Rethinking Financial Regulation and Supervision under 'New Governance': Post-Crisis Lessons for the Kenyan Financial Market, and the Case for Regulatory Nudging

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Abbreviations

BE	Behavioural Economics
BIs	Behavioural Insights
BIT	Behavioural Insights Team
BoE	Bank of England
CAC	Command and Control
CA	Communications Authority
CAK	Competition Authority of Kenya
CBK	Central Bank of Kenya
CIS	Credit Information Sharing
CRB	Credit Reference Bureau
E-Money	Electronic Money
EU	European Union
FCA	Financial Conduct Authority
FinTech	Financial Technology
FSA	Financial Services Authority
GFC	Global Financial Crisis
KBA	Kenya Bankers Association
KEPSS	Kenya Electronic Payments and Settlement System

MC	Mobile Credit
MFS	Mobile Financial Services
MFS/MC	Mobile Financial Services/ Mobile Credit
MNO	Mobile Network Operator
M-Pesa	Mobile Pesa
NG	New Governance
P2P	Peer-to-peer/ person to person
PBR	Principles Based Regulation
RBA	Risk Based Approach
RBS	Risk Based Supervision
RN	Regulatory Nudging
TLL	Traffic Light Labelling
UK	United Kingdom
US/USA	United States of America

Foreign words

Pesa	Swahili word for money
Shwari	Swahili word meaning smoothen or make something better or good

Dedication

This work is dedicated to my family—thank you for your support and encouragement.

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Above all, I wish to thank God and my family. I thank my parents and siblings for their love, encouragement, and invaluable emotional and financial support throughout this journey. I dedicate this work to them.

Declaration

I , **Sarah Achieng' Ombija**, declare that "Rethinking Financial Regulation and Supervision under 'New Governance': Post Crisis Lessons for the Kenyan Financial Market, and the Case for Regulatory Nudging" is entirely my own work, that it has not been submitted, in whole or in part, for any degree or qualification at this or any other university and that all the sources I have used or quoted have been acknowledged as complete references.

Signed: ____**SARAH A OMBIJA**_____

Date: ___**FEBRUARY 2020**_____

Abstract

Domestic and global financial sectors are continually evolving. On the one hand, they take laudable strides, in the form of improved product and service delivery and growth opportunities for markets. On the other, this process intensifies risk and uncertainty in the financial sector. Advancements in information technology are a key contributor to this process. Financial regulation seeks to keep in step with ongoing changes by employing various risk control strategies, but can fail.

Looking back at the Global Financial Crisis of 2007–2009, post-crisis analyses identified poor regulatory design as a contributing factor to bringing about and perpetuating financial crises. Moreover, it is recognised that, although crises may be inevitable, there are ways to minimise their occurrence and impact, and thereby to reduce market and regulatory failures. Consequently, in the years following the GFC, reform efforts have been initiated globally.

This study explores regulatory reform in Kenya, using the UK as a comparator. It seeks to distil pertinent lessons for the Kenyan market from the experience of the GFC. With regard to regulatory design, it examines the limits of conventional regulatory approaches, and the shifts in post GFC approaches. It also normatively explores the increasing use of behavioural insights in regulation—a prevalent feature in post-crisis financial regulation in several developed markets. The study applies a Behavioural Economics approach and includes discussion of proposals for the use of nudge interventions to improve regulatory outcomes. These interventions are considered relatively simple, cheap and easy to implement—qualities which make them attractive for regulators who often have to contend with limited resources. We posit that they would be even more welcome in an emerging markets context.

1. Introduction

1.1 The Global Financial Crisis – What Lessons for Financial Regulation?

The Global Financial Crisis of 2007–2009 (GFC) has generated sustained academic discourse in its aftermath.[1] Of interest for financial regulation scholarship and practice, and a key well-spring of inspiration for this work, are arguments suggesting that poorly designed regulation can contribute to bringing about and perpetuating financial crises.[2] A case in point is the GFC, where regulation has been identified as having been one of the myriad causes of, and as having played a vital role in the development and advancement of the crisis.[3]

It has been suggested that regulation is fundamentally about risk control.[4] In this thesis we use the GFC as an overall framing device for understanding the interaction between financial regulation and financial markets. This makes it possible to draw key lessons concerning how to structure regulation and supervision with a view to minimising the occurrence and impact of crises, or more broadly to reduce market and regulatory failures. These lessons are worth contemplating for all financial markets with a view to improving their operation, but this thesis will focus particularly on pertinent lessons for the Kenyan market.

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[1] See for example Christopher J Green, Eric J Pentecost and Tom Weyman-Jones (eds), *The Financial Crisis and the Regulation of Finance* (Edward Elgar Publishing Inc 2011); Charles Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar Publishing Inc 2009); John Armour and others, *Principles of Financial Regulation* (Oxford University Press 2016) 6-10; Robert Kolb (ed), *Lessons from the Financial Crisis: Causes, Consequences and our Economic Future* (John Wiley & Sons 2010).

[2] Frank Partnoy, 'Financial Systems, Crises and Regulation' in Niamh Moloney, Eilis Ferran and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press 2015) 70; Erik F Gerding, *Law Bubbles and Financial Regulation* (Routledge 2013).

[3] Julia Black, 'Paradoxes and Failures: 'New Governance' Techniques and the Financial Crisis' (2012) 75(6) *Modern Law Review* 1038.

[4] Julia Black, 'The Role of Risk in the Regulatory Processes', in Robert Baldwin, Martin Cave and Martin Lodge(eds), *The Oxford Handbook of Regulation* (Oxford University Press 2010).

There are many lessons from the experience of the GFC, but the ones that are considered in this work are grouped into two main categories. The first concerns approaches to the regulation of risk and uncertainty in financial systems and the dynamics of implementing regulatory strategies. Of significance for this thesis is the fact that several regulatory strategies falling under the 'new governance' umbrella failed to address the risks that led to the development and unfolding of the GFC. This happened despite decades of advocacy suggesting 'new governance' as superior to the more conventional CAC, due to its superior responsiveness and flexibility. These strategies include approaches such as risk based regulation.[5] This work considers lessons we can learn from these failures. Specifically, it explores why regulation can fail, and in doing so reveals the limits of these approaches. In general, regulatory practice has shown that implementation of 'new governance' strategies can be challenging, and that their operation often creates points of weakness and paradox that can lead to failure.[6] An example of a regulatory paradox is where safety regulation generates moral hazard and in turn leads to greater risk taking activity. Regulation can also give rise to negative externalities, such as fostering creative compliance and regulatory arbitrage. These effects were observed in the GFC, for instance, in the form of the shifting of risk to under-regulated shadow banking activities in the finance sector.[7]

As part of this discussion of strategies, we will also consider approaches to financial innovation and, in particular, product regulation and governance strategies. This is an important topic. On the one hand, financial product innovation has been identified as one of the causal factors contributing to the GFC. On the other, innovation can create vulnerabilities in the financial system. It is suggested for example that loan products became too complex for consumers to understand.[8]

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[5] See generally Black, 'New Governance' Techniques and the Financial Crisis' (n 3).
[6] ibid 1038.
[7] Black ibid 1039-40; Partnoy, 'Financial Systems, Crises and Regulation' (n 2) 73-74.
[8] Steven M Davidoff and Claire A Hill, 'The Limits of Disclosure' (2013) 32(2) *Seattle University Law Review* 599.

The financial services sector continues to experience accelerated technological innovation, which has led firms to adopt new technologies and business models. Technological innovation often creates manufactured risk, and ongoing advancements have, in many jurisdictions, impacted financial regulation. This has created a minefield for regulators grappling with the implications of these changes for the regulatory environment. Regulators are having to balance measures that encourage innovation with the need to ensure that firms adequately address the risks and uncertainties that these advances pose. Achieving the right balance can help avert systemic problems and consumer detriment.

Further, a scan of the global landscape reveals areas that are currently on the policy and regulatory radar. An example is the recognition of regulatory and consumer challenges that new innovations and business models present. One such area is advancements that have led to the growth of short-term, high cost lending provided through digital channels.[9] In this respect, a recent press release issued by the International Financial Consumer Protection Organization (FinCoNet) identified priority themes to be focused on by regulators. These include high cost lending and risk-based supervision in a digital age. Additionally, FinCoNet has initiated projects looking into product governance and culture within firms. These are considered key topics for regulators who have responsibility for financial consumer protection.[10]

The second category of lessons we can draw from the GFC are rooted in what can be termed human cognitive/behavioural complexities. Predictable psychological irrationalities—including groupthink, overconfidence and self-serving biases—are identified as having been at work in firms and as having played a part in the crisis.[11] In general, the behaviour of regulators and the regulated has been suggested as a vital point of fracture in the implementation

[9] FinCoNet, *Report on the Digitalisation of High Cost Short Term Consumer Credit* (November 2017).
[10] FinCoNet Media Release, 'FinCoNet Looks Forward to a Productive Year in 2018' (23 January 2018) <http://www.finconet.org/Media_release_FinCoNet_2018.pdf> accessed 27 November 2019. These were identified as priority areas for the period 2017-2018.
[11] Cristie Ford, 'New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation' (2010) *Wisconsin Law Review* 462.

of regulatory techniques,[12] and can therefore be argued to have a profound impact on the success or failure of regulation. We will in this chapter introduce some theoretical propositions relevant for the analysis of behaviour and decision-making.

We will now consider theoretical propositions applicable to the subject of behaviour. This provides an important lens for analysing behaviour of market actors in financial systems and will help us appreciate where vulnerabilities could stem from.

1.2 Theoretical Background

In this thesis, insights from behavioural science are normatively instrumental. Behavioural science has been described as encompassing systematic analysis of processes that underlie human behaviour. It is a multi-disciplinary science that integrates knowledge and research methods from various fields.[13] Specifically, 'nudge theory', which has its roots in behavioural science is used as a theoretical lens, and we will explore how nudging (an application of nudge theory) can be applied in a regulatory context to address some of the problem areas discussed in this work. In this thesis we will introduce the concept of nudge, explain how it arose and consider how nudging operates.

1.2.1 The Genesis of Nudge

The development of nudge theory can be traced to the field of Behavioural Economics (BE). This is a broad field that combines psychology and theories about cognition to assess the factors involved in economic decision-making processes. In this thesis, we may use the term BE as shorthand for behavioral insights in a broad sense, understanding that BE draws from findings in various disciplines. In view of this, we may use the term BE and BIs (behavioural insights) interchangeably. An in-depth discussion of this field is

[12] ibid 441.
[13] EU Commission Joint Research Centre, *Behavioural Insights Applied to Policy* (European Report 2016).

beyond the scope of this work, we will however introduce it with a view to locating the genesis of nudge.

To better understand nudge we must draw a distinction between economics and BE. Economics is about allocating resources, and will necessarily entail the making of trade-offs and choices. Decision-making is thus central to understanding economics. Nevertheless, the model of economic behaviour in neo-classical economics is very simplified. For example, it assumes that, when humans are making decisions, they will follow their preferences in a bid to obtain the best possible outcome, and that they have complete information that they can assess in order to arrive at the right decision.[14] Behavioural models, on the other hand, try to use more realistic models of human behaviour by drawing on evidence from psychology to show how people *actually* behave, thereby contradicting the rational model of behaviour of neo-classical economics. In other words, BE explores the limits of rationality as expressed in the rational-agent model of neo-classical economics and their effect on the processes of decision-making.[15]

The insights of cognitive psychologists into how people make decisions, and in particular, how people make decisions in the face of risk and uncertainty, began to enter the lexicon of economists in the 1980s and 1990s.[16] Notably, the origins of BE insights have been traced to a much earlier period, going as far back as Adam Smith in 1776. In his discussion of human self-control problems he characterised our passions as myopic or short-sighted. Later, in 1871, Williams Stanley Jevons refined Smith's work on myopia observing that

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[14]Jon Elster, *Sour Grapes: Studies in the Subversion of Rationality* (Cambridge University Press, 1983); See also Jon Elster, 'When Rationality Fails' in Karen Schweers Cook and Margaret Levi (eds) *The Limits of Rationality* (Chicago University Press 1990) 175–180.

[15] James C Cooper and William E Kovacic, 'Behavioral Economics: Implications for Regulatory Behavior' (2012) 41 *Journal of Regulatory Economics* 42; Russell B Korobkin and Thomas S Ulen, 'Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics' (2000) 88 *California Law Review* 1051 (discussing the shortcomings of rational choice theory and uses of heuristics and biases in decision-making); Avishalom Tor, 'The Methodology of Behavioral Analysis of Law ' (2008) *Haifa Law Review* 237.

[16] Fischer Black, 'Noise' (1986) 41 *The Journal of Finance,* 529-543; Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford University Press 2000); Richard Thaler (ed), *Advances in Behavioral Finance Volume II: v2 (The Roundtable Series in Behavioral Economics* (Princeton University Press 2005); George A Akerlof and Robert J Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why it Matters for Global Capitalism* (Princeton University Press 2009).

the preference for present over future consumption reduces over time.[17] There is now a vast body of empirical work by cognitive psychologists on decision-making behaviour, which explores how cognitive biases affect people's preferences concerning what they want, their beliefs concerning their current situation and their options, and their decision making.[18]

The employment of nudges is grounded on behavioural insights that demonstrate that humans are fallible—they are affected by bounded rationality—and additionally that they often make decisions that are irrational because they are hampered by biases and heuristics. The role of heuristics in economics, as related to 'bounded rationality', was proposed by Herbert Simon.[19] Following Simon's work on bounded rationality, Daniel Kahneman and Amos Tversky subsequently undertook extensive research in heuristics in human decision-making, later winning the Nobel Prize for their work. They identified three heuristics types—anchoring, availability and representativeness—and specified biases associated with each.[20] Humans are said to use these mental shortcuts when under pressure, such as running up against limitations to their knowledge or skills, working under time burdens, or simply seeking to avoid exhausting mental exertion. Examples of heuristics are experience-based strategies include rules-of-thumb, educated guesses, and reliance on brand names.

Underlying BE discourse is the notion of two systems of reasoning. This has also been referred to as 'the dual process theory'. The concept distinguishes between automatic, intuitive, or automatic and unconscious process—referred to as system 1—and controlled and reflective processes—referred to as system 2.[21] Human decision-making is said to be based on these two systems. For instance, psychologists have revealed 'judgement heuristics' which are

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[17] Richard Thaler, *Misbehaving: The Making of Behavioural Economics* (Penguin Random House 2016) 87-88.
[18] See for example Cass Sunstein (ed), *Behavioral Law and Economics* (Cambridge University Press 2000).
[19] See Herbert A Simon, 'A Behavioral Model of Rational Choice' (1955) 69 *The Quarterly Journal of Economics* 99.
[20] See generally, Amos Tversky and Daniel Kahneman, 'Judgment under Uncertainty, Heuristics and Biases' (1974) 185 *Science* 1124.
[21] Daniel Kahneman, *Thinking Fast and Slow* (Allen Lane 2011); Jonathan St. B. T. Evans, 'In Two Minds: Dual-process Accounts of Reasoning (2003) 7(10) *Trends in Cognitive Sciences* 454.

mental shortcuts or simplifying rules that humans rely on when making everyday decisions, but which can occasionally expose them to costly mistakes.[22] These are considered a product of system 1.

BE can be summarised as demonstrating that humans are not as in control of decision-making as they think. Affected by biases, humans often rely on heuristics to make decisions, are loss averse, are prone to overconfidence and over-optimism, are affected by framing and social influences, and, rather than following their preferences to obtain best possible outcomes, have a tendency to 'satisfice'.[23] BE proposes that, as a result of these biases and heuristics, humans often make poor decisions and judgments.[24]

The use of nudging, based on the application of nudge theory, is recommended by Thaler and Sunstein as a response to address decision-making challenges and human limitations.[25] The use of 'nudges' is an application of BE referred to as libertarian-paternalism. Nudge theory proposes that people's choices are influenced by various framing factors, including the ways in which options are presented.[26] It relies on what is called 'choice architecture'[27]—the environment that frames an individual's choice—to shape the contexts in which people make decisions. Nudging thus entails structuring choices that people make to lead them towards particular outcomes that are considered to be beneficial to them,[28] or, in the case of

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[22] Daniel Kahneman, Paul Slovic and Amos Tversky, *Judgment Under Uncertainty: Heuristics and Biases* (Cambridge University Press 1982); Peter M Todd and Gerd Gigerenzer, 'Environments that Make us Smart-Ecological Rationality' (2007) 16 (3) *Current Directions in Psychological Science* 167.
[23] A combination of the words satisfy and suffice per Herbert A Simon.
[24] Herbert A Simon, *Models of Man: Social and Rational. Mathematical Essays on Rational Human Behavior in a Social Setting* (John Wiley and Sons Inc 1957); Charles Lindblom, 'The Science of Muddling Through' (1959) 19 *Public Administration Review* 2, 79.
[25] Richard H Thaler and Cass R Sunstein, *Nudge: Improving Decisions about Health, Wealth and Happiness* (Yale University Press 2008) 6-8.
[26] The theory was developed by Cass Sunstein and Richard Thaler from the insights of scholars Kahneman and Tversky. See generally Amos Tversky and Daniel Kahneman, 'Choices Values and Frames' (1984) *American Psychologist* 341-343 (discussing framing at 341); Kahneman, *Thinking Fast and Slow* (n 21).
[27] Thaler and Sunstein, *Nudge'* (n 25) 3—defining a choice architect as having responsibility for organising the context within which people make decisions.
[28] Robert Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (2014) 77 (6) *Modern Law Review* 831.

market actors such as financial firms, outcomes that are also beneficial to the regulator in so far as they align with regulatory objectives.

In regulation discourse, biases and heuristics have been argued to be cases of market failure meriting government intervention.[29] Further, BIs are increasingly being used to inform regulation aimed at addressing such instances of market failure. Regulators and policymakers have come to accept that failing to take these insights into account may result in regulatory failure, and efforts have been made to incorporate them into policy and regulatory processes in various jurisdictions. This represents a radical change in the analytical framework for designing regulatory techniques and strategies.

Experiences from jurisdictions like the UK, which has been front-running the application of nudges to general policy making, are instructive for exploring how nudging arose. This began with the establishment of the Behavioural Insights Team (BIT) within the cabinet office in 2010.[30] This was driven by a movement from "command-based regulation and fiscal controls to 'smarter' strategies that would use behavioural insights rather than rules or financial incentives to influence behaviour. This change was viewed as a continuation of the push for deregulation by the Better Regulation Executive and as supporting the attainment of behaviour change through 'non-regulatory' means. Four factors were listed by the Minister of Government Policy (Oliver Letwin) as advantages of this so-called non-regulatory approach. They were: effectiveness, cost effectiveness, less rigid impositions on individuals and, reduced burdens on business.[31] From the foregoing we can conclude that politicians saw the more traditional approaches as having shortfalls, and that

[29] Ryan Bubb and Richard H Pildes 'How Behavioural Economics Trims its Sails and Why' [2014] *Harvard Law Review*1595; W Kip Viscusi and Ted Gayer, 'Behavioural Public Choice; the Behavioural Paradox of Government Policy' (2015) 38 *Harvard Journal of Law and Public Policy* 973.

[30] Following the initial set up by David Cameron, the BIT was later privatized in 2014. Its ownership is shared equally between the government, a charity named Nesta, and its employees. In the U.S, use of behavioural insights are also actively shaping policy. The Obama administration issued an executive order in 2015 establishing a Social and Behavioral Sciences Team and directed use by government agencies of BE insights to improve efficiency and effectiveness of work. See BIT website <http://www.behaviouralinsights.co.uk/about-us/ > accessed 10 April 2017.

[31] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (n 28) 834; See also House of Lords Science and Technology Committee Second Report of Session 2010-12 Behavioural Change HL Paper 179 (2011) (House of Lords Select Committee 2011) para 5.3 quoting evidence of the head of the BIT, Dr David Halpern.

the employment of BIs was considered a better alternative to address these shortcomings.

The enthusiasm for the application of behavioural insights (BIs) continues to rise, as seen by their increased adoption in various jurisdictions. For example, at EU level, a number of countries have similarly embraced the use of BIs, and even set up organisations mirroring the UK's BIT or 'nudge unit'. It is accepted by member countries that BIs are understood to include nudges and behavioural economics, and multidisciplinary fields like economics, psychology and neuroscience. The use of BIs, it is agreed, can help with understanding how humans behave and make everyday decisions.[32] BIs have also informed the regulatory approaches to retail regulation by regulators in jurisdictions such as Canada, Australia and the United States.[33] Moreover, it is predicted that the role of BE and BIs is likely to increase in future in view of growing interest in low cost, choice-preserving tools.[34] This increase extends beyond policymakers and regulators to businesses.[35]

Two points regarding the genesis of nudge should be emphasised. First, nudge emerges from this background, in which BIs (including nudge tools) are touted as a better alternative to existing strategies, and as constituting a move towards less restrictive and lower costs controls of behaviour.[36] Secondly, it is also notable that, in the original conception, this use of BIs was viewed as a non-regulatory approach. We can conclude that this view is no longer held, as regulators like the FCA in the UK increasingly rely on BIs to inform their work.

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[32] EU Commission Joint Research Centre, *Behavioural Insights Applied to Policy* (n 13); Note Thaler, *Misbehaving: The Making of Behavioural Economics* (n 17) 345. Thaler highlights a common mischaracterisation of the BIT's work as based on the application of Behavioural Economics, whereas it has for the most part to date employed tools and insights from psychology and other social sciences

[33] PRI, FCAC and SEDI, Why Financial Capability Matters: Synthesis Report on Canadians and their Money (June 2005); ASIC, Hook, Line and Sinker: Who Takes the Bait in Cold Calling Scams? (Report 15 June 2002) < http://download.asic.gov.au/media/1338350/HookLineSinker.pdf> accessed 10 May 2017; Consumer Financial Protection Bureau, Annual Report (CFPB 2012). In the U.S, the Consumer Financial Protection Bureau, changed the format and content of information provided to retail borrowers in the credit and mortgage market.

[34] See generally Cass R Sunstein, 'Nudges.gov: Behaviourally Informed Regulation' in Eyal Zamir and Doron Teichman (eds) *The Oxford Handbook of Behavioural Economics and the Law* (Oxford University Press 2014) 719.

[35] Thaler, *Misbehaving: The Making of Behavioural Economics* (n 17) 10.

[36] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree (n 28) 831.

The FCA has even established a Behavioural Economics and Design Unit.[37] An example of the use of BIs by regulators in the UK, is in the promotion of account-switching in the banking industry, where customers were observed to retain accounts unsuitable to their needs or for which they were excessively charged.[38] Ofcom also relied on it in the case against British Telecom (BT), in which they made a decision to prohibit automatically renewable fixed-voice telephone and broadband contracts to residential customers and small businesses, and required BT to withdraw these contracts from the market. The regulator was concerned about the low levels of customer switching and concluded—on the basis of BE—that this was caused by the automatic renewal feature. They concluded that many consumers did not 'opt out' due to the 'default bias' (largely caused by inertia).[39] In addition to the Ofcom example, the FCA is another regulator that has been observed to be keen to use BE to inform its regulation and supervision activities. Early in its tenure, it stated its intention to employ it to (i) understand consumer behaviour; (ii) identify potential problems and how firms exploit biases; (ii) design and test remedies; (iii) target interventions to curb exploitative practises; and, (iv) decide where to set the level of protection and the limit of consumer responsibility.[40]

It is notable that nudging is only one application of BE. BIs in general can also be applied to help regulators analyse different regulatory processes. For example, they may help them understand why some regulation failed to deliver the expected results. Alternatively, they may inform the design of traditional regulatory tools, such as command and control and disclosure regulation, to

[37] Zeina Afif and others, 'Behavioral Science Around the World: Profiles of 10 Countries (World Bank Group 2019) < http://documents.worldbank.org/curated/en/710771543609067500/pdf/132610-REVISED-00-COUNTRY-PROFILES-dig.pdf> accessed 4 February 2020.
[38] FSA, *Levels of Financial Capability in the UK: Results of a Baseline Survey* (London, 2006) discussing how BE insights are shaping regulation of retail markets.
[39] Ofcom was concerned that at the end of the minimum contract period, the contract was rolled over by default unless the consumer proactively cancelled it. In their view, such contracts benefit consumers who would have wanted to renew anyway, but harm those who did not, but mistakenly neglected to cancel. Econometric analysis of switching behaviour of consumers of the largest firm in the market, BT, showed low levels of consumer switching. Consequently, Ofcom directed that all such contracts were to be removed from the market by 2012 and BT did not challenge their decision.
[40] FSA, *Journey to the FCA* (October 2012) 44-45; See also FCA, 'Applying Behavioural Economics at the FCA' Occasional Paper No.1 (April 2013).

improve effectiveness, and may also be used in the designing of enforcement.[41]

Overall, BIs can shape understanding of the inner workings of various sectors, including finance. They may also illuminate various factors, including behaviour that affects performance and perceptions. It is therefore critical that regulators, in the exercise of their role as gatekeepers and umpires in the financial markets, use BIs to design regulation that helps nudgees make better choices, that cushions them against harm, and also that empowers them.

1.2.1.1 Nudge-tools and tensions

The nudge tools that are proposed in nudge discourse generally fall into the following main categories: defaults; persuasive, campaigning and counseling strategies; design approaches; commitments; transactional shortcuts; information mechanisms; and warnings and reminders.[42] The tools that we will consider in this work are therefore molded around this categorization.

