Slingstone LP

NIGERIA

FINTECH LEGAL OUTLOOK 2024

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Fintech Legal Outlook 2024

HIGHLIGHT

The expanded scope for digital innovation inevitably implies increased legal responsibilities to consumers, investors, and other stakeholders within the ecosystem.

Introduction

Looking back Forward

2023 was a challenging year for the fintech industry, characterized by corporate failures and heightened investor caution. From both commercial and regulatory perspectives, the fintech space would not be the same again with renewed emphasis on corporate governance, business resilience and an observable trend towards increased consolidation.

As 2024 unfolds, we present a retrospective review of legal trends and developments observed in the preceding years with a view to providing an insightful overview of potential legal issues and developments anticipated in the current year to highlight key areas of interest for businesses to diligently monitor.

From both commercial and regulatory perspectives, the fintech space would not be the same again with renewed emphasis on corporate governance, business resilience and an observable trend towards increased consolidation.

A Payment license review underway

During the 58th Annual Banker's Dinner on November 24, 2023, the Governor of the Central Bank of Nigeria (CBN) unveiled plans to tighten regulatory control over payment service providers. This initiative involves a comprehensive review of the existing licensing framework for payment services, with the aim of developing a new regulatory and compliance structure tailored to the dynamic landscape of tech-centric payment services.

Subsequently, in what would appear to be a significant step towards this plan, on December 5, 2023, the Nigerian Interbank Settlement System (NIBSS) issued a directive to financial institutions, instructing the removal of non-deposit-taking financial institutions from the outward transfer channels of commercial banks.

The directive underscored that while these entities may facilitate outward transfers as inflows to banks, their licenses do not authorize them to receive inflows or hold customers' funds. This directive aligns with the CBN's commitment to refining licenses, ensuring a clear separation of financial activities by Fintech companies, and preventing them from operating beyond the scope of their existing licenses.

The existing licensing framework, outlined in the CBN's circular dated December 9, 2020, establishes distinct license categories for payment systems. In light of recent developments, it is evident that the CBN is poised to heighten its regulatory focus on payment systems. This may involve the introduction of more stringent rules for operators, the imposition of stricter penalties for non-compliance, and redesignation of license categories and scope.

Key Takeaways

- Proactively review current business model and scope based on existing licensing framework and potential future regulations.
- Prepare for potential changes in licensing frameworks and be ready to adapt to stricter rules.

Setting the bar higher for digital banking

Current trends in the digital banking landscape signal a forthcoming wave of stringent regulations for entities operating under MFB licenses. As digital banks expand in size, transaction volume and introduce increasingly innovative financial products, it becomes more likely that the Central Bank of Nigeria may consider implementing additional risk management measures for digital banks, aligning them more closely with the standards applied by traditional commercial banks.

Earlier in 2021, CBN voiced apprehension regarding the expanding operations of Microfinance Banks (MFBs), citing their "comparatively low capitalization" as a significant risk factor. The CBN restated the permissible activities outlined in the 2012 Revised Regulatory and Supervisory Guidelines for MFBs, emphasizing their role in providing financial services to retail and micro-clients, with at least 80% of their loan portfolio dedicated to microcredit facilities. The Governor's statement on November 24, 2023, urging payment system firms to streamline operations, reflects a continued concern. In 2024 and beyond, digital banks operating under MFB licenses may come under closer regulatory supervision.

New measures could involve increased regulatory focus on aspects of credit risk, operational risk and liquidity risk, among others as the CBN aims to ensure that digital banks are equipped to manage and mitigate risks effectively, given the increasingly dynamic nature of the financial services they offer.

To foster resilience in the rapidly evolving landscape of digital banking, the Central Bank may consider implementing comprehensive risk management frameworks comparable to those employed by conventional commercial banks.

As digital banks expand in size, transaction volume and introduce increasingly innovative financial products, it becomes more likely that the Central Bank of Nigeria may consider implementing additional risk management measures for digital banks, aligning them more closely with the standards applied by traditional commercial banks.

Setting the bar higher for digital banking

With the primary aim of setting higher standards, potential regulatory approach may encompass a spectrum of areas such as elevated Minimum Capital Requirement, Capital Adequacy Ratios (CAR), refined guidelines on board composition, internal controls, and stress testing.

Additionally, a heightened focus on cybersecurity measures and robust data protection frameworks is anticipated to safeguard customer information, fortify defenses against cyber threats, and mitigate the risk of potential breaches.

