for example, we are to realise the potential of DLT to satisfy other types of regulatory requirements. For example, DLT-based products, such as cryptocurrencies (like bitcoin, ethereum and corda based currencies), may potentially be used by regulated institutions to satisfy their prudential capital requirements. In particular, certain cryptocurrencies have qualities of a 'tier 1' type asset for purposes of meeting minimum and solvency capital requirements under the Solvency Assessment and Management (SAM) framework. Cryptocurrencies such as bitcoin have been lauded as being immune to inflation and highly liquid, thus making them readily available to absorb losses as required for tier 1 assets under SAM.

However, cryptocurrencies are currently not recognised as securities in South Africa, let alone as securities that can be used for purposes of meeting the capital requirements of regulated institutions. Also, the current insurance framework (including the Insurance Bill) does not provide a clear position on whether such instruments can be regarded as eligible assets for purposes of meeting capital requirements. This is just one of the areas that may benefit from regulatory reform or clarification.

Although regulation may not be moving as fast as innovation, it is positive to see that the Financial Services Board, in particular, is adopting a more hands-on approach in keeping up with fintech innovations and has indicated that it will establish a regulatory sandbox to test new product developments. This will also allow it to leverage off the strides made by the UK's Financial Conduct Authority in regulating fintech-based products, as our financial services regulatory framework is largely similar to that of the UK.

There are clearly a number of moving parts with regards to DLT and fintech innovations. Whether it is from the perspective of expediting financial inclusion, developing regulatory sandboxes to test new DLT use cases or grappling with whether or not these innovations will necessitate significant regulatory reforms, it is reassuring to see DLT, and generally fintech, receiving buy-in from South African regulators.

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