One of the tensions surrounding the use of nudge tools concerns their effect on autonomy. Critics of BE/nudge claim that it unnecessarily invades decision-making processes and that individuals' desires are overridden. They characterise it as paternalistic interventionism. Manifestly paternalistic interventions, such as instances where regulators have made decisions to ban products are considered to be an especially interventionist form of regulation, as consumer choice is curtailed and is viewed as a manifestation of a paternalism thought abhorrent in some quarters.[43] In the context of consumer decision-making, for instance, it has been asserted that applying BE assaults the concept of 'consumer sovereignty'—the idea that consumers with the right information are the best judge of their interest. Instead it is suggested that

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[41] Fabiana Di Porto, 'State of the Art Regulation Scholarship in Italy and Some Thoughts on Cognitive-Based Regulation' in M Lodge (ed) *Regulation Scholarship in Crisis* (LSE 2016) 35-36 <http://www.lse.ac.uk/accounting/CARR/pdf/DPs/CARR_DP84-Martin-Lodge.pdf> accessed 19 December 2016.
[42] Thaler and Sunstein *Nudge* (n 25) 233-234; Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree (n 28) 833.
[43] Niamh Moloney, 'Regulating the Retail Markets: Law Policy and the Financial Crisis' (2010) 63 (1) *Current Legal Problems* 375.

people's preferences ought to be respected and treated as sovereign.[44] On the other hand proponents challenge the notion of consumer sovereignty and assert that such interventions are warranted as citizens are often prone to making errors.[45]

Those who favour paternalism raise additional arguments in support of such interventions. Nudge proponents point out that many policy and regulatory interventions outside of nudging are paternalistic.[46] The point they make is a valid one, namely that paternalism is not unique to nudging. However, they make a further argument which distinguishes nudging from other forms of paternalism. BE practitioners assert that underpinning nudging is the libertarian-paternalistic approach, which is seen as offering more of a compromise.[47] Libertarian paternalists "urge that people should be free to choose", (libertarian aspect) but, at the same time, that institutions, including governments, should "steer people's choices in directions that will improve their lives" (paternalistic aspect).[48] Libertarian paternalism does not, therefore, exclude consumer choice, but instead uses framing and 'nudges' to preserve it in frameworks that minimise consumer detriment on account of human fallibility. For example, consumers could be offered default choices or menu options, but would retain the freedom to opt out. To illustrate the preservation of freedom of choice, the writers compare two sets of interventions, one involving the placement of fruit at eye level and the second involving a product ban. They argue that the former qualifies as a demonstration of libertarian paternalism, but that the latter would be plainly paternalistic, as the ban precludes consumer choice. In light of the evident challenges posed by limited retail consumer competence, for instance,[49] an approach that steers

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[44]Abba Lerner, 'The Economics and Politics of Consumer Sovereignty' (1972) 62 (1) *American Economic Review* 258.
[45] Christine Jolls, Cass R Sunstein and Richard Thaler, 'A Behavioural Approach to Law and Economics' (1998) 50 *Stanford Law Review* 1541-43.
[46] Cass R Sunstein and Richard H Thaler 'Libertarian Paternalism Is Not an Oxymoron' (2003) 70 *University of Chicago Law Review* 1159.
[47] Sunstein and Thaler ibid; Hansen, Pelle Guldborg, 'The Definition of Nudge and Libertarian Paternalism: Does the Hand Fit the Glove?' (2016) 7 (1) *European Journal of Risk Regulation* 155.
[48] Thaler and Sunstein *Nudge* (n 25) 5-6; Sunstein and Thaler 'Libertarian Paternalism Is Not an Oxymoron' (n 46).
[49] See Joseph E Stiglitz, 'Government failure vs market failure: Principles of Regulation' (2010) Policy Dialogue Paper, 13 <http://policydialogue.org/files/events/Stiglitz_Principles_of_Regulation.pdf > accessed 19 December

consumers towards particular choices that result in their arriving at better outcomes whilst retaining opt-out alternatives is considered an acceptable compromise. It ensures that ultimate responsibility resides with consumers, and has the benefit of being less patently paternalistic.

Another concept of relevance to the discussion on criticisms pertaining to autonomy is the concept of 'three degrees of nudge' that is proposed by Robert Baldwin. The conceptual framework developed by Baldwin elevates the traditional categorisation of nudge tools. He argues that nudges vary in the degrees to which they impact on the autonomy of the individuals as decision-makers, and distinguishes between three levels of nudge.[50] He sees first degree nudges as respecting decision-maker autonomy and enhancing reflective decision-making. Second degree nudges, he asserts, build on behavioural and volitional limitations to bias a decision in the desired direction, and there is greater intrusion on autonomy than in the case of a first degree nudge. He argues that third degree nudges impose the highest level of intrusion on autonomy, as they entail the highest level of behavioural manipulation. [51] *Figure 1* illustrates this further. This concept of 'degrees of nudge' highlights the fact that not all nudge interventions are equal and some are less invasive than others.

It is also notable that, although classical economic theory and BE explain that behaviour is always a product of choices, the psychological dual process theory that buttresses BE[52] differentiates automatic behaviours and reflective choices. It is suggested that nudging always influences the former, but only intermittently affects the latter. The conceptual consequence of this is that nudging only occasionally targets choices.[53] This means that nudges might

2016, 27. He argues that disclosure requirements may not avert market failure for example because participants are not able to fully process disclosed information.

[50] See generally, Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree (n 28) 831-857.

[51] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree (n 28) 835-837.

[52] Employed by Thaler and Sunstein in their application of nudge theory.

[53] Pelle G Hansen and Andreas M Jespersen, 'Nudge and the Manipulation of Choice: a Framework for the Responsible Use of the Nudge Approach to Behaviour Change in Public Policy' *European Journal of Risk Regulation* (2013) 27.

not always have the intended outcome of steering towards a particular choice, especially in the presence of system 2.

The point to emphasise from the above discussion is therefore that nudging should not be unduly vilified, as embedded in it is a respect for autonomy as seen is in the libertarian aspect. Further, as degrees of nudge differ, not all nudges should attract the same level of criticism about interference with autonomy.

	Typical Characteristics	**Example**	**Impact on Autonomy**
First Degree Nudge	Supply of simple information or a reminder with the aim of improving the target's capacity to make an informed, rational and conscious choice.	1. Health warning on cigarette pack. 2. Reminder to fill in tax return.	Respects the autonomy of the decision-maker and enhances the target's rationality.
Second Degree Nudge	Behavioural or volitional limitations are exploited so as to bias decisions in a favoured direction	1. An opt-out organ donor regime is instituted 2. The office smoking zone is placed at a distance from the work area.	The target could, on reflection, unearth the nature and effect of the nudge— but is unlikely to do so because of behavioural limitations and the tendency to exhibit an 'automatic' response.
Third Degree Nudge	Framing strategies, emotional responses, or covert techniques used to influence decisions or shape preferences	1. A campaign promotes healthy eating with the slogan: Don't lose your looks, junk the food! 2. Shocking images are used to control behaviour—as when photographs of lung cancer victims are	The target is influenced but reflection is obstructed, or reflection materially fails to unpack the nature and extent of the decision or preference shaping.

		used to control smoking. 3. Unpublicised subliminal TV messages are used to encourage e.g. healthy eating or abstention from smoking	

Figure 1: Three Degrees of Nudge

Source: Robert Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (2014) 77(6) Modern Law Review 838.

Another criticism that has been levied is that paternalistic regulation generates moral hazard. This is the risk that nudgees, for example consumers purchasing financial products, perceive themselves as enjoying a safety net that protects them from accountability for their actions. So, on the one hand, such regulation will be seen as championing consumer interests, but, on the other, it can complicate the regulator's obligation to balance between consumer protection and consumer choice.[54] With these concerns in mind, it is reassuring to note that accompanying the application of BIs is a suggestion of regulatory recognition that a balance should be struck between consumer protection and consumer choice. This is seen, for instance, by regulatory statements asserting that BE will inform determination of the level of protection that consumers need, and where to set the limit for consumer responsibility.[55] This is an important consideration, especially in view of the criticisms surrounding the employment of BIs.

Another argument in support of nudging—one of the most persuasive in our view—is the argument that biases and heuristics do not just have the potential to harm individuals, but that poor decision-making can generate spill-over effects that can affect other market participants and even give rise to systemic failure.[56] In the event of such occurrences, governments often feel obliged to

[54] Eilis Ferran, 'The Break-up of the Financial Services Authority' (2011) *Oxford Journal of Legal Studies*, 455.
[55] See for instance the FCA statement suggesting that it plans to use BIs to facilitate this delicate balancing. FSA, *Journey to the FCA* (n 40) 45.
[56] The GFC exemplifies this.

bail out affected individuals and firms. As such, it is absolutely in the interest of the government to intervene with appropriate tools and at the earliest opportunity, in order to avoid bearing this burden later. Consequently, intervention—even seemingly intrusive intervention—is justified to prevent such effects to the wider economy.

The criticisms made about approaches like nudge that harness BIs have not diminished policy and regulatory interest in them. Enthusiasts are convinced of their potential to support the improvement of regulation and policy. The increasing reliance on BIs, and the continued championing of tools such as nudging in various jurisdictions is a manifestation of this.

However BIs, and nudge tools, are not just being harnessed in policy and regulation, and it would be naïve to assume that they are always leveraged for good. The potential for BIs to be exploited by firms resulting in harm to market actors continues to be a matter of concern. There are examples of egregious conduct, such as big tech firms including Uber and Netflix already using it to manipulate behaviour. Uber has reportedly invested millions of dollars in research to help it harness BIs, and reportedly implemented several nudges largely aimed at its drivers, applying them to encourage behaviour such as longer working hours and selection of preferred shifts or pick-up points. Another prominent firm that has applied BIs insights is Netflix, in their use of 'automatic queuing' systems whereby, as one programme is nearing its end, the next is automatically queued. This is worrying because it leads to 'binge watching' of TV shows.[57] There is potential for such techniques to be transposed into the financial sphere. For example, a credit provider noticing that a consumer is about to complete their loan repayments could begin bombarding a consumer with advertisements regarding other loan offers, or sending push notifications regarding other credit offers for which they are eligible for. There is likely some manipulation of this nature already going on

[57] See generally, Ryan Calo and Alex Rosenblat, 'The Taking Economy: Uber, Information, and Power ' (2017) 117 University of Washington School of Law Research Paper No 2017–08 <https://ssrn.com/abstract=2929643> accessed 16 April 2017. See also N Scheiber and J Huang, 'How Uber Uses Psychological Tricks to Push Its Drivers' Buttons' *The New York Times* (New York, 2 April 2017). <https://www.nytimes.com/interactive/2017/04/02/technology/100000005019770.mobile.html?_r=5&pagewanted=all>accessed 16 April 2017.

in the area of finance, and regulators ought to keep a watchful eye out for potential abuses. Additionally, when it comes to understanding cases of manipulation, firms who may be using BIs for manipulation may not readily admit to doing so, hence there is a need for regulators to have a good understanding of applications that harness BIs so they can properly identify and address possible misconduct in this regard.[58]

We argue in this work that analysis of firm and consumer behaviour using a behavioural lens may prove to be an important element for the analysis of financial systems and markets. In chapter 5, we will examine in more detail proposals for how nudging can be applied in a regulatory context, specifically in connection with addressing the key questions raised in this thesis. In so doing we apply a concept we term 'regulatory nudging' (RN). The application of this concept of RN in this work is rooted in an appreciation of the potential of BIs for enhancing regulation, and a keen interest in exploring the extent to which this is possible.

1.3 Originality, Contribution to Knowledge, and Significance

This study adds to discourses on the regulation of risk and uncertainty in the financial sector, particularly in the wake of the GFC which revealed important lessons for financial regulation. It employs Behavioural Economics as a theoretical lens. The novelty of this work is in this application of Behavioural Economics, and especially studies on the use of 'nudge and nudging', as a theoretical lens, and the application of this approach to the Kenyan financial regulation context. Overall, although this work seeks to distil pertinent lessons for Kenya and more broadly for financial markets in emerging economies, the

[58] European Commission Final Report, 'Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective' (Brussels, November 2010); US Consumer Financial Protection Bureau Strategic Plan FY 2013-FY 2017 <http://www.consumerfinance.gov/strategic-plan/> accessed 10 April 2017; Andrew Haldane, 'Patience and Finance' (Speech to the Oxford China Business Forum Beijing, September 2010) <http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech445.pdf>.accessed 10 April 2017. See additional examples of interest in the application of BE by regulators.

analysis conducted will be of significance for other regulatory regimes as the issues discussed are crosscutting.

1.4 Methodology

The study methodology adopted is a reform oriented research approach. [59] The study explores regulatory reform in Kenya using the UK as a comparator in order to draw conclusions. Additional perspectives from other jurisdictions are also incorporated where considered relevant. The choice of the UK as comparator is based on the fact that there is limited literature from Kenya covering specific issues in scope for examination. This is especially with regard to approaches to regulation and supervision that have been interrogated, particularly in the years following the GFC. Moreover, as English common law forms part of the legal system in Kenya, we considered that it may be easier to draw from legal and regulatory practise in this jurisdiction.

With regard to the methods used, this study includes a review of literature relevant to the issues under consideration. The research analysed documents divided into primary and secondary sources. The primary category included primary legislation, secondary legislation, directives, and guidelines. The secondary category included bills, recommendations, books, journal and research articles, policy papers, government publications, reports, and other written works.

The study also integrates some non-doctrinal elements. Three expert interviews were conducted with persons working for financial sector regulators ─ two interviews for Kenya and one in the UK. During the study, additional perspectives were also gathered from informal discussions with two financial sector specialists.

The interviews with representatives from the Kenyan regulators were conducted on an informal basis. This approach was taken as a request made to the Central Bank of Kenya to interview relevant staff was declined. All

[59] Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17 *Deakin Law Review* 101. 'Reform oriented research' is described as that which evaluates existing rules and recommends changes.

interviews were not recorded, and handwritten notes were taken instead. The Kenyan respondents chose to remain personally anonymous.

The Kenya specific expert interviews and informal discussions were conducted to validate the analysis that was carried out in chapters 3 and 4 of the thesis relating to the regulatory concerns within the national context, and the shortcomings present in the current legal and regulatory regime. This analysis isolated weaknesses in the application of New Governance approaches like risk based regulation and limitations in the approach to financial product regulation. In addition to the information on Kenya gathered from the primary and secondary sources, the additional analysis of the national context considered in this work is based largely on an examination of publicly available material, such as information published on the regulator's website, and was supplemented by the informal interviews and discussions with experts.

In the UK, an expert interview was conducted with a representative from the FCA who shared perspectives on the application of Behavioural Economics (BE). This shaped the understanding of this regulator's experience with the application of behavioural insights in a regulatory context. The interview with the FCA was important as this is an area that is under-explored by Kenyan financial regulators. The literature that the FCA highlighted in the discussion was subsequently examined and included in this work. The interview with the FCA was also used to explore how BE and particularly nudging can be used modify firm behaviour, in addition to consumer behaviour. One of the proposals made in this thesis on the use of Traffic Light Labelling (TLL) for financial products as a regulatory nudge was also discussed in the interview. The FCA expressed great interest in this product intervention proposal, and likewise, the suggestion that the TLL approach could be useful for addressing problematic financial products in light of financial mis-selling concerns, even in the UK financial market, in addition to usage in addressing similar issues in emerging markets like Kenya.

1.5 The Chapters in Outline

Following the above introduction to the study, below is an overview of how the discussion in this thesis will proceed.

The first chapter is this introduction to the thesis. Following this preliminary section, the discussion is divided across several chapters as summarised below.

Chapter 2—In this chapter we consider how the GFC has informed our understanding of risk and its regulation. We look at this subject principally in the context of the UK financial market, and later we consider relevant lessons for the Kenyan market. We start by framing the concept of risk and discuss some key risk theories, examining the difference between risk and uncertainty, risk society propositions, and how these theories have shaped risk regulation. This discussion provides an overview of the theoretical underpinnings that explain approaches to the regulation of risk and uncertainty.

This is followed by an analysis of the risk-based approach to regulation (RBA) that has been adopted in many jurisdictions. The adoption of RBA signals a shift from the more conventional and oft criticised CAC, to the use of techniques falling within the 'new governance' paradigm. We consider how approaches like RBA support regulators in their quest to manage risk and uncertainty and also investigate the challenges this move presents—especially in light of the limits of RBA. We also interrogate how risk and uncertainty influences rule design. This is necessary as rules are important regulatory tools and determine how discretion is dispersed within regulatory systems and processes.

Chapter 3—In this chapter we scrutinise the Kenyan financial market and analyse the legal and regulatory framework to isolate regulatory concerns, including weaknesses, risks and challenges present in the current regime. We argue that there are areas of risk and uncertainty that are inadequately captured under the current framework. The main boundary that we use to undertake this regime analysis is the Mobile Financial Services (MFS) sector,

and specifically in relation to the financial product 'mobile credit' (MC). This is a novel product that is giving rise to issues of regulatory concern within the national context. A chief concern already observable in the market relates to the risk of possible financial product mis-selling. MC is a lending innovation that enables the delivery of loans to consumers entirely over a mobile phone, and its development is viewed as an important avenue for extending financial services to the underserved, especially in developing countries. The main concern is the adequacy of the current regulatory and supervisory framework. As more consumers purchase it, and in the absence of a framework that addresses the risks it presents, there are fears that an over-indebtedness crisis could develop on the back of this type of lending.

The experience of the GFC, in which sub-prime mortgages were mis-sold, is a leading example illustrating the detrimental and widespread effects of financial mis-selling in a lending context.[60] Based solely on this experience, we can appreciate Kenya's need for a robust regulatory framework to cushion it against similar harm. Naturally, given the global scale of sub-prime lending, the financial impact was quite high. Although the impact from potential credit mis-selling to borrowers in developing countries may not reach comparable amounts in pure money terms, the context-specific effects could nonetheless have major ramifications in such economies. As a majority of people are poor, unmanaged debt could make their lives even more precarious.

Chapter 4—Having identified the lack of an explicit financial product regulation and governance approach as a key weakness of the Kenyan regime, in this chapter we consider various themes relevant to the structuring of a coherent financial product regulation and governance regime. Such a regime would effectively address consumer protection and innovation risks and other weaknesses in the current regime— including the shortcomings immanent in the regulation and supervision of MFS/MC. Further, in recognition of the

[60] John R Boatright, *Ethics in Finance* (3rd edn, John Wiley & Sons Inc 2014) 102. Author discusses toxic products in the context of the financial crisis. A combination of factors are said to have contributed to the bust that ensued in the US, including: the claim that innovation led to the sale of some toxic products that ought not to have been sold; the claim that the manner in which the mortgages were sold exhibited aspects of predatory lending; the fact that there were product sales to persons who were unsuited; the fact that large quantities were sold.

importance of appropriate timing of regulatory interventions,[61] the chapter also discusses a regulatory strategy that focuses on a pre-emptive approach, which has been identified as a necessary element for regimes to incorporate in view of lessons from the GFC. This is recommended for adoption in the Kenyan product regulation and governance context as in our view this is one of the key vulnerabilities of the existing regulatory framework.

Chapter 5—This chapter explores how nudging—an application of nudge theory—can be applied in a regulatory context. The chapter discusses a concept we refer to as 'regulatory nudging' (RN), a term we use specifically to refer to the use of nudge tools by regulators as a regulatory strategy. This work characterises RN as a soft, more informal, compliance-oriented approach, and we suggest that such approaches might be particularly beneficial for countries searching for cost effective regulatory approaches, especially given the limited regulatory resources that many regimes have to contend with. RN is proposed as a strategy that can address some of the limits of command and control and 'new governance'. In this chapter we principally consider how the RN approach can be used to address the perimeter between risk and uncertainty, and more broadly how its application can support regulation and supervision efforts, as well as the achievement of regulatory objectives including consumer protection. In this chapter we explore the extent to which RN could be applied to the regulatory context to augment the 'new governance' approaches to financial regulation like RBA, which also have inherent limitations. We also consider how it can be employed to shape the relationship between regulators and the regulated. Additionally, the examination of the proposed applications of RN allows us to examine the extent to which regimes can use non-coercive techniques to modify the behaviour of regulatees.

Chapter 6—This final chapter concludes by summarising the themes discussed in this thesis. It emphasises the point that there is no 'one size fits all' approach for regulating risk and uncertainty in the financial system. The RN approach proposed in chapter 5 is suggested as part of the process of

[61] Mads Andenas, and Iris HY Chiu, *The Foundations and Future of Financial regulation: Governance for Responsibility* (Routledge 2013) 66-71 and Chapter 17.

addressing the limits of command, and is recommended in this work as a possible approach that could be adopted by regulatory regimes to enhance the robustness of financial regulation.

2. New Governance Approaches to Risk and Uncertainty

2.1 Introduction

Risk has been defined as the probability that a particular adverse event will materialize, or result from a specific challenge, and encompasses the ensuing gravity of the impact of that event.[1] Risk is an inherent part of markets and market participants have always pursued ways to predict and control it. In financial markets, risks can be posed by payments, credit and investments products.

Regulation, it is suggested, is fundamentally about risk control.[2] In this chapter we consider how the GFC has informed our understanding of risk and its regulation. We look principally at this subject in the context of the UK financial market, and later consider relevant lessons for the Kenyan market.

We start by framing this concept of risk and discuss some key risk theories with regard to the difference between risk and uncertainty. This is followed by an examination of the regulation of risk and uncertainty more broadly. Later there is a consideration of the risk-based approach to regulation (RBA) that has been adopted in many jurisdictions. Discussion then turns to strategies that have taken centre stage post the GFC, which are viewed as capable of augmenting RBA by addressing some of its weaknesses. The question of how regulators exercise discretion is an underlying point of inquiry. There is a particular focus on how this is employed in decision making with regards to how much risk to tolerate, the ranking of competing regulatory objectives and what trade-offs they make as they balance competing objectives. It is recognised that it is possible for conflicts in objectives to arise and undermine

[1] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation Theory, Strategy, and Practice* (2nd edn, Oxford University Press 2012) 83.
[2] Julia Black, 'The Role of Risk in the Regulatory Processes', in Robert Baldwin, Martin Cave and Martin Lodge (eds), *The Oxford Handbook of Regulation* (Oxford University Press, 2010).

certain regulatory objectives.[3] The balancing issue is a crucial one given that regulators have faced difficulties striking the right balance.[4] Trade-offs are often made as they grapple with how to address competing objectives given budget and resource constraints. One of the most common demonstrations of this is greater oversight for the formal banking system in many regimes, in comparison to non-banks (and the shadow banking sector more generally). Yet, the latter, who now have a greater presence in financial services provision, and particularly in the domain of consumer payments, are not focused on. In all, there are fears that governments have not kept abreast of risk divergence in this respect.[5] Finally, we will consider how regulators deal with risk and uncertainty arising in rule design, and questions about when they ought to apply more qualitative rules (principles) versus more prescriptive rules.

2.2 Framing Risk

Studies exploring why risk has taken centre stage have been conducted in various fields including economics,[6] law[7] and sociology.[8] These studies explore the meaning of risk, how it is identified and how risks are dealt with by various actors in society, including governments and institutions. Notably, most areas of executive government, including regulatory processes, have become imbued with the language of risk. Risk is one of the central concepts

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[3] Eddy Wymeersch 'The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors' (2007) 8 (2) *European Business Organization Law Review* 237; Joseph J Norton 'Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience-A Critical Reevaluation' (2005) 39 *International Lawyer* 15.

[4] For instance it is said that in the years leading up to the crisis, the UK regulator (the FSA) imprudently over-focused on legacy issues relating to conduct risk and not enough on prudential regulation.

[5] Marissa Fenech and others, 'The Challenge of Convenience: Understanding and Regulating Global Mobile Financial Services' (2011) 12 *Georgetown Journal of International Affairs* 44, 46.

[6] Frank Knight, *Risk, Uncertainty and Profit* (Boston, 1921); in management, for decision theory, see James G March, and Zur Shapira, 'Managerial Perspectives on Risk and Risk Taking' (1987) 33 *Management Science* 1404, 1413; Mary Douglas, and Aaron Wildavsky, *Risk and Culture: An Essay on Selection of Technological and Environmental Dangers* (Berkeley 1982); Branden B Johnson and Vincent T Covello (eds.), *The Social and Cultural Construction of Risk: Essays on Risk Selection and Perception* (Dordrecht 1987).

[7] Nicklas Luhmann *: A Sociological Theory of Law* (Elizabeth King-Utz, and Martin Albrow (trs.), 2nd edn,
Routledge 2014) 193.

[8] Nicklas Luhmann, *Risk: A Sociological Theory* (Aldine De Gruyter 1993).

considered by governments and regulators. Not only does it shape their core activities, it also informs regulatory reform processes. The expectation is that regulatory action will be proportionate to the risk.[9]

Different disciplines have taken different approaches to questions regarding the role of risk. The leading economist who considers these questions is Frank Knight. In the social sciences, Luhmann and Beck are considered the prominent sociologists in the area of regulation and the role of risk.[10] The theories put forward by these scholars are instructive for analysing financial markets like the UK in the wake of the GFC for the purpose of drawing lessons that could be applied to the regulation of the Kenyan financial market.

An overview of risk theories will be considered below, with the caveat that a more detailed analysis falls outside the remit of the thesis.

2.2.1 Risk vs. Uncertainty

The discourse on risk regulation, draws distinctions between risk and uncertainty. [11] Frank Knight, a leading economist of his time, is accredited with contrasting the notion of risk with that of uncertainty.[12] An appreciation of the distinction is important, given the recognition in the literature that risk regulation entails a consideration of the highly contested management of Knightian risk and uncertainty.[13]

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[9] Joanna Gray and Jenny Hamilton, *Implementing Financial Regulation: Theory and Practice* (John Wiley and Sons Ltd 2006) 2-4; 'Language of risk' here refers to the focus on the concept of risk as evidenced, for instance, by the majority of regulators engaging in formal risk assessments and in risk management.