Building on the trend noticeable from recent regulations in the digital lending sector, an enhanced regulatory framework for digital banking may include measures to establish fair debt collection practices, ensuring a balanced and ethical approach to handling financial obligations. Moreover, there is a likelihood of more frequent and detailed reporting requirements, promoting transparency and enabling more effective supervision of digital banking activities.

Key Takeaways

- Digital banks should anticipate increased regulatory scrutiny and proactively implement robust risk management frameworks,
- Strengthen internal controls, cybersecurity measures, and data protection protocols.

Growth of Banking as a Service (BaaS) and Embedded Finance

The embedded finance sector is currently witnessing robust growth, characterized by a growing collaboration between financial service providers and non-financial platforms. This collaboration aims to expand market reach and improve customer experience by offering a diverse range of financial products. Building on the success of embedded payments, which seamlessly integrate payment processing into digital platforms, there is a notable uptick in the development of innovative products which integrate financial services into non-financial services products.

Fintech companies and traditional financial institutions are now offering Banking as a Service (BaaS) to non-financial service providers, empowering them to incorporate essential financial services into their own products. Furthermore, more co-branded products are expected; offering financial and non-financial brand the opportunity to expand their reach and provide added value to their customers.

The embedded finance industry is poised for substantial growth, especially in Nigeria, given the continuing push for financial inclusion.

The World Bank highlights that only 40% of Nigeria's adult population currently has access to financial services, underscoring a significant opportunity to create solutions for non-banking digital platforms to collaborate in providing access to financial services. Globally, embedded finance transactions are projected to grow by 54.5% annually, reaching $1,775.5 million in 2023 and an impressive $9,842.5 million by 2029, with a Compound Annual Growth Rate (CAGR) of 43% [1].

The increasing popularity of embedded finance poses new challenges for regulated financial services entities and regulators, particularly in terms of supervising the regulatory compliance of counterparties to regulated financial service providers. Regulated financial services companies must assess their risks closely when considering potential collaborations. As the industry continues to evolve, addressing these regulatory considerations will be crucial to ensuring the stability and integrity of the embedded finance ecosystem.

[1] Embedded Finance Opportunity in Nigeria, accessed at https://fintechpad.com/how-embedded-finance-opportunity-in-nigeria/%20last%20accessed%20on%20January%2010,%202023

The increasing popularity of embedded finance poses new challenges for regulated financial services entities and regulators, particularly in terms of supervising the regulatory compliance of counterparties to regulated financial service providers.

Key Takeaways

- Regulated financial services entities should carefully assess legal risks associated with potential collaborations and evaluate the cost of ongoing compliance supervision of counterparties,
- Anticipate and prepare for potential regulatory measures that may be introduced to ensure compliance of non-financial institution counterparties,

Operationalizing open banking

In a significant development, open banking guidelines were officially released in March 2023, marking a pivotal moment in the evolution of financial services in Nigeria. These guidelines lay the foundation for how open data exchange will be operationalized within the country, ushering in a new era of collaboration and innovation in the financial sector.

As of the current date in 2024, more details on the practical implementation and functioning of open banking in Nigeria are expected to emerge. Open banking typically involves the secure sharing of financial data between different financial institutions, allowing customers to have more control over their financial information and fostering competition and innovation within the industry.

Key aspects that may unfold in 2024 could include practical application of the recent guidelines in establishing data exchange protocols and implementing prescribed API standards.

Further insights will also emerge on how CBN's Open Banking Registry will oversee and regulate open banking practices and the mechanism for efficient regulatory collaboration with other key relevant regulators such as the Nigeria Data Protection Commission and National Information Technology Development Agency (NITDA).

Considering the regulatory interdependencies that would be required for open banking, 2024 may witness the emergence of more interagency agreements and understandings. This is essential for greater coordination and to reduce the prevalence of regulatory arbitrage, particularly for non-financial services third parties.

Key Takeaways

- In 2024, more details on the practical implementation of open banking in Nigeria are anticipated, including the application of guidelines, establishment of data exchange protocols, and adherence to API standards.
- 2024 may witness the emergence of more interagency agreements and understandings, essential for coordinating regulatory efforts and reducing the risk of regulatory arbitrage, especially for non-financial services third parties.