[10] Gray and Hamilton, *Implementing Financial Regulation* (n 9).

[11] See Jonathan R Nash, 'Law and Risk' (2015) 12 International Encyclopedia of the Social & Behavioral Sciences (2nd edn, Elsevier Ltd) 504; Pat O'Malley, *Risk, Uncertainty and Government* (Routledge-Cavendish 2004); Hazel Kemshall, *Risk, Social Policy and Welfare* (Open University Press 2002) 11; Christopher Hood,
and David KC Jones (eds.), *Accident and Design: Contemporary Debates in Risk Management* (UCL Press 1996).

[12] Knight, *Risk, Uncertainty and Profit* (n 6).

[13] See Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 83; See Christopher Hood, Henry Rothstein, and Robert Baldwin, *The Government of Risk* (Oxford University Press, 2001); Bridget M Hutter (ed.), *Anticipating Risks and Organising Regulation* (Cambridge University Press, 2010); Bridget M Hutter and Michael Power (eds), *Organizational Encounters with Risk* (Cambridge University Press, 2005); John Adams, *Risk* (London, UCL Press, 1995), 25-27 and Chapter 3.

Risk bears a key distinction in the form of its attachment to probability calculations, which makes it quantifiable. Ergo, an event for which probability is mathematically calculable with actuarial precision is predictable. It is therefore also controllable. Gray and Hamilton argue that uncertainty is distinguished from risk because it is immeasurable, incalculable and based on conjecture and judgment. It is therefore uncontrollable because its outcomes are "unknown and unknowable."[14] This description of uncertainty leaves out a further distinction made by Knight, who isolates two categories: measurable and true uncertainty. The latter is immeasurable and therefore unknowable, while we argue that the former, being measurable,[15] is knowable and addressable through regulation. To highlight the difference between risk and uncertainty, we may consider an example used by Andromachi Georgosouli regarding financial crises. She explains that, despite our knowledge that they are coming, we know neither how nor when. As such, our capacity to respond to the most extreme cases and unpredictable systemic events is also limited.[16]

The literature also captures further attempts to dissect Knightian uncertainty. Uncertainty according to Knight arises from partial or imperfect knowledge.[17] An analysis of Knight reveals that early interpretations of his work led to certain circumstances of uncertainty being overlooked. It was long assumed that the difference between risk and uncertainty lay in the distinction between measurability and unmeasurability or the objectivity or subjectivity of probability, or between the insurability and uninsurability of probabilistic outcomes.[18] The interpretative challenge, as articulated by Langlois and Cosgel, is that if probability could be isolated in a decision-maker's subjective assessment, then "there is no state of the world whose probability cannot be articulated" and therefore "by definition, all probabilistic situations are a matter of risk."[19] More recent interpretations suggest that it could not have escaped Knight's understanding that agents could generate subjective probability

[14] Gray and Hamilton, *Implementing Financial Regulation* (n 9) 20.
[15] Knight, *Risk, Uncertainty and Profit* (n 6) 231-232.
[16] Andromachi Georgosouli, 'Judgement-Led Regulation: Reflections on Data and Discretion' (3–4 July 2013) 14 *Journal of Banking Regulation* 214.
[17] Knight, *Risk, Uncertainty and Profit* (n 6) 199.
[18] Richard N Langlois and Metin M Cosgel, 'Frank Knight on Risk, Uncertainty and the Firm: a New Interpretation' (1993) 31(3) *Economic Inquiry* 457.
[19] ibid.

assessments from any situation.[20] In other words, so long as probability can be assigned to a situation, even where the assignation is by an individual (subjective probability) then that can be categorised as risk as well.

Langlois and Cosgel further assert that an understanding of the role of judgement in economic life is central to understanding Knight.[21] According to Knight's theory of organization, decision-making in business relies on intuition, common sense and not scientific knowledge—this is what Knight terms 'judgement'. This exercise of judgement enables transformation of a knowledge shortfall regarding the classification of outcomes into a form that can be used to take make business decisions. Further, Knight suggests that, in the presence of uncertainty, those appointed to organisational leadership positions will have demonstrated a good use of their judgement and skill—this is seen as the basis of specialization.[22] Additionally that some people specialize in the judgement of other people's judgement.[23]

Knight's theory of organization also suggests that the examination of judgement of others over time can lead to a classification of instances. Knight suggests that the subjective aspect is important for unpicking uncertainty. He further suggests that, when the judgements or decisions made by one or several managers who have specialized in a particular area are taken over-time, these become more than subjective judgments. That is, they become instances which can be used to make classifications about outcomes directly.[24] This serves to minimise uncertainty so that situations that start off as subjective judgements can with time be accorded greater predictability. We suggest that a point of reflection for both firms and even regulators is whether they can build a database of judgements that can be interrogated as necessary to inform decision-making.

[20] Stephen F Leroy and Larry D Singell Jr., 'Knight on Risk and Uncertainty' [1987] *Journal of Political Economy* 394
[21] Langlois and Cosgel (n 18) 458-459.
[22] ibid 460-461.
[23] ibid 462.
[24] ibid, 460-461.

Economists discussing the difference between risk and uncertainty have argued that when we encounter risk, although we are uncertain of the outcome, we know the probability of distribution of the likely outcomes. On the other hand, when faced with uncertainty we do not even have this much.[25] It is argued that in reality it can be challenging to distinguish between situations of risk and of uncertainty. Moreover it has been said that, in the legal context, many discussions combine these two different concepts.[26]

Another situation that illustrates the difference between risk and uncertainty is that of global warming, in which deficiencies in knowledge and understanding mean that it can be categorised as an issue of great uncertainty as opposed to a risk. It is important to note that, as in the case of global warming, future scientific knowledge can help to reduce uncertainty.

The close connection between risk and uncertainty is supported by arguments suggesting the possibility of risk and uncertainty intersecting and blending. We see this for instance under the 'social-constructivist' 'social political' post-modernist model.[27] This model further emphasises the link between these two areas by arguing that the circumstances from which probabilities descend are always flawed and grounded on uncertain knowledge, in other words that risks emanate from uncertainty.[28]

We suggest that it is possible to see risk and uncertainty as existing in a continuum with gradual change in the level of measurability as one moves from risk at one extreme to uncertainty at the other.

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[25] Knight, *Risk, Uncertainty and Profit* (n 6) 19–20.
[26] See Jonathan R Nash, 'Law and Risk' (2015) 12 International Encyclopedia of the Social & Behavioral Sciences (2nd edn, Elsevier Ltd) 504.
[27] Barbara Adam, and Joost van Loon, 'Introduction: Repositioning Risk: The Challenge for Social Theory' in Barbara Adam, Ulrich Beck, and Joost van Loon (eds.), *The Risk Society and Beyond, Critical Issues for Social Theory 8.*
[28] Pat O'Malley, *Risk, Uncertainty and Government* (Routledge-Cavendish 2004) 18.

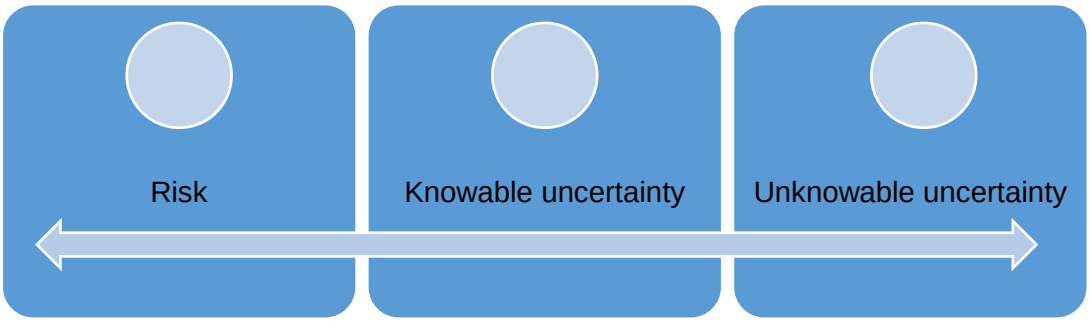

Figure 2.1: Risk and uncertainty continuum

Of concern is that there are instances where regulatory or industry practice conflates these areas. When no distinction is made between risks and knowable/unknowable uncertainties the effect may be that they are accorded similar treatment and thus responses may be inadequate or ineffective. This is a challenge in the financial sector and a potential challenge for MFS/MC as well. Leaving aside the theoretical underpinnings momentarily and looking to actual practices in finance, it is significant that public dissemination may affect the choice of terms used. Gray and Hamilton point our attention to the fact that in the practice of finance and investment the distinction between risk and uncertainty is not always preserved. In such circumstances, "uncertainty may masquerade in the language of risk" for the purpose of lending expert judgments a cloak of certainty and objectivity. Using the term 'risk' conveys that odds are known, whereas terming something 'uncertain' connotes conjecture. As finance practice reveals, the term 'uncertainty' may be substituted for 'risk' even in circumstances of actual uncertainty.[29] Hutter likewise argues that positioning problems and decisions in probability terms makes them seem foreseeable and manageable.[30] This, it is suggested, affects organisations who, in seeking to project a sense of control over their activities and wanting to be seen as taking steps to anticipate risk, might opt to label something as risk whereas it is essence an uncertainty. This may happen irrespective of sound evidence or technical competence.[31] The fact that this is an organisational challenge means that regulators and not just firms

[29] Gray and Hamilton, *Implementing Financial Regulation* (n 9) 20-21.
[30] Bridget M Hutter, 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' in Bridget M Hutter (ed), *Anticipating Risk and Organising Risk Regulation* (Cambridge University Press, 2010) 15.
[31] ibid.

could be impacted. Regulators should bear this in mind in supervisory activity that requires definition and assessment of finance sector risks and uncertainties, so that these differing categories—risk, knowable uncertainty and unknowable uncertainties—are properly identified.

2.2.2 Risks and Knowable Uncertainties

In order to deal with uncertainty regulators should, in addition to conceding that there is a difference between risk and uncertainty, also concede that they have a limited capacity to anticipate uncertain and unknown events. Further they should also appreciate that uncertainties fall into two categories—the knowable and unknowable.[32] Knowable uncertainties also have the capacity to shape and support the regulatory process.[33] The interplay between risk and knowable uncertainties will entail risks continuing to propel regulatory action through risk identification and assessment processes. Knowable uncertainties, for their part, might assume the secondary role of supporting the design and implementation of risk-based regimes.[34] In other words, risk based regimes are also fed by knowable uncertainties. Effective cooperation among different regulators, as well as transparent and comprehensive information sharing in the course of interactions with regulated firms as part of ongoing supervision, can support the sharing of different views about the future, and in turn help to unearth knowable uncertainties.[35]

The MFS/MC context, necessitates a detailed consideration in order to isolate risks and knowable uncertainties, such as those presented by product innovation.[36] Innovation processes typically generate uncertainty[37] and there are situations in which the impact of products is still unclear. This may, for instance, be the case at the design stage or even upon deployment into the market. Innovation in general presents challenges for regulation. In this

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[32] Barbara Adam, Ulrich Beck, and Joost van Loon (eds.), *The Risk Society and Beyond: Critical Issues for Social Theory* (Sage Publications 2000) 8.
[33] Joanna Gray, 'Is it Time to Highlight the Limits of Risk-Based Regulation? (2009) 4(1*) Capital Markets Law Journal* 51.
[34] ibid 53, 60.
[35] Ligia Catherine Arias-Barrera, *Regulation and Supervision of the OTC Derivatives Market* (Routledge 2018) 24.
[36] See chapter 4 for additional discussion.
[37] Anthony Giddens, 'Risk and Responsibility' (1999) 62 (1) *Modern Law Review* 1.

regard, concern has been raised about innovation, the dangers of which may be inescapable and often difficult to detach from its benefits. This is because innovation creates new situations in which rules for proper conduct and safe practice are uncertain and slow to develop. Moreover they stress that, in the post-innovation environment, the old rules may be rendered obsolete and although new rules may be introduced in time, the interim period presents a window for misconduct to brew. Despite these challenges, scholars urge that, even in the midst of such uncertainty, it behoves regulators to think about how to address risks and knowable uncertainties in order to ensure consumer protection and financial stability. Underscoring this point, Cristie Ford asserts that regulatory design needs to provide for ways to manage uncertainty, since failure to do so will lead to other forces filling the regulatory gaps that are generated, including self-interested powerful actors, to deflection tactics such as industry over-reliance on risk modelling computer code, or to regulators over-delegating to industry. [38]

Later in the chapter we will consider regulatory approaches that might be suitable for addressing the boundary between risk and uncertainty (and especially knowable uncertainties). The Risk Based Approach to regulation will be interrogated and we will see in line with Knight's analysis that to manage uncertainty we must rely on judgement.[39] This means that regulation must incorporate elements of discretion. Additionally, with regard to regime design, anticipatory or resilience-based approaches are considered to be better able to deal with situations of uncertainty.

2.2.3 Subjective vs. Objective Risk

Studies relying on the psychological approach to the definition and measurement of risk focus on comprehending the individual biases that explain responses to risk.[40] However, one of the limitations of this approach is

[38] Cristie Ford, 'Macro-and Micro-level Effects on Responsive Financial Regulation' (2011) 44 (3) UBC *Law Review* 589 625.
[39] Langlois and Cosgel (n 18) 462.
[40] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 89- 90; Paul Slovic and others, 'Risk as Analysis and Risk as Feelings: Some Thoughts about Affect, Reason, Risk, and Rationality' (2004) 24(2) *Risk Analysis: An International Journal* 311–22.

its focus on the individual, which is considered problematic given that individuals have been shown to be influenced by group, social, and cultural factors.[41]

Sociologist, with a view to addressing this gap have explored the ways in which "social relations and institutions impacts risk perception and by questioning how moral positions and valuations affect responses to risk.[42] The 'social-constructivist' 'social political' post-modernist model is instructive here. It discusses 'subjective risks' arguing that other types of knowledge (besides mathematical) shape risk. In this regard it examines the notion of 'subjective risk' that postulates that social, cultural and political factors are at play[43] and that behaviour can be influenced by subjective perceptions of risk which can in turn alter objective outcomes.[44] Also of interest is that there might be a distinction between 'subjective' and 'objective risk'. Whereas the former are viewed as non-expert perceptions by an inexpert public, the latter are considered assessable by experts and probabilistic.[45] Additionally, drawing from organizational studies has enabled the isolation of distinct 'man-made' processes that heighten risk in the context of interorganizational production processes. In this regard, it has been asserted that when small deviations from the norm that are perceived not to have major consequences are condoned, they become accepted with the passage of time.[46]

2.2.4 Behavioural Risk

In this work we propose that the risks that arise in decision-making contexts may be considered behavioural risks. Further, applying the Knightian

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[41] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 89- 90; Royal Society, *Risk: Analysis, Perception, Management* (London 1992) 11, 108; Alonzo Plough and Sheldon Krimsky, 'The Emergence of Risk Communication Studies: Social and Political Context' (1987) 12 *Science, Technology and Human Values* 4.
[42] Sheldon Krimsky and Dominic Golding, *Social Theories of Risk (1992)*, 356; Anthony Giddens, *Beyond Left and Right: The Future of Radical Politics* (Stanford University Press 1994).
[43] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 87.
[44] Adams, *Risk* (n 13) 23.
[45] ibid 7-9.
[46] See on normalization of deviance, Diane Vaughan, 'Organizational Rituals of Risk and Error', in Bridget M Hutter and Michael Power (eds), *Organizational Encounters with Risk* (Cambridge University Press, 2005).

distinction, we suggest that it may also be possible to have behavioural uncertainty.

How are we to deal with decisions that require us to contemplate risk or uncertainty? The situation we are presented with may be incalculable or immeasurable from an individual 'subjective' perspective (although objectively measurable). The uncertainty that arises here may not fall neatly into line with strict theoretical definitions, as has been highlighted in discussion of risk theories, but may simply evoke the ordinary meaning of the word 'uncertain'. So, ordinarily when a person is unsure, they often use their judgement or, in everyday parlance, 'guess'. The normal human response in decision-making scenarios is to rely on a combination of knowledge, experiences and, if in doubt, to guess. However, the basis for our guesses or even the decisions that we are confident about could be flawed, or we may be influenced by our environment. Discourses in fields such as behavioural economics, psychology, and neurological science that explore decision-making demonstrate that individual are affected by biases and heuristics, and this often results in their making predictable errors.[47] Poor decision-making as a result of these biases and heuristics can have a deleterious effect on consumers and markets alike, and an examination of this aspect is therefore of relevance to this thesis. For example the prevalence of financial innovations like pay day lending has been linked to short-termism and weak willpower.[48] In chapter 1 we considered the behavioural element and highlighted how behaviour impacts decision-making. This discussion is developed further in chapter 5 where we will interrogate how nudges can be employed to address behavioural risk and uncertainty.

[47] See Nicklas Luhmann, *Risk: A Sociological Theory* (n 8) 1, 4-5. He discusses perspectives from psychology how humans deviate from rationality and individuals in their daily interactions underestimate risks; Richard Thaler, *Misbehaving: The Making of Behavioural Economics* (Penguin Random House UK, 2015) 22-24.

[48] Tim Harford, 'Richard Thaler: If you want people to do something, make it easy', *Financial Times* (02 August 2019) <https://www.ft.com/content/a317c302-aa2b-11e9-984c-fac8325aaa04> accessed 02 August 2019.

2.2.5 Risk Society

Ulrick Beck developed the concept of the 'Risk-Society' and used it to analyse the notion of risk and its societal role. From Beck's perspective "risks exist in a permanent state of virtuality, and only become "topical" to the extent that they are anticipated. Risks are not "real," they are "becoming real."[49] A risk society is preoccupied with the future and with safety, which creates the phenomenon of risk.[50] The rationale of the Risk Society is the distribution of 'bads' or 'dangers'.[51] The debates on the topic of risk regulation have traditionally revolved around the causes of disaster and failure.[52] According to Beck, for instance, risks denote the anticipation of catastrophe and are always synonymous with threatening events. In further distinguishing between risk and catastrophe, he states that when risks materialise, they become catastrophes.[53]

The Risk Society has its roots in industrial society and the emerging understanding from that era that society is not controlled by nature or tradition. This society held that human intervention in the physical world is pervasive and therefore that lives are not lived as fate.[54] Beck asserts that risk society comes to the fore in this post-nature and tradition society propelled by reflexive modernity which triggers societal change. In the era of reflexive modernity, the place of the manual worker has been taken by the educated and informational society and individualism is the driver. As a result of this change, risk society theorists began to question the role of risk.[55] In a risk society, it is not that risks have multiplied, but rather that they become more salient. Moreover, a risk society is typified by the existence of dynamic technological innovation that often is not fully comprehended, with the result that a multiplicity of possible futures is engendered.[56] As is the case with current financial markets, Kenya's

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[49] Beck, 'World Risk Society and Manufactured Uncertainties' (2009) 1 *IRIS 291*, 292 <https://academicpublishingplatforms.com/downloads/pdfs/iris/volume2/201201030948_IRIS_Vol1_No2_2009_1.pdf> accessed 26 July 2019.
[50] Giddens, 'Risk and Responsibility' (n 37) 3.
[51] Beck, *Risk Society: Towards a New Modernity* (Sage Publications 1992) 3.
[52] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 85.
[53] Beck, 'Living in the World Risk Society' (2006) 35 (3) *Economy and Society* 329, 332.
[54] Giddens, 'Risk and Responsibility' (n 37) 3.
[55] Beck, *Risk Society* (n 51) 3.
[56] Giddens, 'Risk and Responsibility' (n 37) 3.

MFS/MC market embodies these attributes and Beck's risk society proposition is therefore relevant to it.

2.2.5.1 Manufactured Risks

Another key concept derived from Beck's discussion of risk society is that of manufactured risks or uncertainties. The notion of manufactured risks questions the description of risks as being measurable on the basis of data, which is the conventional interpretation of the distinction between Knightian risk and uncertainty. Manufactured risks are unmeasurable and incalculable based on historical data and, in light of the definition of uncertainty considered before, they embody the notion of uncertainty. Interrogating historical data will thus have limited benefit for the purpose of identifying manufactured risks or uncertainties. Similarly recognising the limits of relying on the past, Briault points out that, although past events may propel reforms, they may be unreliable for predicting the future.[57] Consequently, isolating this category of risk/uncertainty necessitates a different approach, one that is forward looking, as opposed to retrospective.

Often the terms 'manufactured risk' and 'manufactured uncertainty' are used interchangeably. Whereas Giddens often swaps the terms,[58] Beck, for his part, favours the term manufactured uncertainties'. [59] According to Giddens, manufactured risks emerge in the post-nature and post-tradition era, driven by advancements in human development, and innovations in science and technology in particular. This is a novel risk environment in which looking to history may be unhelpful for gaining information that would support present day decision-making. Not only are the risks often unknown, but there is limited knowledge regarding how to accurately assess their probability of occurrence [60] and how to deal with them .[61] This environment of manufactured risk forces society to "take a more active and risk-infused orientation to their relationships

[57] Clive Briault, 'Risk Society and Financial Risk' in Bridget M Hutter (ed), *Anticipating Risk and Organising Risk Regulation* (Cambridge University Press, 2010) ch.2.
[58] Giddens, 'Risk and Responsibility' (n 37) 4.
[59] Beck, 'World Risk Society and Manufactured Uncertainties' (n 49) 291.
[60] Giddens, 'Risk and Responsibility' (n 37) 4.
[61] Anthony Giddens, and Christopher Pierson, *Conversations with Anthony Giddens: Making Sense of Modernity* (Stanford University Press, 1998) 210.

and involvements."[62] In other words, people are more involved with thinking about risks in a given context and risk permeates their interactions.

In distinguishing between risk and uncertainty, Beck identifies the essence of manufactured uncertainties by listing several factors that are unique to them: dependence on human decisions, societal construction, immanence to society (non-externalizability), and joint imposition (individually inescapable); perceptions departing from the past and from previously encountered risks and entrenched practices; incalculability, uncontrollability, and non (private) insurability.[63]

Although the existence of manufactured risks may convey a sense of limited control, encouragingly, and to borrow Beck's words, from manufactured uncertainties can spring "creativity, the reason for permitting the unexpected and experimenting with the new."[64] The remarkable innovations observable in financial markets including Kenya's MFS/MC market can be said to have been partly generated in such an environment of manufactured risk/ uncertainty.

2.3 Legal and Regulatory Approaches to Risk and Uncertainty

The law employs different strategies to deal with risks that actors in society are exposed to. A first approach is to take no action, leaving the risk in the hands of the societal actor. The societal actor can then choose to minimise their exposure to the risk or bear any negative consequences arising from the risk if it materialises. The societal actor also has the option of obtaining insurance from a private provider following the payment of an agreed premium. It is notable that government regulation typically applies to these private providers.

A second approach entails mandating that a societal actor who could be caught by a particular type of risk should demonstrate that they have the

[62] Giddens, 'Risk and Responsibility' (n 37) 4.
[63] Beck, 'World Risk Society and Manufactured Uncertainties' (n 49) 298.
[64] ibid 291.

financial capacity to cover a risk if a negative outcome materializes. Examples of such measures include bonds and private insurance. The law may stipulate in particular that private insurance should be secured by a private actor. A common example of this is laws that require vehicle drivers to obtain private insurance.[65] A third option is providing insurance underwritten by the government; for instance in situations in which private insurers have shown a reluctance to insure a specific risk.[66] A fourth option at the government's disposal relates to mandated disclosures. It could be made a requirement that specific information relevant to a risk must be disclosed, including aspects such as possible results and the nature and extent of harmful results. The rationale for this is that such knowledge can equip persons at risk, helping them make a decisions about whether to expose themselves to a particular risk, and which risk categories are acceptable. A fifth option entails employing ex post mechanisms to minimise risks, such as reliance on tort law rules that impose strict liability on property owners who use their property in ways that are intrinsically risky. Number six is the use of ex ante government rules, such as those made my regulators bodies and agencies, to attempt to reduce risks. A seventh option is to take the matter before a court of law to have it assess the risk and provide a ruling that touches on it by applying relevant legal rules. An example of this is in connection with bail hearings, in which courts make a determination on whether or not to grant bail and, where they are in favour of granting, make a determination as to the amount.[67]

It is common for governments—via the legislature—to entrust specific sector regulators with the making of assessments regarding the need for rules to address risks, as well as granting the power to make rules to govern/regulate the identified sector risks. It is presumed that regulators will have greater expertise and thereby promulgate better rules than a non-expert regulator would. To check on the often wide discretion of regulators to make rules to govern risks, governments in common law jurisdictions have put in place

[65] Nash, 'Law and Risk' (n 26) 504-505.
[66] Frank Knight proposes this as one of the ways to meeting uncertainty. Knight, *Risk, Uncertainty and Profit* (n 6) ch.8.
[67] For discussion on the different government approaches to risk regulation see Nash, 'Law and Risk' (n 26) 504-505; for court-led approach to risk assessment, see specifically Jonathan R Nash, 'Standing's Expected Value' Michigan Law Review (2013) 1283–1335, 1317.

mechanisms such as judicial review. This allows regulatory actions to be subjected to challenge.[68] However, the approach of entrusting regulation to experts in the form of sector regulators has evolved. On account of dwindling public trust in experts, organisations and governments, regulation has become de-centred and even non-experts have now been co-opted into regulation with a view to improving credibility and legitimacy.[69]

A number of approaches exist with regard to risk management. These include employing cost benefit analysis in the processing of enacting laws and regulations, which would entail a quantification process to determine whether the benefits outweigh the costs. Another approach open to regulators is what is called a risk-risk analysis. This involves regulators weighing the risk that an intervention will minimise against the risk that it will introduce. This entails the recognition of the fact that there are often risk trade-offs. An example used by Nash is of policemen trying to apprehend a criminal and therefore engaging in a high speed car chase. They would have to consider the risk of letting the fugitive get away against that of possible harm to themselves, other innocent people and even the fugitive, should something go wrong in the process.[70]

In the years after the financial crisis, risk culture is another concept that has come to the fore and is shaping risk regulation. Its perimeter is said to extend past risk management and corporate governance. Championed by institutions such as the Financial Stability Board, for application particularly in the case of systemically important institutions, it is considered a comprehensive concept encompassing an "institution's norms, behaviour and attitude in relation to risk awareness, risk-taking and risk management." Its purpose is to alleviate extreme risk-taking.[71]

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[68] Nash, 'Law and Risk' (n 26) 505.
[69] Hutter, 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 18.
[70] John D Graham, and Jonathan B. Wiener, 1997, 'Confronting Risk Tradeoffs' in: John D. Graham and Jonathan B. Wiener, (eds.), *Risk Vs. Risk: Tradeoffs in Protecting Health and the Environment* (John Wiley & Sons Ltd, 1996), 1; Jonathan R. Nash, 'The Supreme Court and the Regulation of Risk in Criminal Law Enforcement' (2012) 92 *Boston University Law Review,* 214-215.
[71] Peter O. Mülbert, 'Managing Risk in the Financial System' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press 2015) 374.