A renewed focus on cybersecurity and AML-CFT challenge and emergence of industry-led initiatives on mutual assistance

The Nigerian financial sector has witnessed a significant surge in cybersecurity risks, with the country experiencing an estimated annual loss of $500 million to cybercrime, as reported by the Nigerian Communications Commission (NCC)[2]. In 2023, Nigeria found itself among the top 100 most breached countries, recording as many as 82,000 leaked accounts in the first quarter alone[3].

In addition to the cybersecurity concerns, the CBN has an immediate and pressing challenge to increase its scrutiny over the Anti-Money Laundering/Combatting the Financing of Terrorism (AML-CFT) in response to Nigeria's Grey listing by the Financial Action Task Force ("FATF"). There may also be increased KYC standards, especially for digital banks and payments companies given the escalating rate of fraud (such as chargeback fraud) in the sector.

Despite the alarming statistics on cybersecurity, there is a growing concern that the actual threat to Nigeria's FinTech industry may be more substantial than what has been disclosed.
Without a coordinated framework for cooperation and assistance, the entire industry could become more vulnerable. To address this critical issue, concerted efforts from FinTech organizations are imperative to foster open communication and collaboration in managing cybersecurity incidents and vulnerabilities. This approach aims to cultivate a culture of transparency and accountability, encouraging self-regulation within the industry through the development of cybersecurity standards and breach management protocols. These standards would establish a baseline level of security across all FinTech companies.

[2] https://punchng.com/cybersecurity-threat-grows-ncc-issues-six-alerts/ last accessed on January 10, 2023
[3] https://surfshark.com/research/study/data-breach-statistics-2023-q1 Data breach statistics 2023'Q1 vs. 2022'Q4, published on May 10 2023, last accessed on January 5, 2023

A renewed focus on cybersecurity and AML-CFT

As a call to action, there is a pressing need for an effective management of cyber breach incidents through consultative engagement with relevant stakeholders-emphasizing the necessity for prompt legal responses, especially in judicial proceedings for interim reliefs for freezing of suspicious financial transactions, funds tracing and recovery.

This collaborative effort will facilitate the establishment of response mechanisms that swiftly and effectively address the legal aspects of cybercrime, thereby fortifying the financial sector against evolving cyber threats.

Key Takeaways

- An industry-led framework for cooperation and assistance would enhance communication, develop cybersecurity standards, and create breach management protocols for a unified security baseline.

- Efficient legal intervention in court proceedings to freeze suspicious transactions and facilitate fund tracing and recovery can mitigate financial losses from cybersecurity breaches.

Anticipating More Consolidation and Transactions for Change of Control

The financial landscape is poised for further transformation with an expected increase in mergers and acquisitions, building on the trend observed in 2023. This surge in consolidation is anticipated to drive growth and foster enhanced competition within the industry. As organizations come together, viable and innovative ideas are likely to thrive, propelling the financial sector towards increased dynamism and efficiency.

This trend is indicative of a strategic response to the evolving market conditions, enabling financial institutions to pool resources, expertise, and innovative solutions. The resulting synergies can lead to the development of more robust and adaptable entities better positioned to navigate the complexities of the modern financial landscape.

The overarching impact of this anticipated consolidation is expected to create a more competitive environment, stimulating the emergence of new and improved financial products and services. As organizations join forces, the sharing of knowledge and technological capabilities can pave the way for transformative advancements, benefiting both industry players and consumers alike.

In essence, the wave of mergers and acquisitions foreseen in the financial sector is not merely a trend but a strategic move towards fostering growth, adaptability, and innovation. This trajectory reflects a commitment to staying ahead in a rapidly evolving industry and delivering enhanced value to customers.

Key Takeaways

- Prepare for a rise in mergers and acquisitions in the financial sector, building on the trend observed in 2023.
- Evaluate consolidation as a strategic response to evolving market conditions.
- Recognize the potential for synergies resulting from mergers to create more viable fintechs and foster a more competitive environment.

Increased investor due diligence, and focus on Environmental, Social, and Corporate Governance (ESG)

The tech ecosystem in Nigeria underwent significant shock in 2023, marked by the closure of several fintech startups. The closure of companies like 54Gene, Pivo Africa, Zazuu, KippaPay, Bundle Africa, Vibra, Payday, and Lazerpay, leaving over $70 million in investor funds unrecovered, has prompted a re-evaluation of investor due diligence practices and corporate governance within the sector.

Several factors contributed to the high rate of closures, including regulatory uncertainties, dwindling access to additional funding, and alleged mismanagement of investors' funds. These events highlight potential weaknesses in corporate governance structures among fintech companies, indicating a need for increased transparency, accountability, and risk management. The industry is entering a period of introspection and adaptation, with a focus on strengthening corporate governance structures, refining due diligence processes and rebuilding investor confidence.

The aftermath of these closures is expected to lead to the following developments:

Strengthened corporate governance:
The closures emphasize the importance of robust corporate governance structures within fintech companies. In 2024, investors are expected to increasingly rely on Environmental, Social, and Governance (ESG) benchmarks throughout various stages of the investment process, including investment selection, deal origination, due diligence, monitoring, reporting, and exit.

Furthermore, the Financial Reporting Council of Nigeria will look to operationalize the ESG protocols built into its new legislation, the Financial Reporting Council of Nigeria (Amendment) Act 2023, which took effect on May 3, 2023. This regulatory update signifies significant changes to financial reporting regulations and standards, aiming to enhance the quality and reliability of financial reporting. More ESG reporting by Fintechs are envisaged in 2024.

Increased investor due Diligence:
The closures are prompting a re-evaluation of investor due diligence practices, leading to stricter scrutiny for startups seeking funding. Investors are likely to become more cautious, conducting thorough assessments of the financial health, management practices, and risk management strategies of potential investment targets.

Decline in funding:
The closures contribute to a shift in investors' risk attitude and the funding environment is more challenging with observable decline in deal activities and funding volumes for the African startup ecosystem. Of note, Nigeria dropped to the third place from first in deal value. [4] It is feared that the already observed decline in financing may persist through 2024[5].

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[4] Briter Bridges, HI Africa Investment Report 2023, https://static1.squarespace.com/static/5ab2a4d655b02c29746fc58c/t/64df39edf1432b11c33b9266/1692350998532/Briter%27s+H1+2023+Africa+Investment+Report.pdf H1 Africa Investment Report 2023 by Briter Bridges
[5] Briter Bridges, HI Africa Investment Report 2023,

The industry is entering a period of introspection and adaptation, with a focus on strengthening corporate governance structures, refining due diligence processes and rebuilding investor confidence.

Key Takeaways

- Expect increased reliance on Environmental, Social, and Governance (ESG) benchmarks by investors in 2024. Strengthening corporate governance has become more imperative for growth.
- Startups seeking funding must prepare for increased investor caution, with rigorous assessments of financial health, management practices, and risk strategies.
- Anticipate decline in funding and shifting risk attitudes.

Heightened pressure on Fintech founders for liquidity and potential investor disputes

Venture-backed fintechs may face increased pressure on founders to unlock liquidity by some investors. This renewed challenge could stem from various factors, including unrealized investor expectations (particularly when influenced by exaggerated valuations and overly optimistic market projections), or the need for liquidity events to facilitate further growth. The pressure to unlock liquidity could manifest in the form of initial public offerings (IPOs), sale or acquisitions, or other strategic exits.

Simultaneously, this intensified focus on liquidity may give rise to potential investor disputes. Differing opinions on the timing, strategy, or valuation of liquidity events could lead to disagreements between founders and investors. Striking the right balance between meeting investor expectations and ensuring the long-term success and sustainability of the fintech venture may become more challenging for founders.

In the midst of ongoing funding downturn, down rounds may become increasingly prevalent as businesses turn to bridge rounds to secure immediate capital for growth ahead of their upcoming major funding round. This trend is not solely driven by the changes in the funding environment, concerns also arise regarding companies that conducted previous financing rounds at high valuations.

These companies face heightened pressure as follow-on funding becomes uncertain, and potential investors in the bridge round push for significantly lower valuations amidst other financing terms that may unsettle the balance with existing investors.

Local investors might increasingly scrutinize the intricacies of investment instruments; testing the application of Nigerian laws to more sophisticated financial arrangements, including equity, future equity, and convertible debts executed by venture-backed fintechs over the past 5-10 years. This increased scrutiny may be driven by several factors growing sophistication of investors as they become more familiar with the legal structures underlying their investments and the need to proactively seek to mitigate potential risks associated with some of the financing arrangements in view of recent startup failures.