Jonathan Nash summarises the general regulatory response to risk as comprising two main elements. The first is risk assessment, which involves a determination as to whether there is actually a risk. The next step is risk management, which considers suitable responses. Nash asserts that, while the matter of risk assessment is seen as being a scientific one, risk management is considered to be a policy question. Because of the different nature of these two elements, he proposes that different sets of experts be given the task of handling them.[72] Risks are regulated in different ways, and the manner in which risks are perceived and addressed is largely driven by subjective considerations, as opposed to objective risk profiling. Divergent approaches suggest that decisions to regulate risks stringently or with a light touch are governed mainly by factors such as fears and anxieties and moral panics. [73]

2.3.1 Lessons in Regulating Risk and Uncertainty in the Financial System

In this section, we will consider several lessons that emanate from the financial sector and also look at the example from the GFC. The soundness of the financial system is considered to be crucial for the proper working of the wider economy. It is therefore important to reflect on the sources of risk and uncertainty in the financial system.

Uncertainty in the financial system can arise in a number of scenarios. In one, the failure of an individual bank causes spillover effects for other banks as well as the wider economy. It is suggested that the failure of banks and bank-like institutions involves externalities and weakens other banks and financial markets with which they are involved.[74] So the failure of a bank can result in depositors and lenders losing confidence in it. This may in turn lead to the

[72] He refers to this as a paradigmatic regulatory risk analysis and management. See Nash, 'Law and Risk' (n 26) 506; Jonathan R Nash, 'Standing and the Precautionary Principle' [2008] *Columbia Law Review* 108, 494; Jonathan R Nash,' The Supreme Court and the Regulation of Risk in Criminal Law Enforcement' [2012)] *Boston University Law Review* 92 171.
[73] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 85; Hood, Rothstein, and Baldwin, *The Government of Risk* (n 13).
[74] Markus Brunnermeier and others, 'The Fundamental Principles of Financial Regulation' Geneva Report on World Economy II, 6 January 2009.

withdrawal of funds—an outcome that could jeopardize the solvency of the troubled bank. The effect for other banks similar to the failed bank is that they could be judged as equally troubled, which could lead to a more widespread loss of confidence in the banking sector.[75] Another situation of uncertainty relates to the sales of assets by banks. When the probability of loss is high, such a sale may be a rational decision from the perspective of an individual bank. However, when considered from a collective bank standpoint, it can be seen that, if more banks respond in the same way, asset prices may collapse, which may undermine bank system safety. [76] These two scenarios are the outcomes of uncertainty as, although we may know that it is possible for these kinds of situations to arise in the financial sector, it is difficult to predict how things will unravel.

2.3.1.1 Moral Hazard and Adverse Selection Problems

Risk and uncertainty also arises in financial service provision in the form of information asymmetries, as is reflected in adverse selection and moral hazard problems. [77] These problems are knowable uncertainties that can be minimised through the implementation of approaches to risk regulation. They are a concern for policymakers since they hold the possibility of spreading to the entire industry in the form of herd behaviour,[78] which can have damaging effects on competition and market performance.[79] Such problems could lead to the under-production of information and may also manifest in a reduction in demand for products and services on account of information asymmetry and the dampening of market confidence. [80]

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[75] ibid.
[76] ibid.
[77] Andromachi Georgeosouli, 'The Debate Over the Economic Rationale for Investor Protection Regulation: A Critical Appraisal' (2007) 15 *Journal of Financial Regulation and Compliance*, 239; Julian Franks, Colin Mayer, and Luis C da Silva, *Asset Management and Investor Protection: An International Analysis*, (Oxford University Press 2003) 268-72.
[78] David S Scharfstein and Jeremy C Stein,' Herd Behaviour and Investment' (1990) 80(3) *American Economic Review*465.
[79] Georgeosouli, 'The Debate Over the Economic Rationale for Investor Protection Regulation' (n 77) 239; George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84(3) *The Quarterly Journal of Economics* 488.
[80] Georgeosouli, 'The Debate Over the Economic Rationale for Investor Protection Regulation' (n 77) 239.

2.3.1.1.1 Adverse Selection

Adverse selection arises in the pre-contract phase. Poor quality of information in a market and an absence of market confidence may lead to a fall in demand for products and services.[81] In respect of contracts, it is suggested that information asymmetry generates an adverse selection problem with regard to standard terms in consumer contracts. Sellers offering high quality terms to consumers may consider this more expensive as high quality terms remain unobserved. Consequently, sellers are dis-incentivised from offering high quality terms as this is not a business strategy that attracts consumers.[82]

Due to competition and market mechanisms, the quality of terms in consumer contracts may be driven down and this leads to consumer contract terms of low quality. The environment in which this transpires has been referred to as a 'flea market', in which consumers receive low quality bargains characterised by minimum rights against the producer.[83] An inability to verify contract quality may lead to consumers and providers finding themselves confined to this market, even if they may wish to conclude a contract containing high quality terms that are more favourable for them.[84]

2.3.1.1.2 Moral Hazard

Frank Knight's work has been interpreted as highlighting the risk of moral hazard. Barzel, for instance, attributes a moral hazard theory of the firm to Knight, which hinges on the failure of markets in the presence of moral hazard.[85] Highlighting Knight's reference to moral hazard, he states that moral hazard ensues in circumstances in which neither objective definition nor external control of an individual's ventures or uncertainties are feasible, and

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[81] Akerlof, 'The Market for "Lemons"' (n 79).
[82] Michael G Faure and Hanneke A Luth, 'Behavioural Economics in Unfair Contracts' (2011) 34 *Journal of Consumer Policy* 341-2.
[83] Hans-Bernd Schäfer and Patrick C Leyens, 'Judicial Control of Standard Terms and European Private Law-A Law & Economics Perspective on the Draft Common Frame of Reference for a European Private Law, 12. <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1520457> accessed 1 November 2019.
[84] Faure and Luth, 'Behavioural Economics in Unfair Contracts' (n 82) 343-3.
[85] Yoram Barzel, 'Knight's "Moral Hazard" Theory of Organization' (1987) 25 (1) *Economic Inquiry* 117-120.

so the possibility of moral hazard prevents insurance by an external agency.[86]

So, Knight discusses moral hazard in the context of entrepreneurship and argues that entrepreneurship is a source of uncertainty. Given the risk of moral hazard, it is difficult for an external party to insure an entrepreneur against risks posed by the firm as it would be too costly to do so. As such, the entrepreneur is obliged to assume said risks. It is contended that Knight acknowledged in his theory of the firm that the entrepreneur is a bearer of uncertainty.[87] It is argued that the difficulty of obtaining external insurance arises partially due to the uniqueness of business risks and also because of the nature of subjective decision making made by the entrepreneur. The factors that inform such decision-making are primarily internal to the decision-maker, and an external party who is not the actual decision-maker would face great challenges trying to classify instances from an objective perspective. Consequently, as the moral hazard risk is considered to be high, it is difficult to insure externally. Moreover, when the entrepreneur assumes the risks, the risk of moral hazard is removed.[88] To put it differently, business risks are considered uninsurable as there is no objective way to differentiate between bad business decisions and bad luck.[89]

The risk of moral hazard can be fostered by regulation and it can manifest either in consumers or financial service providers. Risk of this kind may arise through the existence of safety net arrangements, such as lenders of last resort and deposit insurance. The lender of last resort has been argued to lead to firms continuing to take excessive risk. This is because they know that the government will always intervene to avert any crisis, or bail them out because they want to avoid consumer losses that may result from not taking action.[90] Another manifestation of moral hazard can be found in situations in which firms

[86] Barzel, ibid 117; Knight, *Risk, Uncertainty and Profit* (n 6) 251 and 256.
[87] Barzel, ibid; Knight, ibid ch. 9 and 10.
[88] Barzel, ibid 118.
[89] LeRoy and Singell 'Knight on Risk and Uncertainty' (n 20) 394.
[90] Kevin Dowd, 'The Case for Financial *Laissez-Faire*' (1996) 106(436) *The Economic Journal*, 679. Arguing that the existence of a lender-of-last-resort can have *adverse incentive* effects and induce banks into excessive risk-taking.

decide to hold lower amounts of capital on the basis of the existence of deposit insurance.

It may also be argued that consumers may equally fall into the moral hazard trap, whereby they place reliance on regulators for their decision making. They may, for example, assume that certain products have regulatory approval, and consequently not undertake their own due diligence to determine suitability. Or, where there are consumer compensation arrangements, consumers may take less care, knowing that they will be compensated.[91] In their interventions, regulators must guard against creating this perception, as they cannot guarantee that consumers/investors are making the right choice. In general, the concern with moral hazard is that the existence of these safety-net arrangements adversely affects the behaviour of both firms and consumers, because they can pass the risks on to others.

2.3.1.2 The Experience of the GFC

Crises have been categorised as uncertainties because we know they will happen but we do not know when. However, there may be elements of crises that are knowable. Power, for instance, explains that their occurrence is gradual, that they are 'organised', and that their roots are often traceable to management failures and intelligence processes. Failure to heed early warning signs has been identified in the examination of corporate scandals and failures.[92] Such early warnings can be indicators of problem areas that need to be addressed. They can be considered as capable of enhancing the predictability of uncertainties.

Clive Briault argues that the risk society thesis that characterises modern society as a risk society, can help support our understanding of financial crises. In doing so, he draws from Beck's warning on the limits of 'rationality'. Beck holds that the experience of the past can encourage the anticipation of the wrong kind of risk, namely one which we believe is controllable and

[91] An example of such a scheme is the UK's Financial Services Compensation Scheme.
[92] Michael Power, *Organized Uncertainty: Designing a World of Risk Management* (Oxford University Press, 2007) 10.

calculable, while disaster stems from the unknown and incalculable. Moreover, Beck also recognises that modern society's developed, institutions—science, the state and business—are limited in their ability to anticipate risk, as this is an ineffectual attempt to anticipate the unforeseeable.[93]

Debates on the GFC point to a multiplicity of causes, but one of the key lessons was the difficulty of keeping advancements in risk understanding, management and control in step with financial innovation. Of significance in this respect are events in the lead up to the crisis that promoted the development of complex and new-fangled innovations for risk diversification and hedging. Notably, the pre-crisis environment in which these developed was characterised by economic growth and optimism, resulting in the under-pricing of risk. Firms are said to have overestimated their capacity to identify and control new and unforeseen risks linked to the financial innovations they developed, and, in the face of an economic recession, the GFC resulted. The global effects on solvency and liquidity were immense, touching several firms, starting with Northern Rock in the UK. Other impacted firms in the UK and US included retail and investment banks, and non-banks, comprising mortgage associations and insurance firms. [94]

Briault sees the GFC as an exemplification of lessons of the 'risk society'. He identifies the weaknesses of the risk society as stemming from an inadequate understanding of risk as well as over-reliance on science, and draws several lessons from this. First, there is a need for financial institutions, led by their senior management and board, to understand the risks their firms take and to develop a strong risk culture within firms. This understanding should inform the implementation of appropriate mechanisms for successful risk monitoring and control.[95] The second lesson concerns the place of science. Society's institutions often rely on science, but not only does science have a limited capacity to anticipate risk, it is asserted that over-reliance on science can

[93] Beck, 'Living in the World Risk Society' (n 53) 329, 330; Briault, 'Risk Society and Financial Risk' (n 57) 26.
[94] Briault, 'Risk Society and Financial Risk' (n 57) 25 and 32-42. Key affected firms were: HBOS, Bear Stearns, Lehman Brothers, Freddie Mac and Fannie Mae, and AIG; Hutter 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 17.
[95] Briault, 'Risk Society and Financial Risk' (n 57) 26-42.

create undue confidence in a firm's capacity to quantify control and mitigate risk. Further it should be understood that financial innovation can generate new and unanticipated risks that science is incapable of anticipating and that can have system wide effects. In view of this it is recommended that science is augmented with careful judgement to uncover two types of risk. The first is risk that can be anticipated, which necessitates an understanding of the measures that would be appropriate to minimise it, and the limits of measurement and control. Appreciating limits includes recognising that there are risks that cannot be anticipated. The second is risk that needs to be addressed by way of resilience. Regulatory approaches that emphasise this aspect of judgement are therefore essential for regimes, and regulators and regulatees should bear this in mind.[96] These lessons are also relevant for finance sector regulators who oversee firms. They are particularly pertinent in their implementation of approaches like the risk-based approach to regulation, which we will consider below. In all, we emphasise that both regulators and regulatees need to improve their understanding of risk and appreciate the limits of science.

In conclusion, Briault challenges overconfidence in the ability of financial institutions to anticipate and control risk. His central argument is that crises are not new but that recent crises have been characterised by the global financial sector's over dependence on science, which has left the system exposed to greater shocks than previously encountered.[97]

2.3.2 Challenges of Regulating Risk and Uncertainty

One of the challenges of regulating risk relates to risk identification and how this informs risk related decision-making. Of concern is the quality and scope of information on risks, explanations about causes of insufficient information in the course of making decisions about risks, and the cost (in time and resources) of obtaining this information.[98]

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[96] ibid.
[97] Hutter, 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 10; Briault, 'Risk Society and Financial Risk' (n 57) ch.2.
[98] Kenneth R MacCrimmon and Donald A Wehrung, *Taking Risks* (New York, 1982) 15–17.

Another challenge concerns the point at which to intervene, and specifically whether to focus on anticipation or resilience. The former would entail a pre-emptory approach, requiring risk identification and prediction and reducing opportunities for risk creation, for example, by providing information to persons who might be impacted. The latter focuses on cushioning against risks and providing mechanisms that facilitate swift and effective recovery in the event of adverse effects from risk production. An example of this would be the putting into place of contingency plans. This issue of whether to adopt an (active) anticipatory or (passive) resilient approach to risk regulation is recognised as being a perennial one in the scholarship on risk management.[99]

Anticipation is core to the concept of risk.[100] Risk regulation in particular is considered to be about the anticipation of risk and preventing its materialisation.[101] Distinctions have been made between risk regulation and routine regulation. The former is considered as a response to crisis and the latter is more pre-emptive, addressing events that could likely lead to detriment if left unaddressed.[102]

Wildavsky, in his work examining the subject of organisational resilience, recommends care in using anticipatory strategies. In doing so, his arguments connect to Becks' risk society analysis. As mentioned earlier, Beck identifies the 'fatal irony' of attempting to anticipate the unforeseeable.[103] In view of our inability to predict all risks, Wildavsky favours resilience building, which entails trial and error and learning from mistakes. He cautions that anticipatory strategies can be costly, leading to a waste of effort and resources. This is because they often generate large numbers of presumed risk, the bulk of which may comprise overestimated or untrue predictions. Additionally, he

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[99] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 94; Louise K Comfort, Arjen Boin and Chris C Demchak (eds.) Designing Resilience Preparing for Extreme Events (University of Pittsburg Press, 2010) ch 2; Andromachi Georgosouli, 'The FCA, the PRA and the Idea of Resilience as a Narrative of Policy Coherence', SSRN Working Paper (27 June 2012). < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2094569> accessed 8 August 2019.
[100] Beck, 'World Risk Society and Manufactured Uncertainties' (n 49).
[101] See generally, Hutter 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 3-22.
[102] Hutter, 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 17; Hood, Rothstein, and Baldwin, *The Government of Risk* (n 13).
[103] Beck, 'Living in the World Risk Society' (n 53) 329.

argues that using them minimises an organisation's ability to handle the unforeseen.[104] Moreover, caution is advised as anticipatory strategies can also generate risks, such as severe risk aversion. Extreme avoidance could result in losing out on opportunities presented by innovations whose safety levels are unconfirmed.[105]

Macrae, on the other hand, identifies recovery and learning from adverse events as being at the core of organisational resilience. Further, he argues that safety and resilience serve two key functions—risk prevention to the greatest extent possible and building mechanisms for handling risk events and regrouping.[106] This suggests that resilience building has an anticipatory component, especially in the post-error stage. Learning from past mistakes necessitates a consideration of how to prevent similar risks from materialising in the future, and includes the implementation of coping mechanisms in the event of risk materialisation. In light of the debates on this area, there is a need for balancing between anticipation and resilience.

The link between anticipative approaches and the precautionary principle is also notable. This principle proposes that, in situations where risk or detriment (to the public or environment) is considered likely but there is no evidence, then the burden of proof rests on the risk creator to demonstrate the absence of riskiness.[107] Debates on the application of the principle have revolved around the fact that innovations are unalterable once chosen.[108] Critics of the precautionary principle condemn its capacity to be capitalized on by powerful groups (political and economic) to steer regulation in their favour by leveraging popular fears and concerns.[109] Other opponents consider an anticipatory

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[104] Aaron Wildavsky, *Searching for Safety* (New Brunswick, 1988); Hutter 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 11; Briault, 'Risk Society and Financial Risk' (n 57) 26.
[105] Hutter, 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 12.
[106] Hutter, ibid (n 30) 12; Carl McCrae 'Regulating Resilience? Regulatory Work in High-Risk Arenas' in Bridget M Hutter (ed), *Anticipating Risk and Organising Risk Regulation* (Cambridge University Press, 2010).
[107] Jurisdictions such as the EU have explained their approach to the precautionary principles. The European Commission has indicated that it will apply where 'scientific evidence is insufficient, inconclusive or uncertain' and where initial scientific evidence raised 'reasonable grounds for concern. See European Commission, Communication on the Precautionary Principle COM (2000)1; Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 94.
[108] See Baldwin, Cave and Lodge, ibid (n 1) 94-95.
[109] ibid 95.

approach to be expensive and resource intensive. They argue that the process of identification of all risks and solutions to address them would come with very high opportunity costs.[110] Others have even argued that the principle is difficult to apply on account of a lack of clarity, and have suggested that it is contradictory.[111] Notably, commentators have identified up to nineteen different interpretations of how the principle applies.[112] In an attempt to offer some clarity on this aspect, commentators have proposed a "heartland area of clear applicability of the principle."[113]

An example of the application of the precautionary principle in regulation is in the use of interventions that ban products or practices to address risks like mis-selling. These have been criticised for being too stringent. Regulators often have to trade-off such interventions against other potential effects. For instance, these interventions might instead stimulate the acceptance of more significant risks as a consequence of limiting the consumption of products that were in circulation before the introduction of rules implementing the precautionary principle. Other concerns relate to reduction of innovation, choice and competition, and increases in cost of regulation to enable regulators to make the necessary judgements to support the intervention decision.[114]

Another criticism directed at proponents of the precautionary principle, is that they hold the mistaken view that non-intervention is a risk free choice. Opponents such as Wildavsky instead prefer an approach aimed at building resilience.[115] Despite the criticisms of the precautionary principle, it is embodied in many international instruments, such as laws and treaties, which

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[110] Aaron Wildavsky, *Searching for Safety* (New Brunswick, 1988) quoted in Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 95.
[111] Jonathan B Wiener, 'Whose Precaution After All? A Comment on the Comparison and Evolution of Risk Regulatory Systems' (2003) 13 *Duke Journal of Comparative and International Law*, 207, 224.
[112] Jonathan B Wiener, *Precaution in a Multi-risk World* in Dennis D Paustenbach, (ed), *Human and Ecological Risk Assessment: Theory and Practice* (John Wiley & Sons 2002) 1513; See Nash, 'Law and Risk' (n 26) 507.
[113] For further discussion on this heartland area see Nash, 'Law and Risk' ibid (n 26) 507.
[114] Hector Sants, Chief Executive FSA (Speech at the Financial Conduct Authority Conference 28 June 2011).
[115] Aaron Wildavsky, *Searching for Safety* (New Brunswick, 1988) quoted in Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 95.

demonstrate its value. Many of these are relevant to the context of environmental law.[116] In sum, the focus of arguments relating to the application of the principle is on the question of degree. That is, whether to go for a strict or softer application—the latter would permit utilizing the principle in instances of doubt.[117]

Another challenging area in the regulation of risk and uncertainty is whether regulation should be geared towards blame. In this regard it has been suggested for instance that an institutional set-up in which blame is absent might foster transparency and learning about the challenges of dealing with risky activities. It is suggested that an approach focused on placing blame on individuals or organizations could have negative effects such as encouraging risk averse behaviour and gaming or system manipulation.[118] Additionally, this aspect of blame also drives political and bureaucratic considerations regarding the best approach to adopt. Risk aversion may result in favouring resilience based strategies over anticipatory ones out of a fear of regret.[119]

The potential of a blame focused approach to result in adverse effects is an important factor for regulators to reflect on. This is the case, for instance, in the applications of mechanisms like naming and shaming. They may for example decide to minimise the use of a blame-emphasising approach, limiting it to extreme cases or repeat offences. This may be particularly beneficial in situations such as following the launch of new market innovations whose risks are not yet fully understood. It is quite possible that things may go wrong, even where risk management plans have been put in place. Where firms understand that the regulatory stance emphasises a blame free position, and provided the firm's actions were in good faith, then they are more likely to be open and even approach the regulators with a view to finding solutions to address the problems that have arisen. This is not to say that regulators should

[116] Nash, 'Standing and the Precautionary Principle' (n 72).
[117] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 95.
[118] Baldwin, Cave and Lodge ibid (n 1) 97; Richard A. Posner, *Economic Analysis of Law* (Boston, 1986), 147–51; Brent Fisse and John Braithwaite, 'Accountability and the Control of Corporate Crime' in Mark Findlay and Russel Hogg (eds), *Understanding Crime and Criminal Justice* (Sydney, 1988); Eugene Bardach and Robert Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (Philadelphia, 1982).
[119] Hutter, 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' (n 30) 14.

not hold culpable individuals/firms accountable. Rather they need to know when to select blame as an option—it should not be the default. [120]

The views of regulators with regard to the challenges presented in the regulation of risk and uncertainty —some of which have been highlighted above—will inform the approach taken by regulators concerning whether to adopt an anticipatory or a resilience-focused approach. [121]

2.4 The 'New Governance': Capturing Risk and Uncertainty

Risk has emerged as an organising concept in private and public sector management. [122] It is suggested that the expansion of the risk industry indicates pressure for change in organisational approaches to the management of uncertainty. [123] Michael Power also asserts that when uncertainty is organised it becomes 'risk' to be managed, but he cautions that this is not a claim that all risks are 'manageable'.[124]

The key to understanding risk management in modern society is said to lie in an interrogation of organisations and how they respond to and manage risks. [125] Power argues that risks and uncertainties "must of necessity be organized, ordered, rendered thinkable, and made amenable to processes and practice of intervention." Moreover, "risk analysis is itself part of this organizational construction of risk from uncertainty."

A consideration of how organisations manage risk and uncertainty requires an examination of internal control. Private firms typically have staff in risk management, compliance departments and elsewhere who are tasked with organisation wide responsibility for risk identification, assessment and

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[120] The use of shaming is discussed further in chapter 5.
[121] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 98.
[122] Michael Power, *The Risk Management of Everything: Rethinking the Politics of Uncertainty* (Demos London, 2004) 13.
[123] ibid 12.
[124] Power, *Organized Uncertainty* (n 92) 5- 6.
[125] Bridget Hutter and Michael Power, 'Organizational Encounters with Risk: An Introduction,' in Hutter and Power (eds), *Organizational Encounters with Risk* (Cambridge University Press 2005), ch.1.

management.[126] In response to risk incidences, organisations develop formal risk tools that they can use to avert the recurrence of prior risk incidences and to enable the identification and management of novel risks.[127] In addition to the above, it is suggested that risk governance in organisations serves another objective. Instead of focusing only on harm prevention, governance of this kind also leverages opportunity, this entails risk management for gain.[128] Whereas the normal construction of risk in private sector risk management is linked to the risk to profitability, in the public sector, risk is defined in terms of the risk of failure of government departments to meet their objectives or deliver public services. However, in both areas the main elements that comprise the risk management strategies that have been adopted are similar, namely, risks identification, management and evaluation.[129]

The rise of internal control and organisational risk management is traceable to a recognition of the limits of the Command and Control (CAC) model. Regulating via CAC has proved challenging because it envisions more direct regulation. This is made difficult by pressures on regulatory resources, including budget limits and a shortage of staff with the necessary expertise.[130] Consequently there has been a need for and rise of regulatory strategies that work with and harness the resources of firms. Originally driven by feasibility, such strategies have been embedded into regulatory design.[131] With this change of approach, emerges the characterisation of the regulatory state as a risk management state. Such a state is reliant on organisational internal control systems that proceduralise risk.[132] The rise of de-centred regulation, for example, is an indicator of this move. This notion of de-centering or delegating regulation, leads to the recommendation that agents in the firm be relied on to ensure that the firm is complying.[133] This proposal aligns with

[126] Hutter, '*Anticipating Risks and Organising Regulation* (n 13).
[127] ibid.
[128] Power, *Organized Uncertainty* (n 92) 22.
[129] Julia Black, 'The Emergence of Risk-Based Regulation and the New Public Risk Management in the United Kingdom' *(*2005) *Public law* 513.
[130] Power, *Organized Uncertainty* (n 92) 36.
[131] ibid.
[132] Power, *The Risk Management of Everything'* (n 122) 23.
[133]Julia Black, 'Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation' [2003] Public Law 62-90.

‘smart regulation’ theory, which asserts that regulation can also be undertaken by other bodies for example corporations, self-regulators, professional or trade bodies and voluntary organisations.[134] Another approach that falls into this category is that proffered by Ayres and Braithwaite, who propose the concept of enforced self-regulation, in which cooperation between regulator and regulated is a key feature.[135] This approach, it is argued, fosters significant self-regulation and ‘natural’ compliance by the organization.[136] It encourages compliance, as the regulatory process is not hinged on regulating detailed processes, but rather on the achievement of desired outcomes.[137] These approaches, including ‘soft law’, are underpinned by the idea that other market actors may and should be involved in norm creation and enforcement.[138]

The rise of, and emphasis on internal control reveals a shift from risk analysis to risk governance. Internal control focuses on systems of organisational control, senior management responsibility and ‘naturally’ enforced cultures of compliance.[139] In short, internal control has been reframed as risk management. Power refers to this as the turning of organisations ‘inside out’, with the consequence that their risk-based internal control systems are transformed from private to public and serve as a resource and model for regulation.[140]

Internal control does not work on the basis of direct surveillance. Instead, there is observation of the organisation’s self-regulation.[141] Thus, internal control makes the inner workings of organisations observable.[142] This approach has

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[134] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 3; See also, Cristie Ford, 'Financial Innovation and Flexible Regulation: Destabilizing The Regulatory State' (2013) 18 North Carolina Banking Institute 27, 29 for a discussion of the related concept of flexible regulation which proposes the incorporation of non-state actors in regulation. It tailors regulation to the regulatees, collaborating with them where possible, and providing them with the latitude to comply with regulatory goals as they see fit, but conversely it intensifies oversight on non-cooperative actors; Neil Gunningham and Peter Grabosky, *Smart Regulation* (Oxford University Press 1998).
[135] Ian Ayres, and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press 1992).
[136] Power, *Organized Uncertainty* (n 92) 37.
[137] ibid
[138] ibid.
[139] ibid 42.
[140] Power, ibid (n 92) ch.2; Power, *The Risk Management of Everything’* (n 122).
[141] Power, ibid (n 92) 40.
[142] Ibid.

been labelled 'meta-regulation' and has also been described as the regulation of self-regulation.[143]

In sum, the rise of risk management and the expansion of its application in both the private and public sector has, according to Power, resulted in 'organizations of all kinds being organized, legalized and made auditable'.[144] Further, this model has been transposed beyond private firms to include states that have similarly embraced risk based approaches to regulation.[145]

As a consequence of adopting this approach uncertainty has been minimised. This is considered an advancement when looked at from the Knightian perspective. Per Knight's analysis, entrepreneurship was characterised as a source of uncertainty, with the entrepreneur being identified as the bearer of that uncertainty. Moving on from this, Power asserts that the shift to risk management/governance has implications for the conventional distinction between risk and uncertainty is attributed to Knight. He argues that the Knightian distinction must be considered, not as inconstant, but mutable. Importantly, it should be considered that incalculable uncertainties can be 'tamed' as calculable risks.[146] Thus, post-Knight, we appreciate that levels of uncertainty continue to diminish and models like internal control and risk-based approaches have contributed to this process.

2.4.1 The Risk-Based Approach to Regulation

Risk regulation is distinguishable from the risk-based approach to regulation.[147] The risk-based approach to regulation (RBA) is but one of the strategies that can be applied to risk regulation.[148] It has gained popularity in many jurisdictions and has been adapted to the regulation of many sectors besides finance. RBA is considered a new governance structure for regulators,

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[143] Christine Parker, *The Open Corporation: Effective Self- Regulation and Democracy* (Cambridge University Press 2002), chapter 9.
[144] Power, *Organized Uncertainty* (n 92) 30.
[145] Ibid chapter 3.
[146] Power, *The Risk Management of Everything* (n 122) 53.
[147] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 83.
[148] Others include: principles based approach, meta-regulation and judgement based regulation. These are categorised under the new governance umbrella.

supplying a framework and a list of elements to inform the way that decisions are made and assigned according to how they have been prioritised.

Power asserts that risk-based regulation demands a new 'politics of uncertainty' comprising who should be responsible for handling its consequences. He further suggests that, underlying this politics, there is a recognition that failures are possible in complex environments and that no one is to blame for true uncertainty.[149]

The UK offers important lessons on the application of RBA, and we will consider several examples as the discussion develops. Before examining these, however, we will discuss the genesis of RBA. The origins of the application of RBA in UK financial regulation and supervision can be traced back to the FSA, which was formed in 1997 and received full statutory powers in 2001. The FSA adopted this approach early in its tenure, as is demonstrated by early documentation, which shows a commitment to RBA. It was considered a way to bring together differing supervisory approaches that were in use by the multiple sectoral divisions that composed the FSA at the outset. It took the regulator four years to develop their RBA approach to the supervision of financial services firms and the result was the ARROW – Advanced Risk-Responsive Operating Framework. [150]

2.4.1.1 Elements of Risk-based Regulation

The main elements of RBA will now be considered. Firstly, regulatory objectives are identified along with the risks that regulatees pose to their achievement. This is followed by risk assessment and scoring. Different jurisdictions and regimes employ different approaches to risk scoring, with jurisdictions often showing a preference for either qualitative or quantitative approaches. The scores used distribute firms or their activities into wide-

[149] Power, *The Risk Management of Everything* (n 122).
[150] Julia Black, 'The Development of the Risk-Based Regulation in Financial Services: Canada, the UK and Australia- a Research Report (London: ESRC Centre for the Analysis of Risk Regulation, LSE 2004) https://www.researchgate.net/profile/Julia_Black/publication/268395436_The_Development_of_Risk_Based_Regulation_in_Financial_Services_Canada_the_UK_and_Australia_A_Research_Report/links/54d5c60b0cf2464758083251/The-Development-of-Risk-Based-Regulation-in-Financial-Services-Canada-the-UK-and-Australia-A-Research-Report.pdf> accessed 17 October 2019.

ranging categories. For instance, so called traffic light regimes often employ a high, medium or low ranking of risks or alternatively use a more granular ranking with even more categories. The scoring often relies on qualitative elements, such as in-field (off-site) assessments by regulatory personnel, that assess aspects like a firm's management, capacity and dedication to managing risks. RBA emphasizes costs and benefits of regulation, requiring regulators to rationalize their decisions to supervise firm activity in the manner that they have proposed.

The next element entails the allocation of regulatory resources on the basis of risk score or evaluation to inform regulator prioritisation of firms. This typically results in high risks being given more attention. However, increasingly regulators are basing their choice of intervention tool on the risk score. For instance, risk scores are used to inform the selection of tools, such as with regards to whether to opt for education, persuasion or sanctions to modify behaviour of regulatees.[151]

RBA also requires that regulators make decisions regarding the risks they will not prioritise. Consequently, their decisions, and particularly their risk tolerance is often subjected to intense public scrutiny, which may sometimes leave them vulnerable to political challenges. Moreover, they may be faulted harshly when harm ensues that is attached to a risk or a regulatee that they had not prioritised. So, as experience suggests, political considerations are inherent in the regulator's application of RBA.[152] RBA is seen as facilitating regulatory accountability by ensuring that, should the regulator's decision be subjected to legal and political interrogation, they can clearly explain why they have taken certain decisions.

[151] For discussion on these elements see Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 281-283. See). Julia Black, 'Risk-based Regulation: Choices, Practices and Lessons Being Learnt' in *Risk and Regulatory Policy: Improving the Governance of Risk* (OECD Publishing, 2010). Discussing the changing approach linking risk score directly to intervention decision.
[152] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 283.

2.4.1.2 Limits and Challenges of RBA

The challenges of applying risk based regulation that emerge from the literature can be grouped into three categories. First are those that relate to the identification and evaluation of risks. Second are those that relate to implementation. Third are challenges in respect of managing change.[153] These will be considered below. This categorisation should not be construed very strictly as some of the limits and challenges are cross cutting, traversing more than one category.

2.4.1.2.1 Risk Identification and Evaluation

Power challenges the notion that risk analysis is a purely scientific machine-like process. In making this argument he relies on discourse from decision science and considers how individuals *actually* act in situations of uncertainty when making decisions about risk. Far from acting as rational actors, individuals are influenced by various factors that shape their risk decisions: complex inter and intra-organisational relationships, organisational and institutional self-interest, and personal experience and heuristics.[154]

Regulators under risk based regimes face the initial task of evaluating their objectives against the risks that regulatees pose to their achievement. These are the risks they will be striving to control. This process can be complicated, especially with regards to the judgements that inform the risk definition and bundling process. This process can sometimes result in inattentiveness to systemic and cumulative risks, which, it has been suggested, was the case with the GFC. The crisis is said to have highlighted the failure by risk-based regulators to address the systemic risks linked to the sale of complex securitized products prior to the crisis.[155]

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[153] This categorisation, which I consider a useful shorthand, is drawn from Baldwin, Cave and Lodge, *Understanding Regulation* (n 1). For discussion of these challenges see 283-292.
[154] Power, *Organized Uncertainty* (n 92) 14.
[155] See Gillian Tett, *Fools Gold*: *How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed Catastrophe*(Hachette UK, 2009); US Government Accountability Office, *Financial Crisis: Recent Crisis Reaffirms the Need to Overhaul the US Regulatory System*, GAO-09–1049T (Washington, DC, 2009); Erik F Gerding, 'The Subprime Crisis and the Outsourcing of Financial Regulation to Financial Institution Risk Models: Code, Crash and Open Source' (2008), available at SSRN: http://ssrn.com/abstract=1273467 accessed 20 March 2019.

Regulator distraction may also cause regulators to occasionally fail to notice systemic problems because they are distracted by other priorities. In the UK for example, post-crisis analyses of Board minutes revealed that, in the run up to the RBS bailout, the Board was more focused on dealing with legacy issues from the previous regime and did not allocate enough attention to prudential regulation issues.[156]

Complexity of risk regulation can be another challenge, especially in the context of innovation. The use of RBA can create manufactured risks stemming from financial innovation. Considering risk identification and management from a firm's standpoint, it is suggested that they may misconstrue the extent of their control which can generate misplaced optimism and trust in their abilities to manage risks. This, coupled with distraction brought on by the balancing of different objectives, can lead to the accumulation of risk. With regard to innovation, Lord Turner commented after the crisis that people were in love with the risks of financial innovation and therefore did not realise that the risks had been building up.[157]

Another limitation concerns the externalities that can stem from the identification and management of one category of risk. This can result in the redistribution of risk to persons lacking the capacity to comprehend how various parts of the original risk coalesce, in order to permit identification of the real risk.

The focus on high impact risks may present another problem. It could lead to low risk firms being disregarded, and this may in turn lead to such firms generating higher risks which, in the absence of review mechanisms that could help regulators to become aware of such developments, may remain unnoticed.[158]

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[156] FSA, *The Failure of the Royal Bank of Scotland: Financial Services Authority Board Report* (2011), 266.
[157] A Turner, *The Financial Crisis and the Future of Financial Regulation The* Economist Inaugural City Lecture (London, 21 January, 2009).
[158] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 284.

The assumption that proposes regulatory prioritization of higher risks on efficiency grounds can also pose difficulties. It has been pointed out that "the cost of influencing regulatees may vary according, *inter alia* to the regulatees' dispositions, cultures and capacities." [159] This will therefore result in different amounts—in terms of resources—being expended to influence different regulatees. Efficiency considerations would dictate that regulators focus on sites or activities in which expenditure is less, or where an amount of resources allocated will have the greatest impact in terms of risk reduction. However, where applying the efficiency rationale leads to a conclusion that they should focus on a regulatee that is lower risk, this might create difficulties as it challenges the rationale that underpins risk-based regulation, which calls for focusing on activities or tasks of regulatees who pose the greatest risk to regulatory objectives. It has been proposed that under such circumstances regulators, in allocating risk scores, should be guided by the disposition of the regulatees, particularly their amenability to behaviour modification. However this presents another problem in which firms that are more cooperative are evaluated as lower risk, potentially leading regulatory focus away from areas where they have the potential to make the greatest impact. The RBA does not resolve this conundrum. However, this amenability approach has been adopted in some jurisdictions, for instance in Portugal.[160]

We further argue that the fact that a firm is amenable today is no guarantee that this will always be the case, and the risk-based approach may have difficulty providing mechanisms for dealing with changing dispositions over time. An instructive approach for addressing this issue is that proposed by Baldwin, who has developed a conceptual framework mapping nudge techniques (different degrees of nudge, categorised into three types) onto different dispositions of regulatees and argues for targeting nudges on this basis. [161] This approach emphasizes the general point that, when contemplating how to target interventions, or when making judgements about

[159] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 284.
[160] The environmental regulator (IGOAT) in risk scoring process takes amenability into account. See Julia Black, 'Risk-based Regulation: Choices, Practices and Lessons Being Learnt' in *Risk and Regulatory Policy: Improving the Governance of Risk* (OECD Publishing, 2010) 185.
[161] Robert Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (2014) 77 *Modern Law Review* 831.

how to identify and evaluate risks, it is important to consider the amenability of regulatees. The regulatory nudging approach, considered in chapter 5 could thus be valuable for addressing this specific weakness in RBA

The application of RBA can also pose problems, particularly if inadequate attention is paid to low risks. In this regard, Julia Black cautions that, in designing or operating regulatory regimes, low risks may not be given enough attention because, "either cumulative impact is unknown, or at least not recognised in that particular regulatory regime."[162]

Another problem area for regulators concerns how to take into account the quality and character of management and existing risk controls. This has been found to be a huge determinant of the level of risk that a firm poses. A firm's risk score is typically lowered where the regulator trusts its management's ability to control risks. The difficulty arises because of the need to take future risks into account. It is suggested that it would be unwise to place great weight on a backward looking review of management's past compliance performance as a predictor of management future risk control capacity. Such an approach would be considered unresponsive and incapable of addressing risks in a fast changing environment.[163]

The costs attached to allocating resources to making these managerial assessments is also a concern.[164] Another difficulty arises when regulators try to ensure the same approach is adopted by all evaluators. In so doing, they often have to balance between maintaining discretion and ensuring a similar approach is adopted by other evaluators, which is no easy task.[165]

2.4.1.3 Implementation Challenges

One of the main challenges of implementation RBA is deciding the extent to which the risk scores (evaluations) will inform regulatory actions. In this regard,

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[162] Julia Black, 'Learning From Regulatory Disasters', LSE Law Society and Economy Working Papers 24/2014, 10 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2519934> accessed 20 November 2018.
[163] Julia Black and Robert Baldwin, 'Really Responsive Risk-based Regulation' (2008) 71 *Modern Law Review* 59.
[164] Time and staff will need to be allocated, which can be costly.
[165] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 285.

risk scoring may be useful, for instance, for identifying the risk, but much less so for helping determine what the best tool or strategy for addressing it may be (that is, should the regulator employ incentives, nudges, command and control, or other intervention). The challenge is that there might be a tangential link between the risk type and intervention tool. This presents difficulties as the link is not always direct and therefore the challenges relating to determining the best strategy will remain. It is suggested that the best course for determining the most appropriate way to intervene may be to look beyond the risk assessment system and instead to reflect on how firms react to different stimuli. This will require drawing on other theories, such as compliance and deterrence, responsive regulation, and really responsive regulation.

Another challenge that regulators face in the course of implementation involves executing the risk-based approach within the relevant organisation. The process of undertaking management quality and character assessments with a view to transposing this to determine ability to control risk is also of relevance when considering this aspect of implementation challenges. Additionally, ensuring discretion and uniformity of application across a wide range of evaluators when trying to assess management quality is often difficult. Regulators also have to bear in mind factors such as resource allocation and impact on cost, and how to maintain responsiveness and dynamism. Additionally, they need to take into account the fact that assigning regulatory resources based on risk category could lead to simplistic results that camouflage intrinsic risks.[166]

Another challenge for many regulators relates to the need to change their focus. It has been noted that many risk-based regimes emphasise compliance and therefore foster tick-box processes. To address this, regulators are urged instead to work on actual risk assessment.[167] If this shift is not encouraged,

[166] Julia Black, 'Paradoxes and Failures: 'New Governance' Techniques and the Financial Crisis' (2012) 75(6) *Modern Law Review* 1054-1055.
[167] Black, 'The Emergence of Risk-based Regulation' (n 129) 512, 539.

then regulators might keep using conventional methods for evaluating risks, which might not adequately capture areas of risk and uncertainty.

The wider political and institutional settings in which regulators operate may also present problems. This is an area of concern as it is central to the performance of risk-based systems, and regulators sometimes experience difficulties managing it.[168] The failures of the UK's financial services in the lead up to the crisis demonstrate the potential problems that could arise in this regard. The light touch philosophy adopted then is said to have informed regulatory interactions and understandings about the suitability of regulatory demands.[169] It also influenced the extent to which domestic regulators trusted the controls put in place by national regulators to manage the risks presented by markets that interconnected on a global scale. Finally, it informed the extent to which regulators viewed themselves as shackled by regulatory competition within the international institutional environment. One of the acknowledged causes of the GFC was the failure of national and supranational regulators in various jurisdictions to coordinate due to this sense of competitiveness. This is thought to have hindered the formulation of a more concerted response to the excessive risk taking within specific firms and to the challenges of global system-wide risks. [170]

Power sharing among different regulators/agencies/bodies is another area that presents problems insofar as institutional and organizational challenges are concerned. This is expressed for instance in decentred regulation. [171] Another challenge is that different regulators or agencies may apply risk-based regulation in different ways. For example, even when they are responsible for

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[168] Black and Baldwin, 'Really Responsive Risk-based Regulation' (n 163)181.

[169] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 287—authors highlight testimony from a UK Treasury Select Committee hearing (of 26 Feb 2009) where the FSA Chairman (Lord Turner) and BOE Governor (Mervyn King) are reported to have stressed that they would have faced substantial opposition from politicians and the market had they demanded that banks halt their activities.

[170] Baldwin, Cave and Lodge ibid. See also HM Treasury, *Reforming Financial Markets* (London, 2009) para. 3.1.

[171] Julia Black, 'Decentring Regulation: The Role of Regulation and Self-Regulation in a "Post-Regulatory World"' (2001) *Current Legal Problems* 103–46; Eugene Bardach, 'Getting Agencies to Work Together' (Brookings Institution Press, 1998)—Author explores coordination problems and how networks can enhance collaboration; Walter JM Kickert, Erik-H Klijn, and Joop FM Koppenjan (eds.), *Managing Complex Networks* (Sage 1997)—authors identify policy networks as a principal characteristic in modern societies and discuss strategies for network management.

the same sector as in the case of finance, where regulatory oversight is sometimes split, between Treasury and the Central Bank.[172] For example, it is said that in the lead up to the GFC, the manner in which power was allocated between the Treasury, Bank of England and the FSA weakened the effectiveness of the regulatory system. It is suggested that it may be especially challenging for regulators to comply with the logics of risk-based system when they encounter variances between the regulators whose powers coalesce in respect of important areas like: "aims, objectives, and institutional environments; variations in regulatory cultures; differences in capacities, skills, and resources; and varying capacities to modify their operations."[173] This challenge is also present in the Kenyan context, in which mobile financial services operate in a converged space that makes navigating power sharing with other bodies a necessity.

Another implementation challenge concerns the execution of RBA in a manner that does not lead to different regulatory strategies undermining one another. Regulators might have to consider, for example, whether employing a deterrence-based enforcement strategy will have a negative impact on regulatory activities that are fundamental to the operation of risk based systems, such as detection and information gathering. A negative impact would in turn make the work of risk-based regulators much harder. However, sometimes they may be constrained when it comes to options, and in order to modify firm behaviour may be forced to employ formal enforcement actions, like fines. This choice might affect their ability to identify instances of non-compliance, as firms are much less likely to be forthcoming with information. This is due to fear that any information furnished to the regulator could be used against them and, consequently, might make them less amenable to cooperating.[174]

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[172] In some jurisdictions, e.g., Kenya, there is a greater plurality of regulators with oversight over different areas of the financial sector.

[173] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 287; Julia Black, 'Managing the Financial Crisis: The Constitutional Dimension' (2010). *LSE Law Society and Economy Working Papers* 12/2010.

[174] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 288.

It is important to think about the interaction between the different strategies and tools, even in the context of applying the regulatory nudging approach that is proposed in this thesis. As explained in chapter 5, nudges are non-coercive tools that are considered to work best in an environment of trust and cooperation. A deterrence-based or blame-oriented approach may make it difficult to apply regulatory nudging, as it might not help create a positive environment that supports the application of nudge tools.

We also suggest that the risk of moral hazard can arise in the implementation of RBA. In implementing the approach regulators make estimates about risks posed by firms and this informs how they organise their supervisory activity. However, as decision-making is largely internal to firms, only they truly understand what the risks are and what their true risk level is. This may result in mis-assignment of risk category, which may generate moral hazard. For example, a firm assigned a low risk category may not be subjected to a higher level of regulatory scrutiny and this may create incentives for misconduct.

2.4.1.4 Managing Change

Adjusting to different changes can prove challenging for RBA. One area is that of formulating a risk evaluation and management framework. There is a concern that, once formulated, regulators keep using the framework repeatedly, that it becomes an institutionalized process, and that it is not subjected to ongoing critique or review to unearth deficiencies. Additionally, regulators may also become inattentive to new developments that give rise to new risks and, in turn, the effect this could have on risk profiles.

Risk-based regimes have been shown historically to have problems providing for ways to manage future risks or situations of uncertainty. To address this, one proposal has been that random inspections should be occasionally incorporated into regulation for purposes of determining soundness of the risk-based system.[175] Another suggestion for managing uncertainty is to view risk

[175] Baldwin, Cave and Lodge, ibid; Statutory Code of Practice for Regulators 2007, para. 6.2 —for proposal on random inspections. It is argued that they would do a better job of detecting new risks and risk creators than an approach that relies on assessing risks that were previously identified.

regulation as part of resilience regulation. Resolution planning is an example of a technique whose objective is to reduce risk and prepare financial firms for difficult times.[176]

Relatedly, one of the difficulties of RBA concerns how to integrate the behaviour, attitudes and culture within firms into risk assessments. The challenge for regulators is that, rather than aiming to capture the state of the firm at the specific time of the inspection or supervision, they endeavour to "assess the risks of the firm on a dynamic, ongoing, and future basis." They would then essentially be dealing with a moving target and this reality can complicate their efforts. This challenge was recognised in the post-GFC years. According to Hector Sants (the former FSA chief) one of the lessons to be drawn from the GFC is the need to be proactive in addressing risk, and this in his view calls for judgement.[177] The adoption of JBR in the UK in the post years was informed by the recognition of the importance of judgement. This approach will be considered in a later section of this chapter.

The unique challenge of making modifications to the regulatory strategy from within the risk-based system should also be noted. This can prove challenging because it requires a shift in mental gears—from a strategy that focuses on being reactive to one which is more anticipatory or pre-emptive—and aims to design-out risks from economic or social processes. This kind of change would require extensive analysis, which is something the risk based regime does not generally foster on account of what has been termed 'process-myopia'. This is where regulators may benefit from the application of the 'really responsive approach' as it encourages the adoption of strategies that are more than just purely responsive.[178]

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[176] Georgosouli, 'Judgement-Led Regulation: Reflections on Data and Discretion' (n16) 214.
[177] Hector Sants (2012) Update on the Regulatory Reform Programmes and European Issues. Speech at the Cityweek Conference, 7 February, quoted in CPA Audit LLP, February 2012 <http://www.cpaaudit.co.uk/uploads/news/id184/Hector%20Sants%20speech%20on%20regulatory%20reform%20Feb%202012.pdf > accessed 12 August 2019.
[178] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 291.

2.4.2 Meta-regulation

RBA is regarded as an approach that emphasizes the robustness of internal controls within regulation firms. It requires extensive delegation of control functions to the level of risk management of firms being regulated. This approach, which focuses attention on firm level risk control, has been referred to as meta-regulation.