To navigate these challenges, fintech founders may need to engage in early open communication with investors, redefine expectations realistically, and carefully strategize liquidity events to align with the overall business objectives. Moreover, implementing transparent and well-defined mechanisms for addressing potential disputes will be crucial to maintaining a healthy founder-investor relationship.

The intensified focus on liquidity may give rise to potential investor disputes. Differing opinions on the timing, strategy, or valuation of liquidity events could lead to disagreements between founders and investors. Striking the right balance between meeting investor expectations and ensuring the long-term success and sustainability of the fintech venture may become more challenging for founders.

Key Takeaways

- Founders should prepare to manage increased investor pressure for liquidity, potentially leading to strategic exits due to unrealized expectations and the quest for growth.

- In the midst of ongoing funding downturn, Fintechs may encounter down rounds during bridge financing. Founders must manage concerns related to high valuations in previous rounds, balancing uncertainty in follow-on funding and negotiations with potential investors for lower valuations.

- Engage in early, open communication with investors, set realistic expectations, and carefully plan liquidity events aligned with business objectives.

Increased incentives for fintech innovation

For the past 3 years, there has been considerable increase in regulatory support for fintech innovation. Initiatives such as Central Bank of Nigeria (CBN)'s Regulatory Sandbox and the Securities and Exchange Commission (SEC)'s Regulation Incubation (RI) Program are innovative mechanisms set up to assist FinTech companies to develop under a beneficial regulatory climate. By providing a controlled environment, these initiatives allow fintech companies to test and develop their products and services, ensuring compliance with regulatory standards and promoting responsible growth. This, in turn, benefits the entire financial ecosystem by spurring innovation, enhancing financial inclusion, and contributing to the overall economic development of the country.

These initiatives provide a conducive environment that encourages FinTech innovations while maintaining market integrity and ensuring investor protection within established limits. With these initiatives, the Nigeria FinTech landscape is poised for exciting growth.

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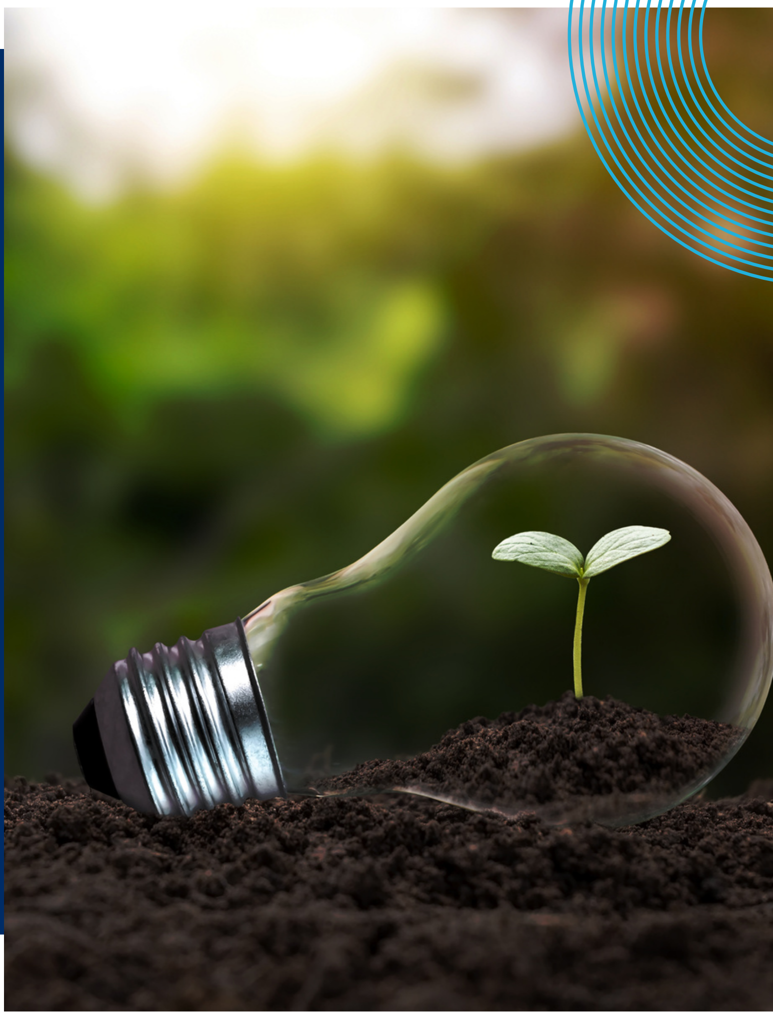


Stablecoin development, growth of digital assets market and more prospect for future virtual assets regulation

The conclusion of 2023 witnessed a notable policy shift by the Central Bank of Nigeria (CBN), as it lifted a two-year restriction on virtual asset transactions. This reversal signals the CBN's openness to exploring the regulation of virtual asset service providers (VASPs), including cryptocurrencies and crypto assets.