Meta-regulation was operationalised with the rise of internal control, which was accompanied by the adoption of standardized and formalized risk management approaches. Meta-regulation has been referred to as 'management-based' regulation, 'enforced self- regulation', or the regulation of firms' own self-regulation. Under this strategy, regulators require regulatees to formulate their own systems for compliance and then to evidence how they are complying.[179] This is seen as helping to address the challenges of imperfect information that regulators often face, as it results in the enrolment of third parties to drive the self-regulation process.[180] The emphasis on self-regulation is considered to be a central element of risk-based regulation.[181]

Meta-regulation intersects with risk-based regulation that requires reliance to be placed on senior management to have in place suitable control systems and processes to comply with principles, and to address the risks that the regulatees face. The reliance of regulators on firms' internal systems for ensuring compliance is not new. The difference is that meta-regulation is said to raise this requirement to a conscious regulatory strategy.[182] Meta-regulation hinges on four elements: (a) firms having a suitable culture that fosters compliance systems that are established; (b) having the right incentives to pursue public objectives, in addition to private profits; (c) regulators having the

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[179] Black, 'New Governance' Techniques and the Financial Crisis (n 166) 1045; Christine Parker, *The Open Corporation: Self- Regulation and Democracy* (Cambridge University Press, 2002), meta-regulation is the term used by Christine Parker, to describe her 'triple loop learning' approach to corporate governance and corporate social responsibility; Cary Coglianese and David Lazer, 'Management- Based Regulation: Prescribing Private Management to Achieve Public Goals'(2003) 37 *Law and Society Review* 691.

[180] FC. Simon Meta-Regulation in Practice: Beyond Normative Views of Morality and Rationality (Routledge, 2017). See for a critique of meta-regulation theory.

[181] Power, *Organized Uncertainty* (n 92) 38.

[182] Black, 'New Governance' Techniques and the Financial Crisis' (n 166).

right skills and industry experience to assess firm performance; and (d) possessing enough courage and political backing to challenge firms.[183] The success of RBA is thus reliant on meta-regulation as the effective operation of the regulatory regime is dependent on the robustness of a firm's internal control systems.

Meta-regulation is considered to have several advantages. It is seen as providing regulatees with greater flexibility by permitting them to design systems and processes which are more fitting for ensuring intra-firm compliance, as opposed to applying universal, prescriptive rules. Moreover, it places the burden and responsibility on regulatees to show how they are complying, rather than on regulators to demonstrate non-compliance.[184] Further self-regulation, which falls under the umbrella of compliance strategies, is commended as promoting organisational learning and responsibility.[185]

Meta-regulation poses difficulties for regulators when it comes to assessing performance. They have to grapple with how to properly assess the controls that have been delegated to regulatees who may have applied different risk evaluation models, and may traverse different firm types and cultures. Additionally, the evaluations of firms and regulators with regards to what constitutes risk may be misaligned.[186] Another major weakness of meta-regulation is that firms' systems and processes are devised with their own goals in mind and may not necessarily align with those of regulators. In general, organisations have also been found to have limited supervisory capacity to identify first instances of non-compliance and their actions are also often mistimed.[187]

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[183] Black, 'New Governance' Techniques and the Financial Crisis' (n 166) 1046.
[184] Parker, *The Open Corporation,* (n 179); Coglianese andLazer, 'Management-Based Regulation' (n 179); John Braithwaite, *Regulatory Capitalism: How it Works, Ideas for Making it Work Better* Edward Elgar, 2008); Cary Coglianese and Evan Mendelson, 'Meta-Regulation and Self-Regulation' in Robert Baldwin, Martin Cave and Martin Lodge (eds), *The Oxford Handbook of Regulation* (Oxford University Press, 2010).
[185] Power, *Organized Uncertainty* (n 92) 38.
[186] Firms may be driven by the profit motive, but regulators will be thinking about risks to their objectives, such as ensuring financial stability or consumer protection.
[187] Power, *Organized Uncertainty* (n 92) 40.

The inevitability of meta-regulation is one that is asserted by scholars of regulation. It is argued that this is necessitated by pressure on regulatory resources.[188] The dependence on internal management and control by regulatees is argued to be an unavoidable part of regulation, as regulators cannot be omnipresent. It is further asserted that this reliance is not created by meta-regulation, but rather that it 'recognises and converts it from an inevitable fact of regulatory life into a conscious regulatory strategy'.[189] However, this weakness of meta-regulation is, paradoxically, also considered to be its potential source of strength.[190]

2.4.3 New Governance and Some Lessons from the GFC

The failures of new governance techniques have been considered in the context of the GFC.[191] Although the analysis considered here is drawn from the UK's experience, useful lessons can be drawn from these failures especially in view of the fact that several jurisdictions across the world have adopted many of these techniques to varying extents.[192]

The complexities and challenges of implementing RBA are exemplified in the post crisis review of Northern Rock.[193] The FSA, in their lessons learned review, concluded that "the extent of the market disruption in the crisis period—to wholesale funding markets, including securitisation markets—was generally not foreseen by commentators. It was the crystallisation of low probability, high impact risk."[194] The FSA audit report prepared after the crisis

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[188] See for instance, Black, 'The Emergence of Risk-based Regulation' (n 129) 512, 544.
[189] Black, 'New Governance' Techniques and the Financial Crisis' (n 166)1047-1048.
[190] ibid.
[191] ibid 1037-1063.
[192] See Julia Black, 'The Development of Risk Based Regulation in Financial Services: Just "Modelling Through"?' in Julia Black, Martin Lodge and Mark Thatcher (eds), *Regulatory Innovation: A Comparative Analysis* (Edward Elgar, 2005); Julia Black, 'Risk Based Regulation: Choices, Practices and Lessons Learnt' in *Risk and Regulatory Policy: Improving the Governance of Risk* (OECD 2010); Black and Baldwin, 'Really Responsive Risk Based Regulation' (n 163) 181.
[193] Northern Rock's main failure was attributed to over-dependence on wholesale funding and securitisation of pools of mortgages to sell on to investors. As demonstrated by the financial crisis, both markets are considered to be vulnerable to dips in investor confidence. When NR was faced with a liquidity problem, it did not have enough medium term funds to finance its business, because as is typical with most banks, it relied on wholesale funds as opposed to retail deposits. Additionally, it was pursuing expansion at an aggressive rate, a fact that was not captured either in its risk assessment or that of the FSA.
[194] FSA Internal Audit Division, *The Supervision of Northern Rock: A Lessons Learned* Review, *Report*, (London, 2008) 1.

ensued identified a number of weaknesses that contributed to the misapplication of the Advanced Risk-Responsive Operating Framework (ARROW risk framework) in use at the time including: that inadequate attention was paid to the firm's strategy and growth appetite and the impact of this on the achievement of regulatory objectives; the limited regulatory resources available to properly carry out its regulatory and supervisory role; the emphasis placed on different areas and risks (consumers and the insurance industry); poor record keeping (for instance of meeting minutes) and inadequate checks and balances over the supervision process. Various recommendations were made in the report and several reforms were subsequently implemented by the sector regulator including: improvements in the allocation of supervisory resources; increased focus on prudential supervision; increased engagement with high impact firms by regulator's senior management; and increased intensity of day to day supervision.[195]

The ability of firms to adequately manage their risks via their internal governance mechanisms was called into question in the years leading up to the GFC and thereafter. The lesson in this regard has been that the incentives of firms are often misaligned with those of regulators. It also emerged that regulators were not actually placing reliance on senior management but on the 'skilful representations of those systems and controls constructed by those responsible for managing relationships with the regulatory bodies'.[196] The fact that regulatees often seek to manage regulators, instead of themselves, has also been demonstrated in the case of the use of disaster-management manuals and stress tests. [197]

The limits and challenges of RBA can be summarised as follows. It attempts to simultaneously manage the clashing demands of risks, resources and reputation, while externally trying to maintain a different face.[198] Regulators

[195] See generally FSA, *The Supervision of Northern Rock* ibid. The FSA introduced the Supervisory Enhancement programme to deliver these changes.
[196] Black, 'New Governance' Techniques and the Financial Crisis' (n 166) 1047. In the words of Black, Management – Based Regulation was shown to be myth-based regulation.
[197] Black, ibid 1047-1048; Lee Clarke, *Mission Improbable: Using Fantasy Documents to Tame Disaster* (University of Chicago Press, 1999); Andrew Haldane, 'Why Banks Failed the Stress Test' (speech presented at Marcus-Evans Conference on Stress-Testing, London, 2009).
[198] Black, ibid1056.

cannot operate in the absence of political license, even if they possess formal legal powers. RBA frequently 'operates in a political context that requires regulators to live a contradiction'. In reality they may be grappling with finding the proper balance between allocation, selection and prioritisation, in an environment of unknown and unknowable risks. This reality therefore has to integrate an acceptance that regulatory failure is both foreseeable and acceptable. However, outwardly the regulator has to portray an image of 'control, rationality and equal protection for all, rooted in the modernist logic of governability'.[199]

Even with the limitations of RBA discussed above, its potential is still appreciated. Gray and Hamilton assert that RBA has the "potential to reshape the relationship between those who govern and those who are governed, to embed norms of behaviour, to attribute blame and to define and delimit responsibility."[200]

We have considered one way in which the adoption of RBA has changed the regulator/regulatee relationship. The increased dependence on meta-regulation—an approach that relies on corporations to have in place systems for the control and management of risk that achieve public policy objectives is a manifestation of this.[201] RBA seeks to encourage self-regulation of behaviour at a micro-level—extending its reach to the firm's core. A number of tools are employed to facilitate this in-depth reach and thereby assure regulators and courts of their determination to comply; these include: codes of practice, accreditation, and audit regimes.[202]

RBA has evolved, and there is now a recognition that the approach needs to pay attention to present as well as future risks. This has been termed a forward looking approach to banking supervision. For instance, The Basel Core Principles for Effective Banking Supervision requires the adoption of a

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[199] ibid

[200] Gray and Hamilton, *Implementing Financial Regulation* (n 9) 16.

[201] Meta-regulation, also called management based regulation, see for example Christine Parker, 'Reinventing Regulation within the Corporation: Compliance-oriented Regulatory Innovation (2000) 32 (5) Administration & Society 529

[202] Fiona Haines and David Gurney, 'The Shadows of the Law: Contemporary Approaches to Regulation and the Problem of Regulatory Conflict' (2003) 25(4) *Law and Policy* 368.

forward-looking approach that captures future risks.[203] However, we caution that even this attempt to look into the future, has its limitations, as there are risks that it may be not be possible to fully anticipate. The previous discussion on risks versus uncertainties, and the upcoming discussion in a later section on knowable uncertainties, explore this latter point.

Given RBA's recognised potential, the question remains how to resolve its inherent tensions. Breyer proposes that the chief solution for addressing the limitations presented by RBA involves the crafting of a "coherent-holistic risk programme and a set of rational priorities covering risk regulatory programmes."[204] Armed with an understanding of the limits and challenges, regulators will be better equipped to develop a more coherent RBA regime. Other proposals beyond resolving the tensions within RBA call for the use of resilience based strategies in light of the limited capacity of regulators to anticipate risk in its entirety.[205] The risks in this category could comprise manufactured risks.

2.5 Risk and Uncertainty, and Rule Design

Regulators rely on rules to shape their regulatory activity. To achieve policy objectives, such as consumer protection and financial stability, rules need to be appropriately designed.[206] However rule design is complex and rules have

[203] Basel Core Principles for Effective Banking Supervision, Principle 8 – Supervisory Approach: "An effective system of banking supervision requires the supervisor to develop and maintain a forward looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable"; The UK's PRA has adopted this forward-looking approach. The PRA has stated that firms will be assessed against both present and future risks. Further, the regulator has adopted an early intervention stance and encourages firms to raise matters that are of prudential concern as early as possible. See PRA, *The Prudential Regulation Authority's Approach to Banking Supervision*, (London 2016), 8.
[204] Stephen G Breyer, *Breaking the Vicious Circle: Toward Effective Risk Regulation* (Harvard University Press, 1993).
[205] Briault, 'Risk Society and Financial Risk' (n 57) 33.
[206] Georgeosouli, 'The Debate Over the Economic Rationale for Investor Protection Regulation' (n 77) 241.

limits. The issues raised by rules are relevant to risk and uncertainty discourse. This includes ways to address them.[207]

2.5.1 Problems Presented by Rules

Black identifies three main challenges with regard to the application of legal rules: over or under inclusiveness; indeterminacy; and interpretation.[208] These problems make it difficult to address questions of risk and uncertainty that arise in a regulatory context.

The first problem is that of inclusiveness. This is a consequence of the fact that rules are generalizations. Since they are generalizations, rules simplify complex events, objects or types of behaviour. In the process of this generalisation, there are things that are excluded or muted, and unimportant elements may also be captured. Consequently, over and under-inclusiveness is argued to be innate in rules.[209]

The inclusiveness of a rule is considered to be a function of the rule's purpose. Moreover, the designation of a rule as under or over-inclusive is attributed to the imperfect match between the rule and its purpose.[210] Inclusiveness can be construed as the determinant of the success or failure of a rule. Under-inclusion is considered problematic because it could be read as suggesting missed goals. On the other hand over-inclusion may be read as over-intrusion. Black explains the impact of under or over inclusive rules. Over-intrusion can present challenges in practice especially when used in combination with an enforcement strategy that stresses prosecution for rule contravention. She also notes that if a rule is over-inclusive in its formulation, and this is coupled with inflexible application at regulatee level, then this can generate economic inefficiencies, and specifically detrimental social effects as a consequence of the imposition of unreasonable regulatory requirements on regulatees. This could have manifold effects on regulatees including affecting their attitude to

[207]See generally Julia Black, *Rules and Regulators* (Clarendon Press 1997); Colin S Diver, 'The Optimal Precision of Administrative Rules' (1983) 93 (1) *Yale Law Journal*, 65.
[208] Black, ibid 6.
[209] ibid 7-9.
[210] ibid 8.

regulation, eroding their regulatory commitment, damaging cooperation, fostering perceptions of injustice and engendering resistance, both legal and political.[211] Under or over inclusive rules have also been condemned for being inefficient. Over inclusion has been argued to have the potential to lead to the suppression of behaviour that is socially desirable. Conversely, it has been suggested that under-inclusive rules promote socially desirable behaviour. To address the problems related to inclusiveness, it is recommended that the precision of the rule is enhanced.[212]

The second problem is that rules are innately indeterminate. This vagueness is partly attributed to the nature of language, and partly to the fact that their application is dependent on others. Here, vagueness is not generated by a lack of clear meaning of words, but by the process of applying the rule to specific scenarios. In some instances there will be no difficulty but in others—such as unforeseen situations—the application of the general words can be problematic. Consequently, even rules which may initially be considered as clear may be construed as vague when applied to a situation that was not foreseen at the time that the term was defined.[213] Hart refers to this indeterminacy as the 'open texture' of rules.[214] It stems from law's incapacity to predict all future events and odds, whether these are created by nature or arise from human innovation. Hart also described rules as comprising a 'core' meaning and a 'penumbra of uncertainty' or 'fringe of vagueness'.[215]

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[211] ibid 9.
[212] Isaac Ehrlich and Richard A Posner, 'An Economic Analysis of Legal Rulemaking' (1974) 3 *The Journal of Legal Studies*, 257; Jason S Johnston, 'Uncertainty, Chaos, and the Torts Process: An Economic Analysis of Legal Form' (1991) 76 *Cornell Law Review*, 341.
[213] Black, *Rules and Regulators* (n 207) 7-9 and 11.
[214] Herbert LA Hart, *The Concept of Law* (3rd edn, Clarendon Press 2012), 124-136.
[215] ibid 12.

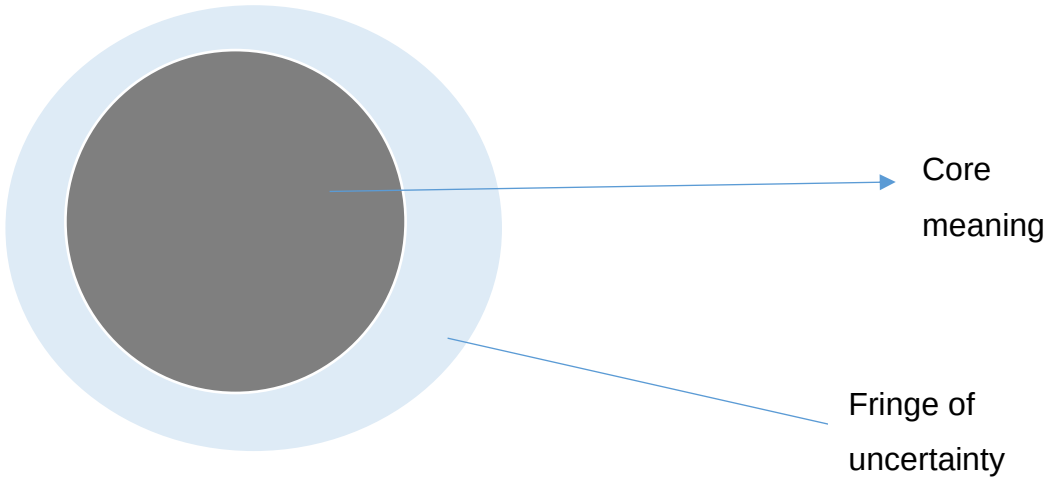

Figure 2.2 Nature of rules

A third problem is that of interpretation. Rules are dependent on others for application. In turn, application requires interpretation. It is asserted that rules need a sympathetic audience to enable their interpretation and application in a way that supports the purpose for which they have been formulated. This creates a relationship between the author and applier of the rule that is reliant on reciprocity.[216] With regard to the problem of interpretation, a literal interpretation might defeat the rule's purpose because of aspects that are muted or excluded by the generalization that is inherent in rules.[217] Creative rule compliance is often a manifestation of such literal interpretation.[218] Another difficulty with regards to interpretation is the use of evaluative or qualitative terms such as 'reasonable' or 'fair,' which are capable of being interpreted in various ways, as opposed to descriptive terms. Qualitative terms may even carry a particular meaning within a specific community.[219] This reveals that the interpretation of a rule with the aim of obtaining certainty about its meaning and application goes beyond the rule itself. It also depends on

[216] Black, *Rules and Regulators* (n 207) 12.
[217] ibid.
[218] Morgan Bronwen, and Karen Yeung, *An Introduction to law and regulation: Text and materials.* (Cambridge University Press 2007), 164-166; Doreen McBarnet, ' Questioning the Legitimacy of Compliance: A Case Study of the Banking Crisis' in Adam Crawford and Anthea Hucklesby (eds), *Legitimacy and Compliance in Criminal Justice* (Routledge 2013) 71.
[219] Black, *Rules and Regulators* (n 207) 12.

consensus within the interpretative community that reads it, which comprises regulators, regulatees and adjudicators and turns on the question of whether they will adopt a similar interpretation in their application of the rule.[220]

2.5.2 Risk and Uncertainty, and Rule Design

The problems discussed above can present challenges for rule design and in turn contribute to risk and uncertainty in regulation. Diver specifies the key challenge in the use of rules that emerges from the regulation literature as being that of rule imprecision, which he argues stems from administrative under precision or inordinate regulatory inflexibility.[221] Influenced by the economic perspective, he considers the use of rules as generating uncertainty and argues that this imposes social costs.

As rules are crafted to address risks, imprecise rules will be inadequate for risk regulation. Further, imprecise rules can create uncertainty about what constitutes compliance with a rule. Uncertainty often arises in the context of the operation of rules.[222] The wider context of regulation often gives rise to additional situations of uncertainty. Often things are ambiguous and the process of reaching consensus regarding the definition of problems and solutions assumes an in-depth exchange of ideas across various subjects, and negotiations of meaning. The process of risk regulation is an example of such a scenario. Other examples are situations in which regulators are charged with meeting clashing principles or objectives, or in which the environment in which they are operating is fast paced and characterised by intricate and changing definitions of problems and uncertainty regarding outcomes of regulatory action.[223]

To illustrate these challenges we will consider the problem of vagueness or indeterminacy and issues for contemplation in connection with the design of pre-emptive rules.

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[220] ibid.
[221] Diver, 'The Optimal Precision of Administrative Rules' (n 207).
[222] Black, *Rules and Regulators* (n 207); Diver, 'The Optimal Precision of Administrative Rules' (n 207).
[223] Julia Black, 'Regulatory Conversations' Journal of Law and Society (2002) 29 (1) 172.

There are several ways in which the vagueness of a rule can be observed. One way is where the manner in which an action is to be performed or the time or place is not stipulated. A rule can also be vague, or its meaning obscure, even where there is common acceptance of the meaning of a word it employs because there may be instances where it is unclear whether it applies to a particular object or arrangement.[224] Advancements in the financial services sector illustrate the difficulty that this can present. Consider for instance the area of shadow banking. Some of the complexities of regulating shadow banking activity emerge from vagueness about whether the legal definition of 'banking' applies to shadow activities. Relatedly, advancements in Fintech innovation, such as the rise of digital banks and digital/mobile financial products and services, continue to challenge many of the commonly accepted meanings of words or business arrangements in the financial sector.

The meaning of a word itself may also be vague because of the use of qualitative or evaluative terms such as 'reasonable', 'fair', or 'suitable'. The use of generic terms may also result in vagueness. Generic terms refer to a whole class of objects or events instead of employing specific terms which refer to particular components of that class. For instance the use of 'financial instruments' instead of 'securities' or for more precision, 'shares'.[225] This point bears reflection in this work as the language of rules used in the context of consumer protection, and market conduct rules more generally, often employ qualitative, generic terms, for instance rules advocating fair treatment of customers or provision of suitable products or advice.

Imprecision, in the form of vague rules, demands the application of discretion. It obliges regulatees to contemplate what conduct meets compliance with the rule, as this may be unclear on the face of it. This can be difficult for them and they may require guidance from the regulator to determine what constitutes compliance. Regulators on the other hand face their own challenges in drafting rules, including market conduct rules. The regulator's objective in this respect is to prescribe standards of quality, which may be difficult for them to determine

[224] Black, *Rules and Regulators* (n 207) 23.
[225] ibid.

in advance as some of these may be informed by specific situations or consumer tastes.[226] This suggests that, with vague rules, the meaning behind the rule is not static. Thus what constitutes compliance may change with the passage of time, especially with the benefit of additional knowledge and experiences drawn from the application of the rule in the market.

To address the problems related to rule design, Diver proposes a consideration of how to reduce the social costs associated with rule imprecision and thereby attain the 'optimal or socially efficient level of rule precision'.[227] As part of this exploration, Diver identifies three dimensions of rules that policymakers or drafters will want to care about because they are the determinants of optimal rule precision:[228]

i. *Transparency:* Firstly, he asserts that the success of a rule in accomplishing its purpose is determined by the words that the author employs to express his intentions. This calls for careful reflection on the effect that choice of words will have on the recipients. This requires the use of words that are properly defined and whose meanings are generally accepted in the target community.
ii. *Accessibility:* Secondly, he calls for a consideration of whether the rule is accessible to the targeted recipients. By this he means the question of whether it can be applied to tangible situations with relative ease.
iii. *Congruence:* Third is whether the substance of the rule has the intended outcome. That is, does it elicit behaviour modification? Is it congruent with the policy objective that underpins it?

Diver recognises that rule precision offers benefits, suggesting for example that it can minimise the number of disputes that arise and simplify their resolutions as the predictions of the disputing parties will converge.[229] In addition to making the above recommendations, he expresses suspicion about

[226] Georgeosouli, 'The Debate Over the Economic Rationale for Investor Protection Regulation' (n 77) 241.
[227] Diver, 'The Optimal Precision of Administrative Rules' (n 207).
[228] ibid.
[229] ibid 74.

attempts to make generalizations on rule precision. In his view, optimal precision differs from one rule to another, and is contingent on the interaction of a number of factors including the author, enforcer and target audience.[230] This suggests that even as regulators strive to achieve optimal rule precision in their rule design, they should bear in mind that there are other variables at play.

Black also offers suggestions about how to address the problems of using rules. She proposes a number of strategies that could be employed on a stand-alone basis or together with others to mitigate some of the problems. These include: using different rule types, adopting a conversational model of regulation, and formulating and using interpretative communities in regulation. However, she cautions that these strategies should not be seen as solutions to all the challenges that rules present. Rather they should be viewed as recommendations for the enhancement of the effectiveness of rule use in regulation. In particular they do not address what the rule should provide or indeed the regulatory approach that should be adopted.[231] These will be discussed later in the thesis (see chapters 4 and 5).

Considerations relating to rule design also arise when regulators are faced with decisions about whether they ought to draft a pre-emptive rule to address specific activity and the specific type of rule that should be used, that is, whether it should be under or over-inclusive.[232] In this respect, Shrader-Frechett makes arguments that take a consumer protection angle and favour the drafting of pre-emptive rules. She contends that in situations of uncertainty it is better to protect (public) consumers than to defend the producer's (industry's) rights to sell products. This, she argues, is because the burden of proof in respect of whether a product risk is acceptable should be placed on the person who is seeking to minimise the risks to the producer as opposed to the consumer. In other words, in cases of uncertainty about the level of harm, it is difficult to justify inflicting risk on consumers. Even so, there are situations that might merit taking a producer's side by promulgating under-inclusive rules

[230] ibid 76.
[231] Black, *Rules and Regulators* (n 207)12; see 19-45 for a discussion of the various strategies.
[232] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 234.

that are favourable to the industry. Instances include those in which compliance costs are expected to be very high and the benefits of the rule are low. Another consideration concerns what stage the rule targets, that is, whether it kicks-in to prevent harm or after harm has occurred. In this respect, it is suggested that, where the costs of prevention are likely to be very high and it is possible to address the harmful effects at the act or the harm stage, it may be preferable to opt for rules that gravitate towards under-inclusiveness.[233]

2.5.3 Tensions in Rule Design and Usage

In designing rules, it may be possible to control how much discretion is to be applied by a rule applicant. The choice of rule type may help to address the challenge of how to calibrate the level of discretion in the regulatory system. In this regard, it is suggested that rules with a vague structure are combinable with those that have a more permissive character to increase the level of discretion that has been accorded. For example, regulation under new governance has been said to be less prescriptive and more outcomes-based as manifested in the drafting of broad principles instead of prescriptive rules.[234] Conversely, if the objective is to limit discretion, the author of the rule should instead craft a more precise rule and/or a rule that is binding or restrictive in character.[235]

The use of rules also demands the making of trade-offs. One illustrative instance may be where the objective is to circumvent over-inclusiveness whilst avoiding complexity and the gaps that precision can create.[236] Another case is where the rule author seeks to reduce regulatee discretion and to simultaneously promote an enforcement strategy emphasising compliance instead of deterrence.

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[233] Kristin S Shrader-Frechette, *Risk and Rationality (*University of California Press, 1991) ch 9; Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 234-236.
[234] Bridget M Hutter, 'Understanding the New Regulatory Governance: Business Perspectives' (2011) 33 (4) *Law and Policy*, 461.
[235] Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 234-236; Shrader-Frechette, *Risk and Rationality* (n 233) ch 9.
[236] Black, *Rules and Regulators* (n 207) 29.

With respect to enforcement, the rule type may have a bearing on the enforcement strategy which can cause tensions and also demand the making of trade-offs. In this regard, it is suggested that some rule types may be more appropriate to some enforcement strategies. As an example, an examination of private enforcement systems through the lens of economic analysis indicates that such systems are likely to result in enforcement and sanctioning of all breaches of rules, and thus over enforcement. To reduce the inefficiency resulting from over-enforcement would require rules that are more precise and more under-inclusive. Moreover, it is suggested that 'bright line' rules are more appropriate for a deterrence strategy of enforcement because they encourage prosecution, and that a compliance strategy that entails negotiation and the use of other approaches, such as advice, education, and compromise with the regulatee, is supported by less precise rules. [237]

An example of this concerns the resolution of the tensions between rule flexibility and certainty. Different rule types could be used that promote adaptability and assurance. For instance, the rule system could integrate simple rules that have sanctions attached (to address instances of breach), with precise, complex rules with no accompanying sanctions, that give guidance for compliance with the vague and simple rule.[238]

Beyond the calibration of discretion, there is also the challenge of ensuring that the discretion granted is used as the regulator intended. Addressing this involves paying attention to the rule type as well as using other strategies like reliance on interpretative communities, which comprise the context in which the rule is 'formed followed and enforced'.[239]

2.6 Rules versus Discretion

Complexity is a problem for discretion based regimes such as RBA. One source of complexity is detailed rules, which are argued to be ineffective for

[237] Black, *Rules and Regulators* (n 207) 28-29; Robert Baldwin, 'Why Rules Don't Work' (1990) 53(3) *The Modern Law Review* 321; and Robert Baldwin, *Rules and Government* (Clarendon Press 1995), 143–57; Keith Hawkins, *Environment and Enforcement* (Clarendon Press 1984).
[238] Black, *Rules and Regulators* (n 207) 29.
[239] ibid 30-44.

dealing with uncertainty. Accordingly, in circumstances of uncertainty it is asserted that it is preferable to rely on principles on account of their flexibility and long term endurance.[240]

Although principles are designed to give more discretion, this can be problematic when it comes to actual implementation. The GFC exemplifies challenges of rule design, as seen in the application of principles-based approaches (PBR) in the UK. In the post-crisis years, PBR was blamed for fostering 'light touch' regulation, and for encouraging too much trust to be placed in firms to do the right thing. However, writers such as Black caution against giving too much weight to PBR rhetoric from regulators and politicians. She argues that, although the previous regulator (the FSA) styled itself as a PBR-based regulator, and had assumed the stance of a light touch PBR driven regulator in the wholesale market, in other areas there was intense supervision going on. She gives the example of its implementation of PBR, as manifested in the TCF initiative in the retail market, which, though touted as 'light-touch', in reality had all the hallmarks of intensive supervision.[241] The lesson we can draw from the UK's experience is that PBR is in practice a complex strategy that can be applied with varying degrees of intensity. There are circumstances in which it is implemented in ways that have the same effect as if they were written as detailed requirements (for example, the TCF case), and others in which it can have the effect of light touch regulation, as happened with prudential regulation of banks by the FSA.[242]

Another lesson is that effective implementation of PBR is reliant on trust and regulatees having in place strong and robust compliance.[243] Ill-disposed and

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[240] On the use of principles see generally Julia Black, 'Forms and Paradoxes of Principles-based Regulation' (2008) 3 (4) *Capital Markets Law Journal*, 425.

[241] See Julia Black, 'The Rise, Fall and Fate of Principles Based Regulation' (2010*) LSE Legal Studies Working Paper* No. 17/2010, 18-19, 24. <https://ssrn.com/abstract=1712862> accessed 19 March 2019. Black discusses the circumstances that led PBR's fall from grace. She also highlights how PBR can both be used as a marketing label or as a derogatory label.

[242] Black, 'New Governance' Techniques and the Financial Crisis (n 166) 1044. The author states that 'with respect to prudential supervision (often of the same financial institutions) then supervision was less intense, with fewer regulatory resources dedicated to it, more dependent on firms' internal systems and controls, and in short, more trusting'.

[243] Black, 'The Rise, Fall and Fate of Principles Based Regulation' (n 241)22-23. <https://ssrn.com/abstract=1712862> accessed 19 March 2019. This was true of the FSA, as well as of the current regulator, the FCA; Julia Black, 'Forms and Paradoxes of Principles-based Regulation' (2008) 3 (4) *Capital Markets Law Journal* 453.

low capacity firms pose greater difficulties for regulators in terms of exerting control. Trust is central to the application of PBR, and promoting trust with this type of firm is not viable for regulators. As such, firms who are considered ill-disposed, low capacity and untrustworthy have to be regulated via exacting command-based rules.[244] In the case of ill-disposed, high capacity firms—which are also referred to as creative compliers and amoral calculators—these bypass principles when it suits them. However, it is harder to creatively comply with principles in comparison to rules, and so the suggested approach to be taken with this category is to employ a mix of precise rules, such as outcome-based rules, and back-up principles.[245]

In general, the use of principles demands the exercise of discretion, as it requires regulatees to exercise their judgment to determine whether their conduct meets the anticipated compliance level. This has had an impact on the application of approaches such as PBR. The approach has been frequently criticised as unsuitable as a control over companies that do not possess the expertise, scale or resources to undertake the roles that PBR requires them to shoulder—namely the formulation of interpretations of principles and strategies for complying with their obligations.[246]

Post-GFC reforms in the UK have seen principles being retained. They buttress and support detailed and prescriptive regulation as opposed to replacing detailed rules. In terms of the interaction between principles and rules, principles are to be applied in the absence of detailed rules.[247] We suggest that this approach can address the perimeter between risk and uncertainty that attaches to rule design and enforcement by creating greater certainty on what should guide regulatees where rules have not been provided for specific circumstances (under-inclusivity). Nonetheless, where available,

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[244] See Baldwin, Cave and Lodge, *Understanding Regulation* (n 1) 305.
[245] Doreen Mcbarnet, 'When Compliance is not the Solution but the Problem: From Changes in Law to Changes in Attitude' in Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion* (Ashgate, 2003); Baldwin, Cave and Lodge ibid 305-306.
[246] Black, 'Forms and Paradoxes of Principles-based Regulation' (n 240) 453; Julia Black, Martyn Hopper, and Christa Band, 'Making a Success of Principles Based Regulation' (2007) 1(3), *Law & Financial Markets Review* 191, 200.
[247] Iris Y-H Chiu and Joanna Wilson, *Banking Law and Regulation* (Oxford University Press, 2019) 250-251.

detailed rules retain their central role in respect of promoting public accountability, legal certainty and enforcement.[248]

2.6.1 Rules vs. discretion—a fine balance

Achieving the right balance between rules and discretion is a crucial problem for regulatory regimes. Rosa Lastra considers the balance between rules and discretion at different stages of the supervision process and concludes that certain stages of the supervision process lend themselves better to the application of judgment. She argues that the market entry stage must be rules-based to define, for example, licensing requirements and acceptable activities. The second stage of monitoring firm behaviour involving risk monitoring and control, she asserts, calls for application of enhanced judgement. The third stage—sanctioning—she asserts must be rules-based and clearly prescribed beforehand to ensure effective enforcement. The final stage of crisis management (entailing aspects like lender of last resort, deposit insurance, and insolvency proceedings) necessitates the exercise of a combination of rules and discretion. For example, while lender of last resort necessitates use of judgement, deposit insurance should be rules-based. With regard to the exercise of early intervention measures, it is suggested that they should be based on discretion, unless there is a sanctioning aspect, which needs to be pre-defined by rules. In view of this assessment, she suggests that approaches like JBR may be better suited to particular stages of the supervisory process.[249] JBR is discussed further below. However, this analysis remains useful for regulators whenever they make choices about whether to adopt a rules-based or a discretion-based approach, no matter what specific New Governance approach they are using.

The question about the extent to which discretion will be exercised by regulators has also been raised, given that their actions can expose them to immunity or liability. It has been pointed out that regulators may sometimes

[248] Georgosouli, 'Judgement-Led Regulation: Reflections on Data and Discretion' (n16) 216. *gulation*, 215-216; Julia Black and Martyn Hopper' Breaking Up is Hard to Do: the Next Stage? (Herbert Smith LLP, May 2012) 12.
[249] Rosa M Lastra, 'Defining Forward Looking, Judgment-Based Supervision' (2013) 14 *Journal of Banking Regulation* 225-226.

shy away from exercising judgment to avoid being blamed if their judgement turns out to have been unsound.[250] Regulators will thus need to build their judgment 'muscle'. One way is by ensuring that they are knowledgeable (building expertise) in order to enhance their confidence. Indeed, there are studies that demonstrate that people prefer to bet on events about which they feel more knowledgeable or competent.[251]

2.7 Judgement Based Regulation

The JBR approach has the capability to ameliorate some of the shortcomings inherent within the New Governance (NG), and in turn resolve some of the problems of CAC. Judgement Based Regulation (JBR) came to prominence as a novel approach to regulation and supervision in the years after the GFC as one of the reforms to address the weaknesses identified in post-GFC analyses.[252] It has been described as entailing the minimisation of reliance on rules and, conversely, emphasising the spirit of regulation.[253] Underpinning this approach is the assumption that regulators will exercise greater discretion and that this will be characterised by the adoption of more interventionist and pre-emptive approaches to support the identification of future risks.[254] It would be misleading to say that judgement in the form of discretion has previously been absent from the regulatory process. As already discussed, inherent within the NG approaches are allowances for the exercise of discretion. The novelty introduced with the adoption of the JBR approach is that it stresses reliance on observable facts and evidence to support judgments that are actually made, as opposed to conjecture as to future risks.[255] A key component in the launch of JBR is therefore prior agreement about the level of discretion to be exercised by the regulator. This will inform what intervention

[250] See Georgosouli, 'Judgement-Led Regulation: Reflections on Data and Discretion' (n16) 216.
[251] Chip Heath and Amos Tversky, Preference and Belief: Ambiguity and Competence in Choice Under Uncertainty (1991) 4 *Journal of Risk and Uncertainty*, 5.
[252] In the UK, its adoption was initiated by the Financial Services Act 2012.
[253] Lastra, 'Defining Forward Looking, Judgment-Based Supervision' (n 249) 224.
[254] Georgosouli, 'Judgement-Led Regulation' (n16); Lastra, 'Defining Forward Looking, Judgment-Based Supervision' (n 249) 224.
[255] Georgosouli, 'Judgement-Led Regulation' (n16).

powers they wield as well as the assumption of a more interventionist and pre-emptive approach to arrest the crystallisation of future risks.[256]

Under JBR there is greater focus on the management and governance of a firm. It calls for regulators and firms to be proactive, with regulators playing the lead role. It permits discretion subject to regulatory definition and control. It envisions that firms will have the latitude to self-govern and that their conduct aligns with pre-defined regulatory objectives and societal goals. This necessitates that firms are completely transparent about their internal control systems. It also requires a more compliant disposition from firms and demands that they avail all their resources and expertise. Consequently, under a JBR model, self-governance is a key component that will be accompanied by regulators stepping in to inform regulatees about system-wide risks.[257]

JBR is characterised as a forward looking approach. It seeks to create awareness among firms by providing examples of future conduct that they should abstain from.[258] It is suggested that this 'forward looking' aspect points to an intention to establish a regulatory style that is "data intensive but prescriptively light *ex-ante*."[259] Moreover, being evidence based, JBR will require reliance on a quantitative approach to supervision. Using qualitative, as opposed to quantitative, information to make judgments can pose difficulties, hence the emphasis on greater disclosure in the form of more granular data under JBR is understandable. Decision-making on the basis of quantitative information is less complicated because quantitative information is more easily subjectable to challenge and it is often more straightforward for those involved in such a process to interrogate and therefore understand such data. The current trend suggests an appreciation of the value of quantitative data for regulatory decision-making. Indeed, in the post-GFC years, more stringent reporting requirements for firms have been introduced. These feature requirements for an increased level of granularity in the collection and

[256] ibid.
[257] Georgosouli, ibid 212; Lastra, 'Defining Forward Looking, Judgment-Based Supervision' (n 249) 224.
[258] Georgosouli, ibid.
[259] ibid.

reporting of data.[260] Such reforms can help to strengthen JBR regimes. Further, in the era of 'big data', it is possible to use technology to enable the collection of vast amounts of data. The challenge might well be how to interrogate these data troves in order to come up with meaningful assessments and to form decisions that will shape regulatory supervisory activity. This means that regulators face limitations in what they can do with the available data. To counteract such challenges, innovations that leverage technology such as RegTech may help to ease the burden of meeting more stringent regulatory reporting obligations and also support regulatory monitoring and compliance. David Bholat suggests that a data intensive regulatory regime, in addition to being prescriptively less onerous *ex-ante*, may also be advantageous as regulators need not be restricted by a limited set of reported metrics. They could instead aggregate and reconfigure granular data to formulate new measures for assessing the state of the financial system. This can allow them to make adjustments in their judgments as necessary over time depending on what the data reveals.[261]

As a relatively new approach, JBR is facing some criticism. Despite the discretion extended, there is a concern that over-intrusion can curtail regulatee discretion. There is greater interference with the independence of the firm as a consequence of requirements for firms to implement measures including meeting enhanced data disclosure, stress testing and recovery resolution planning. It has also been suggested, for instance, that its adoption may undercut risk-based regulation. That RBA lends itself to a retrospective approach, which creates tensions with the adoption of a forward looking judgment based approach that emphasises contemplating and accounting for future risks. The critique is based on the argument that risk regulation is grounded on assumptions about risk and how it crystallises,[262] which may be mistaken from the beginning. One response to this critique asserts the need to look beyond assumptions about risk and to consider how to maintain quality with respect to the judgements made and whether to subject the regulators'

[260] See David M. Bholat, 'The Future of Central Bank Data' (2013) 14 *Journal of Banking Regulation*, 186.
[261] ibid 188.
[262] Georgosouli, 'Judgement-Led Regulation' (n16).

accountability mechanisms in respect of the decisions to implement pre-emptive tools. Such mechanisms might include making judgments open to review by independent senior advisors. Moreover, "implementing strong and updated methods of risk assessment, as well as reasoned and accountable decision-making processes" can help alleviate concerns about combining JBR with approaches like risk-based regulation.[263] Overall, JBR reinforces the importance of discretion for sound decision-making and action.[264]

In this work we argue that the JBR fits within the NG umbrella, given that it shares several attributes with the other NG approaches. This is evidenced by its shedding of the 'top down' stance of CAC to make way for a changed relationship between regulator and regulated that permits the exercise of discretion within parameters set by the regulator.

This thesis proposes a revised regulatory model for Kenya in which JBR is positioned as complementary to the other regulatory approaches that comprise NG. It has been argued that JBR is beneficial for addressing the shortcomings of the other approaches. For example, when we consider RBA, one of the challenges that it presents is that there is a gap between risk assessment and implementation. The JBR approach can help to bridge this gap as it supports the identification of risks that can contribute to financial instability, particularly with the employment of the early intervention powers that accompany its implementation.[265] Applying JBR to the Kenyan MFS/MC market will be beneficial for regulators as they contemplate ongoing and future risks posed by this type of lending. In addition to recommending the JBR approach to address the shortcomings of the current regulatory regime, we propose the use of the pre-emptive approaches to address product risks, such as those posed by MC. This aspect will be discussed later in chapter 4.

[263] Arias-Barrera, *Regulation and Supervision of the OTC Derivatives Market* (n 35) 64.
[264] Georgosouli, 'Judgement-Led Regulation' (n16) 217.
[265] Georgosouli, 'Judgement-Led Regulation' (n16).

2.7.1 Judgement and 'Noise'

The implementation of JBR may also introduce other difficulties in the form of 'noise'. Kahneman et al. identify inconsistent decision making as a huge cost for many firms, and they attribute this to what they refer to as 'noise.' They define noise as the chance of variability of judgements. Noise is said to lead to individuals arriving at different decision when they look at something a second time, and it can also lead to two different parties arriving at two different decisions when presented with the same facts. They suggest ways to minimise noise or, to use their terminology, to "bring discipline to judgement". This is done first of all by firms undertaking organisational noise audits to assess the extent to which decisions vary. To address the level of variance, they propose the use of algorithms which they argue are noise free and can offer superior consistency in comparison to humans. However, they call for humans to reserve the final say when it comes to algorithm usage. As an alternative, they propose other processes that foster consistency and thereby increase reliability.[266]

We would suggest that noise can also exist in a regulatory context, and the suggestions for how to deal with noise in firms, with a view to improving reliability, would likewise be relevant for regulators. This is especially so given the trends encouraging the adoption of JBR, as JBR calls for the use of judgement. Additionally, discretion is embedded within the other NG approaches and hence this point is also applicable to them. The expectation is that regulators presented with the same set of issues, facts, or problems will arrive at more or less the same decision or solution and that this gives regulatory decision-making reliability.

Of course there is some room given for variance because the nature of judgment is that it has subjective components. That is why it is acceptable for judicial officers presented with similar facts and evidence to reach different decisions. We would argue that the inclusion of an appeals process in the legal

[266] See Daniel Kahneman and others, 'Noise: How to Overcome the High, Hidden Cost of Inconsistent Decision Making' (2016) *Harvard Business Review*. Authors also distinguish noise from bias.

context means that decisions of lower courts can be challenged and corrections made. This reinforces the need for incorporating accountability mechanisms in judgment based regulatory regimes to permit the opening up of judgment to independent senior advisors.

2.8 Application of the Risk-based Approach in Kenya

The Central Bank of Kenya (CBK) has explicitly stated that it adopted the Risk-based Supervisory (RBS) approach in 2004. It claims to have done so in cognisance of the limitations inherent in the traditional approach, which prescribed a common supervisory approach to all institutions irrespective of differences in business activities conducted and risk appetites adopted.[267] However, Kenya's application of Risk-based Regulation does not appropriately capture certain areas of risk and uncertainty. The key areas of concern will be discussed in chapter 3.

2.9 Conclusion

In summary, we can note several points from the above discussion. The discourse isolating the distinction between risk and uncertainty helps us appreciate the danger of the conflation of categories, which may result in the implementation of ineffective or inadequate responses. In all, understanding the difference between risk and uncertainty is important as it informs regulatory action, for instance regulatory design and supervisory activity.

The examination of the views of leading sociologists reveals a link between risk and modernity—namely that the theory of risk emerges with the development of modern society. In advanced modernity, there is social production of wealth which is coupled with the social productions of risks.[268] In the period of late modernity that follows, there is a shift towards risk distribution.[269] The modernisation process generates advancement in many

[267]See for example CBK, Risk Based Supervisory Framework. https://www.centralbank.go.ke/wp-content/uploads/2016/08/CBKs-Risk-Based-Supervision-Framework-May-2013-1.pdf (accessed 20 March 2019).The document describes the CBK's approach to Risk Based Supervision.
[268] Beck, *Risk Society* (n 51) 19.
[269] ibid 20.

areas, including science and technology, which plays a notable role as it instigates an increase in our knowledge of risks, and also raises questions about how to deal with risks with a view to mitigating or forestalling their impact.[270] Another element that characterises and confounds modern society is the emergence of unknown risks. The process of modernization creates both known and unknown risks. The latter category too necessitates identification to determine aspects like their possible unplanned effects and what level of risk would be permissible.

The discussion has also conveyed the limits of conventional approaches for dealing with risk. In particular the dangers of over-reliance on science and the unique challenges presented by manufactured uncertainties—those of measurement, calculation and crafting responses to address them—have been shown. The latter categories are intrinsic to modern financial markets, and addressing them requires the application of a forward looking approach.

It is also acknowledged that the notion of risk beyond the negative connotations, such as threats and dangers, can also attract positive associations.[271] An example of a positive is found in the financial markets, where the offshoots of risk-taking including commercial opportunities and profitmaking, are seen as worthwhile, actively sought, and often attract generous rewards.[272]

We have also seen that the legal and regulatory approaches to address risk vary, and in general have come to recognise that risk management is a nuanced process. Different regimes might adopt diverse approaches to dealing with the same type of risk. It must also be appreciated that interventions aimed at minimising risk might themselves give rise to risk. Consequently regulators, as risk managers in the risk assessment and management process, will need to balance competing risks and make trade-

[270] Beck, 'Living in the World Risk Society' (n 53).
[271] Giddens, 'Risk and Responsibility' (n 37) 3-4.
[272] Gray and Hamilton, *Implementing Financial Regulation* (n 9) 19.

offs.[273] The regulatory objectives of financial stability and consumer protection act as perimeters, shaping what approach is adopted.

Our discussion of RBA revealed that it emerged in response to challenges to the implementation of CAC. The difficulty of regulating in a command style is attributable to limited resources and shortages in expertise. In examining the application of RBA as a New Governance approach, we considered its challenges and drawbacks. Examples of challenges include: difficulty ensuring consistency across evaluators, costs to employee time and regulator resources, the regulatory agency being lumbered with centrally imposed checks and procedures and unable to respond to challenges in a timely way.[274] However, we propose in this work that, in order for New Governance approaches like RBA to address the problems of CAC, there is need to combine them with two additional elements. One is responsiveness and the other is judgement, and especially at the more enhanced level contemplated under the JBR approach. Enhanced judgement requires the implementation of a proactive approach to risk management whereby regulators are encouraged to adopt a more pre-emptive stance that is more interventionist. As the discussion of JBR revealed, JBR introduces more enhanced discretion for both regulators and firms and, in order for this to work, there is need for the inclusion of accountability mechanisms to check the operation of this discretion.

With respect to Kenya's approach to risk regulation, we would recommend a revision of the traditional regulatory approach by refashioning the current RBA to make it really responsive (per Black and Baldwin). Further, aspects of JBR should be incorporated into the new model to bolster the RBA approach and, overall, to create a more coherent regulatory strategy. Overall, the revised model would call for the exercise of enhanced discretion in the management of risk.

With respect to questions about how to calibrate discretion in the regulatory process, such as in rule design, we can conclude that it calls for balancing

[273] Nash, 'Law and Risk' (n 26) 507.
[274] Black and Baldwin, 'Really Responsive Risk-based Regulation' (n 163)189.

between flexibility on the one hand and creating legal certainty and predictability on the other. The latter gives clarity to both regulators and regulatees on conduct that is permissible or not, and that there are repercussions when they do not adhere to it.[275] The former is more adaptable to changing contexts.

In conclusion, risk regulation is a wide and multifaceted concept that can be instrumental in various ways. At a granular level it can be employed as a decision-making tool, for instance to guide regulatory agencies as they make decisions regarding the distribution of limited resources. A more technical usage can also be attached to it involving the implementation of risk assessment and risk management techniques. From a macro perspective, it is considered to have great transformative potential, including to alter relationships such as those between regulators and regulatees, to enable blame allocation, to embed norms of behaviour, and to permit the definition and demarcation of responsibility and accountability.[276]

[275] Georgosouli, 'Judgement-Led Regulation' (n16) 218.
[276] Gray and Hamilton, *Implementing Financial Regulation* (n 9)15-16.

3. The Legal and Regulatory Framework—Shortcomings in the Kenyan Regime

3.1. Introduction

In this chapter we will analyse Kenya's legal and regulatory framework to isolate its weaknesses and the regulatory concerns these generate. The main frame that we will use to undertake this regime analysis is the Mobile Financial Services (MFS) sector, and specifically in relation to the financial product mobile credit (MC).

The Kenyan frameworks lacks a specific product regulation and governance regime, but there are provisions in various pieces of legislation that are of relevance to products. These are to be found in banking, payments, telecommunications and competition legislation. Additionally, the question of who regulates and how to regulate, which arises in the general context of MFS, also presents itself in the specific case of MC. As explicit regulation governing this product is currently absent, this is of concern, given the rise of regulatory issues that are already observable in the market for MC.

The chapter proceeds by introducing the product. We thereafter examine the legal framework to identify shortcomings, and the risks and challenges these present for the regulation of financial products, particularly mobile financial products like mobile credit (MC).