The CBN's focus on regulating provision of financial services to VASPs through guidelines suggests a potential avenue for future substantive regulations. These regulations could bring clarity and legitimacy to various operational aspects of the digital assets market, addressing safety, governance, monitoring, and policy supervision issues. These regulatory changes are anticipated to have several ramifications including stimulating greater adoption of virtual assets in Nigeria by providing a regulated framework for transactions involving cryptocurrencies. The revised guidelines provide a regulatory clarity which is anticipated to foster legitimacy and confidence among investors and users in the Nigerian virtual assets market. As the market becomes more formalized, the risk perception associated with crypto transactions may decrease, encouraging a broader spectrum of investors to engage in virtual asset activities.

The guidelines are also a step towards formalizing the virtual assets market in Nigeria.

Over time, this is expected to enhance market dynamics by providing a structured environment for virtual asset service providers to operate. This, in turn, may lead to the development of standardized practices, increased security measures, and improved investor protection, fostering a healthier and more sustainable virtual assets ecosystem especially as more regulations emerge on various aspects of the digital market.

Despite historical restrictions, the Nigerian virtual assets economy has thrived, and the guidelines are poised to nurture further growth. Fintech companies operating in the crypto space are likely to experience increased legitimacy and may find it easier to access financial services, thereby expanding their operations.

These regulatory changes signify a noteworthy shift in the CBN's stance on virtual assets, transitioning from a ban to a more nuanced regulatory framework. This approach aims to manage associated risks while acknowledging the potential benefits of cryptocurrency transactions. The impact of these changes on the crypto landscape in Nigeria and their contribution to the growth of the virtual assets market must be closely monitored.

Stablecoin development and growth of digital assets

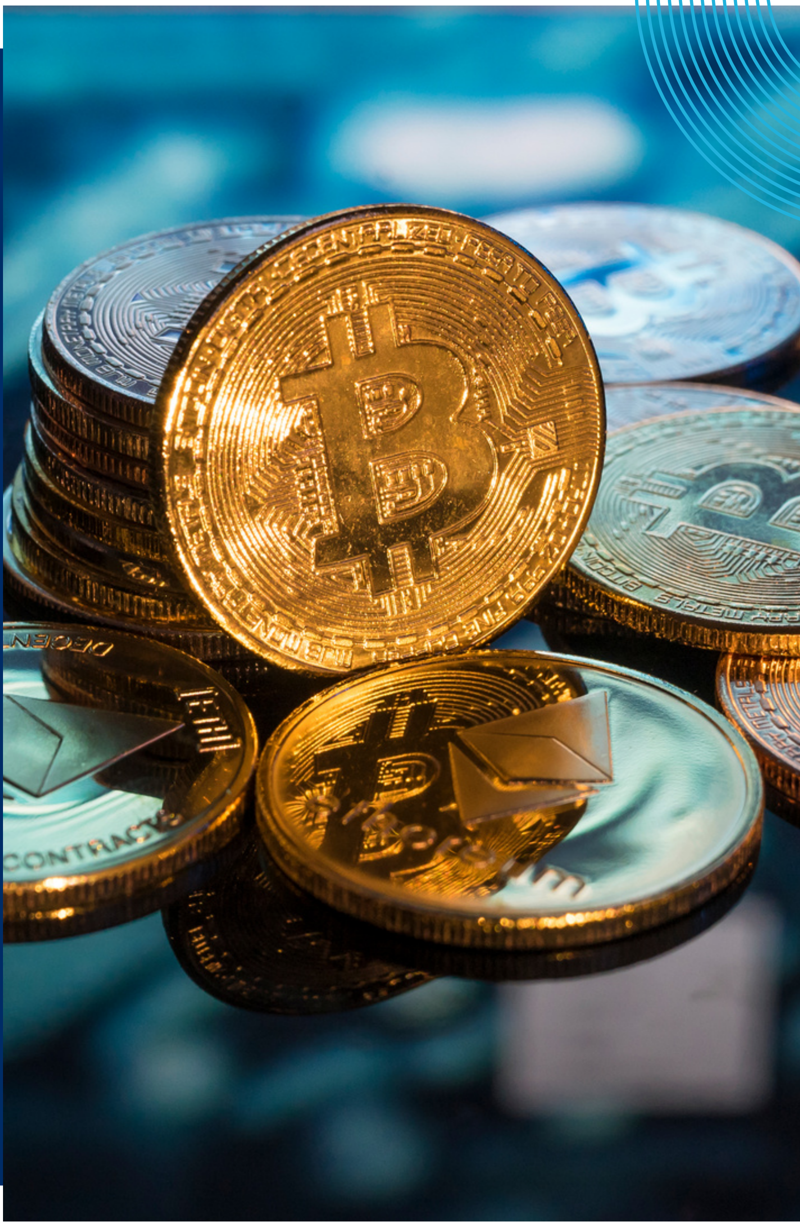
Notably, following the Central Bank of Nigeria's reversal of the ban on digital assets, the Africa StableCoin Consortium (ASC) has recently announced plans to launch its stablecoin (cNGN) in Q1 2024. ASC reports that it has been accepted into the Central Bank of Nigeria's regulatory sandbox to conduct a pilot for the stablecoin.

The Naira StableCoin, denominated at a 1:1 ratio with the Naira, aims to facilitate seamless cross-border transactions involving the Naira. With the CBN's revised stance on virtual asset transactions within the banking sector, cNGN is taking off on a stronger footing as a cryptocurrency, with potential for accelerated adoption.

Key Takeaways

- Fintech companies operating in the crypto space should proactively explore and align with regulatory guidelines for virtual asset transactions, considering the CBN's shift towards openness and regulation.

- Stay abreast of potential future substantive regulations in the digital assets market, focusing on safety, governance, monitoring, and policy supervision. This involves being prepared for changes that could impact operational aspects and compliance requirements.



Enhanced consumer protection

The years 2022-2023 witnessed substantial regulatory interventions geared towards enhancing consumer protection in the digital lending space. As a culmination of these efforts, the Federal Competition and Consumer Protection Commission (FCCPC) announced its plans to establish a comprehensive and permanent regulatory framework specifically for digital lending. This framework, slated for release in 2024, is designed to address identified gaps and issues, surpassing the interim guidelines. Recognizing the critical role of consumer protection in sustaining financial inclusion goals, the regulatory landscape is expected to witness a surge in activities. More regulations, intensified supervision, and increased enforcement efforts are anticipated as the digital lending space continues to evolve with the introduction of innovative financial products.

Concluding remark

The fintech landscape is currently navigating a transformative phase, shaped by the lessons and challenges of the preceding year. The heightened focus on corporate governance, business resilience, and increased consolidation underscores the industry's commitment to adaptability and innovation. Regulation, in this context, emerges as a catalyst, poised to elevate the industry to new heights.

The expanded scope for digital innovation inevitably implies increased legal responsibilities to consumers, investors, and other stakeholders within the ecosystem. As the fintech space gears up for maturity, the unfolding challenge for regulation is to strike a healthy balance—protecting the financial system, fostering innovation, and ensuring the resilience of the ever-evolving fintech industry. This delicate equilibrium will be crucial in shaping the regulatory framework that supports sustainable growth while safeguarding the interests of all stakeholders.

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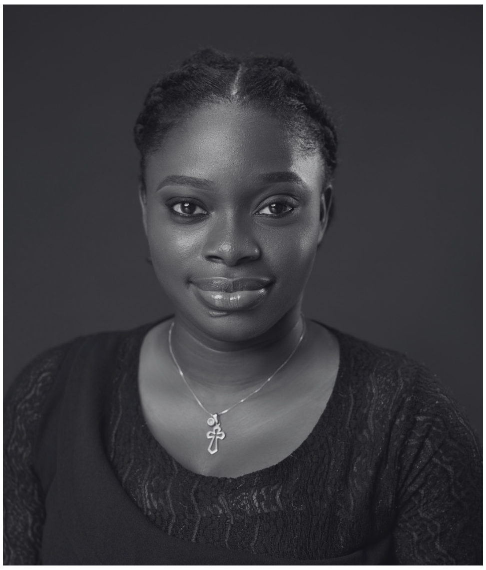

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