3.1.1. The Evolution of Mobile Financial Services in Kenya

'Mobile financial services' has been described as a blanket term that describes the use of mobile telecommunications technology to execute varied financial transactions.[1] It is a broad field that includes the provision of financial services

[1] GSMA, *State of the Industry Report: Mobile Money* (2016) 66.

via mobile. It has been instrumental in contributing to the opening up of participation within the formal financial sector to millions more people, particularly in developing countries. In this regard, it is said that it has done more to extend access to finance than traditional brick and mortar banking did in the last century.[2]

Kenya is part of the success story of mobile financial services. Chief among these is a mobile money service called M-Pesa that was launched by Safaricom, a leading Mobile Network Operator (MNO).[3] Mobile money is a form of electronic money that can be changed to and from cash by visiting a wide network of agents found countrywide. M-Pesa is cited as one of the main innovations that has increased financial inclusion, particularly for people at the bottom of the pyramid.[4] It has also received scholarly recognition as one of the most successful mobile phone based financial services in the developing world.[5]

In respect of the regulation of the MFS sector, at the outset the Central Bank of Kenya (CBK) adopted a 'test and learn' and regulate later approach to regulate mobile payments and mobile money.[6] Whereas the true reasons for this stance remain within the regulator's purview, it has been suggested, for instance, that they may have felt guilty about imposing regulatory pressure, as

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[2] See Collins Daryl and others, *Portfolios of the Poor: How the World's Poor live on $2 a day* (Princeton University Press 2009). Authors discuss the fact that developing country consumers have in the past had to contend with few options for good quality formal financial services; on the comparison of success between brick and mortar banking and mobile financial services, see GSMA, State of the industry report: Mobile money (2016), 8.

[3] For background information on the mobile transfer service M-PESA See William Jack and Tavneet Suri, 'Mobile Money: The Economics Of M-PESA' (2011) National Bureau of Economic Research Working Paper 16721 <http://www.nber.org/papers/w16721> accessed 10 May 2017; William Jack and Tavneet Suri, 'Risk sharing and Transaction Costs: Evidence from Kenya's mobile money revolution' (2014) 104(1) *American Economic Review* 183–223; William Jack, Thomas M Stoker and Tavneet Suri (2012), 'Documenting the Birth of a Financial Economy' (2012) 109 (26) Proceedings of the National Academy of Sciences 10257–62.

[4] M-Pesa in Kenya is said to provide money transfer services and the equivalent of a small balance transaction account to more than 12 million customers through cellphones and a network of 16,000 agents. For more on this see Denise Dias and Katharine McKee, 'Protecting Branchless Banking Consumers' (*CGAP* 15 September 2010) <http://www.cgap.org/publications/protecting-branchless-banking-consumers> accessed 10 October 2015; See also Tonny K Omwansa and Nicholas P Sullivan, *Money, Real Quick* (Ist edn, Balloon View 2012) reporting that, by 2012, 70% of the adult population had signed up for mobile money services.

[5] Jack and Suri, 'Mobile Money: The Economics of M-PESA' (n 3).

[6] Ignacio Mas and Amolo Ng'weno, 'Three Keys to M-PESA's Success: Branding, Channel Management and Pricing' (2010) 4(4) *Journal of Payments Strategy & Systems* 352.

this might have been perceived as an attempt to foil an innovation with potential to offer great benefits.[7] This stance has been taken to be enabling and flexible.[8] This enabling environment is argued to have contributed to the successful deployment and growth of mobile payments/mobile money in Kenya.[9] [10] However, we posit that, whereas the laxity 'enabled' mobile payments and the related mobile money innovation to flourish, the need for the implementation of a more defined regulatory approach that addresses the risks of mobile payments, and additionally now of MC, can no longer be wished away. We would further argue that an enabling regulatory environment is not static—that what is enabling today, will not be enabling for all time. We consider an enabling environment to be a product of various factors, including government policy agenda as well as regulatory focus/agenda. For instance: financial inclusion vs. consumer protection; the type of innovation at play; the moment in time; existence of legislation/regulation; capacity to enforce legislation/regulation. In other words, context matters—and the various factors listed above, will shape the context and determine what is enabling. Porteous defines an enabling environment as comprising conditions that foster a sustainable path towards market development so as to promote socially desirable outcomes. This requires the management of complex trade-offs over time.[11]

The take-off of mobile money services has had positive effects on financial sector development.[12] It has enabled consumers to be more comfortable

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[7]Tonny K Omwansa, 'M-PESA: Progress and Prospects' (2009) <https://profiles.uonbi.ac.ke/tomwansa/files/innov-gsma-omwansa.pdf> accessed 20 September 2019.

[8] Joy Malala, *Law and Regulation of Mobile Payment Systems: Issues Arising 'Post' Financial Inclusion in Kenya* (Routledge 2017) 140-141; As Malala points out, this piece-meal approach left a number of issues unresolved, including those related to the implementation, dichotomy and clarification of the status of MNOs and agents.

[9] Mas and Ng'weno 'Three Keys to M-PESA's Success' (n 6).

[10] Richard Heeks, 'Why M-Pesa Outperforms Other Developing Country Mobile Money Schemes' (2012) ICTs for Development, <https://ict4dblog.wordpress.com/2012/11/24/why-m-pesa-outperforms-other-developing-country-mobile-money-schemes/> accessed 20 September 2019.

[11] David Porteous, *The Enabling Environment for Mobile Banking in Africa* (Report Commissioned by Department for International Development [DFID], Boston, 2006) 12. <https://www.microfinancegateway.org/sites/default/files/mfg-en-paper-the-enabling-environment-for-mobile-banking-in-africa-may-2006_0.pdf 20 September 2019>. Trade-offs to be balanced include: consumer protection, access to finance, financial stability and economic efficiency.

[12] Matthew B Gross, Jeanne M Hogarth, and Maximilian D Schmeiser, 'Use of Financial Services by the Unbanked and Underbanked and the Potential for Mobile Financial Services Adoption

engaging with formal finance providers as a result of dealing with formal money service providers. Additionally, it is drawing people from the cash economy into modern systems of book entry,[13] and in turn is contributing to economic growth in the country. Mobile network technology in developing countries is also being harnessed for other uses, besides mobile money services.[14] Providers using mobile platforms have diversified into distinctive offerings beyond mobile money services,[15] and to products such as savings, credit,[16] and insurance.[17] In the period from the launch of mobile in 2007 up to 2018, mobile money subscriptions are reported to have grown exponentially from 1.35 million to 31.62 million. The value of transactions has been growing over the years with an increase of 10 percent from Ksh.332.622 billion in 2017 to Ksh.367.77 billion in 2018.[18]

MC is a more recent development in the MFS arena and raises new regulatory challenges. MC is gaining currency in many developing countries. Reports show that, by December 2015, there were 45 live mobile credit services across 16 countries and that 82% of these were in Sub-Saharan Africa.[19] The CBK also reported that, as of 2018, there were over 16 million active mobile phone deposit accounts valued at over Ksh.105 billion, corresponding to 30.43

(2012) 98(4) Federal Reserve Bulletin 1–20. They posit that the formalising effects of mobile money arise from the fact that mobile moneys helps low-income users feel more comfortable engaging with formal financial institutions.

[13] Omwansa and Sullivan, *Money, Real Quick* (n 4).

[14] Mukesh Sadana and others, 'Do the M-Pesa Rails Contribute to Financial Inclusion?' Microsave Briefing Note 95/ 2011) <http://www.microsave.net/files/pdf/BN_95_Do_M_Pesa_Rails_Contribute_to_Financial_Inclusion.pdf> accessed 8 May 2017.

[15] See Anastasia Mirzoyants-McKnight and William Attfield, 'Value-added Financial Services in Kenya: M-Shwari—Findings from the Nationally Representative FII Tracker Survey in Kenya (Wave 1) and a Follow-up Telephone Survey with M-Shwari User' (*InterMedia*, January 2015) <http://docplayer.net/35822606-Value-added-financial-services-in-kenya-m-shwari.html> accessed 8 February 2017; *InterMedia*, 'Digital Pathways to Financial Inclusion 2014 Survey' (February 2015) <http://finclusion.org/uploads/file/reports/InterMedia-FII-Kenya-2014-Wave-2-summary-report.pdf> accessed 8th February 2017.

[16] Greg Chen and Rafe Mazer, 'Instant, Automated, Remote: The Key Attributes of Digital Credit' (CGAP, 8 February 2016) <http://www.cgap.org/blog/instant-automated-remote-key-attributes-digital-credit> accessed 8th February 2017. Authors characterize digital credit as instant, automated and remote, and therefore distinguishable from conventionally delivered credit.

[17] See Tellez Merchan Camilo and Peter Zetterli,'The Emerging Global Landscape of Mobile Microinsurance' (CGAP Brief, January 2014) <http://www.cgap.org/sites/default/files/Brief-The-Emerging-Global-Landscape-of-Mobile-Microinsurance-Jan-2014.pdf> accessed 8 February 2017 for discussion on mobile insurance.

[18] CBK, *Bank Supervision Annual Report* (*2017)* 18. See for most recent MFS data.

[19] GSMA, *Mobile Insurance, Savings and Credit Report* (2016) 24.

percent and 3.1 percent of total industry deposit accounts numbers and values respectively. In terms of mobile loans for the same period, there were reportedly 7 million active mobile phone loan accounts valued at over Ksh.60 billion, corresponding to 97.49 percent and 2.41 percent of total industry loan accounts numbers and values respectively.[20]

It has been suggested that the high level of mobile money penetration in Sub-Saharan Africa has contributed greatly to the proliferation of mobile credit.[21] Furthermore, it has also been observed that familiarity with mobile money services has helped support the successful launch of mobile credit because it is delivered in a similar way via mobile, though in this case there is no requirement to visit an agent to convert electronic money. But what is mobile credit and why is its development both at once to be considered transformative and also as something that should give us pause? In addressing this question, this section will start off by outlining the definitions and main elements of mobile credit.

3.1.2. Features of Mobile Credit

No formal definition of MC has been agreed. Even so, there have been attempts at providing some descriptions, which may help us to understand what it constitutes. According to GSMA,[22] mobile credit uses "the mobile phone to provide credit services to the underserved".[23] Also significant is the fact that there are things that GSMA excludes from its reports on mobile credit. A look at these can provide additional insights into what mobile credit is understood to mean. The reports omit things like credit products for mobile airtime, and services that may allow access to traditional credit products.[24]

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[20] CBK, *Bank Supervision* (n 18) 16.
[21] Byoung-Hwa Hwang and Camilo Tellez, 'The Proliferation of Digital Credit Deployment' (CGAP 16 March 2016) <http://www.cgap.org/publications/proliferation-digital-credit-deployments> accessed 7 September 2017.
[22] GSM Association, commonly known as GSMA is a trade body that represents the interests of mobile network operators worldwide.
[23] GSMA, *Mobile Insurance, Savings and Credit Report* (2016) 36; GSMA, Revising our Definitions for Credit, Savings and Insurance Enabled by Mobile money (18 August 2016) <https://www.gsma.com/mobilefordevelopment/uncategorized/revising-our-definitions-for-credit-savings-and-insurance-enabled-by-mobile-money/> accessed 8 February 2017.
[24] For further details on this see GSMA, *Mobile Insurance, Savings and Credit Report* 2016.

Some writers have also excluded the following: products that are targeted as a credit product for mobile money agents, rather than consumers and products that provide financing for collateralised assets.[25]

What mobile credit constitutes can also be gleaned from its main elements, which have been described by the useful shorthand 'automated, instant and remote'. These elements are thought to set it apart from credit offered by conventional banks. 'Instant' refers to the speed of decisions to advance credit, which happen in seconds, with a maximum turnaround time that does not generally exceed twenty-four hours. 'Automated' refers to the process used for arriving at determinations of customer creditworthiness, including how the customer is managed and how activities like repayment collections are conducted, which are all automated based on pre-stipulated parameters. 'Remote' denotes the fact that customers need never visit a branch to make loan applications, or to receive disbursements and make repayments. This remoteness element results in immense time and money savings for customers and further enhances the attractiveness of this product.[26]

Another prominent feature of mobile credit is that it leverages available non-traditional digital data in order to make lending decisions.[27] This is especially crucial in the case of first time lending, since the customer will not yet have established a relationship and repayment record with the provider. This shifting of reliance to non-traditional data is considered radical because a majority of retail consumers lack access to traditional formal credit histories. This may be due to their not having accessed formal loans or if they had been denied a loan in the past, or perhaps due to gaps within the credit reporting framework in Kenya.[28]

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[25] See Jason G Blechman, 'Mobile Credit in Kenya and Tanzania: Emerging Regulatory Challenges in Consumer Protection, Credit Reporting and Use of Consumer Transactional Data', (2016) *African Journal of Information and Communication* 17.
[26] Chen and Mazer, 'Instant, Automated, Remote' (n 16).
[27] Hwang and Tellez, 'The Proliferation of Digital Credit Deployment' (n 21)
[28] Credit reporting became a requirement in 2013, and the governing regulations are the Credit Reference Bureau Regulations 2013 issued by the Central Bank of Kenya. For more on developments in this area see the credit information sharing Kenya website <http://www.ciskenya.co.ke/cis> accessed 8 May 2017.

Another unique feature of mobile credit is the use of algorithms to collect and assess the non-traditional data referred to above. Human intervention in this process is limited to the development of proprietary algorithms by credit providers working with specialty analytics firms. The algorithms are applied to the data collected to evaluate customer suitability for credit as well as to determine disbursement amounts.

But how does this work in practice? What providers of MC often do is tie their service to a mobile subscription or to a mobile money account. In practice, this gives an MNO access to lots of valuable customer information, such as call patterns, deposit, transfer, merchant and bill pay activity via mobile money accounts, and records of airtime purchase. Additional data is also retrieved from users of smart phones, including for activities related to their internet browsing and social media activity.[29]

Other elements that typify MC are small amounts, short repayment periods (30 days or a few months at most) and high interest rates. From a risk management perspective, this makes sense, as providers would naturally want to hedge against the risk of default due to the higher risk that these loans pose, being unsecured and also because the applications are not supported by a credit history.[30] In respect of interest, it has also been observed that in most cases customers are charged a flat fee, and any early repayment is not factored into the interest calculation. The elements described may seem to be limiting and yet they have not hampered the growing popularity of this form of credit in Kenya. In fact, lenders in this market have been able to compete favourably with the more established conventional lenders, like banks.

In view of the fact that there is no agreed definition of MC. We can sum up from the above that it is a product that gives consumers the capability to quickly apply for and receive loans via their mobile phones.

[29] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25).
[30] Usually does not exceed £90-100 equivalent. See Hwang and Tellez, 'The Proliferation of Digital Credit Deployment' (n 21).

3.2. The legal and regulatory regime governing MFS

3.2.1 Financial products regulation in Kenya

This section will examine the Kenyan framework to identify the limitations and tensions in the current regime. In so doing we explore the question of how financial products in Kenya are regulated. We will consider the regulatory architecture to explain how responsibility is divided among the different regulators that comprise the MFS sector. We will examine the current provisions to assess their scope highlighting pertinent consumer protection provisions and considering the extent to which they apply to MFS, and specifically the delivery of mobile financial products like MC.

The Kenyan frameworks lacks a specific product regulation and governance regime, but there are provisions in various pieces of legislation that are of relevance to products. These are to be found in banking, payments, telecommunications and competition legislation.

3.2.1.1 Banking Regulatory Framework

Banking in Kenya is regulated under the Companies Act, the Banking Act and the Central Bank of Kenya Act. There are also several guidelines issued by the CBK to guide regulated financial institutions. The latter are referred to as prudential guidelines.

3.2.1.1.1 Roles and powers of the CBK

The Central Bank of Kenya (CBK) has the key role of promoting the financial system's stability and efficiency through the regulation and supervision of financial institutions that fall under its purview. It also oversees payment, clearing and settlement systems.[31] CBK is also mandated to focus on access,

[31] See Constitution of Kenya 2010 art 231; CBK Act s 4(2)—CBKs role is stipulated as entailing ensuring liquidity, solvency and proper functioning of a stable, market-based financial system; CBK, Our Mission <https://www.centralbank.go.ke/our-mission/> accessed 5 November 2019.

thus bringing financial inclusion into the mainstream.[32] To discharge its mandate, the CBK has the following powers: prevention, monitoring and information gathering and powers related to intervention, sanctions, penalties and the institution of judicial proceedings.[33]

The CBK is involved in the development of the legal framework that governs the operation of financial institutions under its mandate. In addition to the legislation that is promulgated by parliament, in exercise of its power to issue guidelines the CBK has over time issued Prudential Guidelines covering various aspects relevant to the banking sector.[34] The Guidelines are issued under the Banking Act, which empowers the CBK to issue guidelines to be adhered to by institutions in order to maintain a stable and efficient banking and financial system.[35] The Guidelines state that they apply to all applicants intending to be licensed to conduct banking, mortgage or financial business in Kenya.[36] The use of the term financial business here might be wide enough to include other providers of finance, besides banks. However, the guidelines are titled 'prudential guidelines for institutions licensed under the Banking Act', which may suggests that they are inapplicable to non-bank financial service providers, as the only financial institutions that are under CBK's remit for licensing purposes include banks, mortgage companies and deposit taking MFIs (now called Microfinance banks).[37]

In respect of products, CBK's powers with regard to new products are stipulated under the Banking Act,[38] which provides that increases in the rate

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[32] Paul Gubbins, 'An Overview of Developments and Trends in Kenya's Retail Financial Landscape' (FSD Kenya, 1 September 2015) <http://fsdkenya.org/an-overview-of-developmens-and-trends-in-kenyas-retail-financial-landscape> accessed 7 September 2017.
[33] Banking Act s 27 and Part VII.
[34] Including on licensing, corporate governance, consumer protection, money laundering, enforcement of banking laws and regulations, and prohibited business. See CBK prudential guidelines for full list- <https://www.centralbank.go.ke/wp-content/uploads/2016/08/PRUDENTIAL-GUIDELINES.pdf>
[35] Banking Act s 33(4) and Prudential Guidelines para 1.2.
[36] Para 1.3.
[37] CBK, *Bank Supervision* (n 18)—The CBK explained that the change of name from "deposit taking microfinance institution" to "microfinance bank" is to allow MFBs to operate current accounts, issue cheques (and participate in the national payment system) and engage in foreign trade operations, as well as require MFBs to share both positive and negative credit information with Credit Reference Bureaus (CRBs).
[38] s 44.

of banking and other charges are subject to CBK prior approval.[39] CBK's mandate over new products is read from sec 44 Banking Act. This framing is problematic and limiting in our view, as it is couched within the framework and language of tariffs, and yet product approval should involve a more comprehensive analysis, involving a detailed consideration of product risks, for example. In processing such applications, CBK considers—[40]

- Whether the proposed increase is in conformity with the Government's policy of establishing a market oriented economy in Kenya; and
- The average underlying inflation rate prevailing over twelve months preceding the application.
- For new charges, whether the proposed charges are justifiable and are comparable to the industry average.

As an example of the exercise of this power, in the year 2017, it is reported that banks submitted over 80 applications seeking CBK's approval to introduce new products related charges. Most of the applications sought to introduce money transfer services in partnership with firms in the United States of America and the United Kingdom.[41] This points to an influx of activity in the payments space.

The limited role of the CBK has been noted by scholars such as Malala, who call for an expanded role for this regulator, in the context of payments systems regulation.[42] We would additionally urge that this role expansion be extended to the arena of MC as well. In general, as mobile payments systems continue to develop and firms continue to leverage the payment infrastructure and move into new domains, CBK needs to not only keep pace with these changes, but to ensure that the regulatory framework that spells out its role and function extends its reach and supervisory role to these new domains as well.

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[39] The Cabinet Secretary, National Treasury, delegated this role to the Governor of the CBK via legal Notice 34 of May 2006 on the Banking (increase of rate of banking and other Charges) Regulations 2006.
[40] CBK, *Bank Supervision* (n 18) 17.
[41] ibid. According to CBK, the products will facilitate flow of foreign remittances.
[42] Malala, *Law and Regulation of Mobile Payment Systems* (n 8) 139-140.

3.2.1.1.2 Consumer Protection under the Banking Framework

Banks are required to comply with the Prudential Guidelines for institutions licensed under the Banking Act, which include a guideline on consumer protection, CBK/PG/22. With regard to consumer protection aspects relevant to the delivery of MC, there are a number of pertinent provisions that banks are required to comply with. The Guideline requires banks to act "fairly and reasonably in all dealings with consumers," to explain products and services "clearly in simple and ordinary language," and to inform the customer of all "charges, fees, penalties and any other financial liability".[43] Banks are also required to inform a consumer of and provide terms and conditions that highlight all fees, charges, penalties, interest rates and other liabilities or obligations.[44] It is also a mandatory requirement for banks to make specific disclosures on interest rates, including disclosing the rate, explaining how it was calculated and disclosing the total cost of credit.

The Banking (Increase of rate of banking and other charges) Regulations stipulate requirements on pricing. Banking institutions are required to post, in a conspicuous position at every place of the institution's business in Kenya, the rates of banking and other charges levied on the products offered.[45] Additionally institutions seeking to introduce a new product are required, prior to charging, levying or imposing any rate or charge on the new product, to notify the Minister in writing of the rate or charge applicable to the new product.[46]

The MC environment introduces new questions in respect of fees and charges. An example concerns the interpretation of section 16 A of the Banking Act which provides that—

> *(1) No institution shall impose any form of charges on a savings, seven day call or fixed deposits account.*

[43] Guideline on Consumer Protection, CBK/PG/22 para 3.2.1 (a) and 3.2.3 (a).
[44] Guideline on Consumer Protection, CBK/PG/22 para 3.4.4.
[45] reg 6—a copy of the document so displayed is to be submitted to the Minister of Finance.
[46] reg 44.

(2) An institution shall, in respect of a savings account, pay interest accruing, or a return in the case of an institution carrying out business in accordance with Islamic law, to that account as long as the minimum balance is maintained.

It is unclear whether the above provision in the Banking Act would apply to the M-shwari hybrid model, which comprises accounts with savings and credit components. Specifically, whether the savings accounts that consumers have to open with CBA comprise savings account which would not attract charges and for which interest would be payable.

3.2.1.2 Payments Regulatory Framework

3.2.1.2.1 Roles and Powers of the CBK

As was mentioned above, when MFS was first launched in Kenya, the CBK was the lead regulator. In the beginning, it adopted a flexible approach, which was a 'light touch' approach as demonstrated by the issuance of a letter of no objection.[47] The approach has since changed. The payments sector in Kenya is now regulated under the National Payment System Act 2011 (NPSA) which was enacted to provide a new legal framework for the regulation of payments systems in Kenya. The Act makes provision for the regulation and supervision of payment systems and payment service providers, and for connected purposes. Further to this, the National Payment System Regulations 2014 (NPSR) was enacted to operationalize the NPSA.[48]

It is important to note that the NPSA specifically empowers the CBK to regulate and supervise payments systems in Kenya.[49] The CBK has oversight responsibilities over payment service providers (who also include mobile money service providers). These are stipulated under the NPSA and accompanying regulations (NPSR). Additionally, the CBK Act is also

[47] Gerald Nyaoma, 'Regulating Mobile Money: the Case of M-PESA in Kenya' (2009) <https://www.afi-global.org/sites/default/files/GPF_Gerald_Nyaoma.pdf> accessed 7 September 2017.
[48] NPSA was enacted in 2011 and became operational on 1 August 2014. In the intervening period, public consultations were conducted.
[49] NPSA s 17(1)—powers and functions of CBK.

relevant.[50] The Provisions under the NPSA and NPSR are also arguably applicable to MC lenders who are mobile money service providers (and therefore payment service providers), who are regulated under the aforesaid framework.

Relying on NPSR, the CBK may be interpreted as having the power to review additional partners in the course of authorizing a Payment Service Provider. Another provision that they could draw on is one requiring Payment Service Providers to notify the CBK before introducing a new functionality to its mobile money services or altering major partners in the business.[51] With regard to notification of partnership changes, there is potentially a loophole here, as, because there is no definition of what comprises major and minor, a provider could argue that the change to the partnership is not major.

The CBK has the power to prohibit any person from issuing or using any payment instrument if—(a) the issuing or use of the payment instrument is detrimental to the reliable, safe, efficient and smooth operation of a national payment system; or (b) the prohibition is in the interest of the public.[52] This power to prohibit could be beneficial to the MC. However, its application to mobile lending would depend on the interpretation of the term “payment instrument”. At present there is a lack of certainty about whether MC can be construed as a payment instrument, and this might make the application of this provision to MC challenging.

The NPSA also gives the CBK power to advise and direct.[53] It states that the CBK may, from time to time, issue directives to any person regarding a payment system or a payment instrument on the application of the provisions of the Act. The language used here suggests that the advice or directives is likely channelled to the payments service providers and other providers to whom the Act applies, directly. It is proposed that public guidance to the entire

[50] CBK Act s 4(A) (2) in subsection (1) (d) provides the CBK with the mandate to exercise the oversight powers of promoting financial stability through cohesion in financial market infrastructure.
[51] NPSR 2014 r 13(2)
[52] NPSA 2011 s 17(1).
[53] NPSA s 22 (1); Note also that CBK has power to advise and direct under the Banking Act s 33, including on matters of market conduct.

financial sector might be beneficial; for instance, to guide existing actors and future new entrants as they develop products that ride on payments systems infrastructure that could be subject to the provisions of the NPSA. This power of CBK to advise and direct is nonetheless of value, as it can be leveraged to tackle problems that arise in respect of payments systems. Whereas it remains within CBK's remit to issue directives to specific parties privately, we proposed that public industry wide guidance to the financial sector might offer additional benefits, for instance to guide existing actors and future new entrants as they develop products that ride on payments systems infrastructure that could be subject to the provisions of the NPSA. This could be used to address emerging issues of system-wide concern. The rising disquiet surrounding MC is an example of a situation that could benefit from the issuance of an industry-wide directive.

The NPSA provides for a number of considerations that CBK may take into account prior to issuing a directive,[54] including whether: (a) persons are engaging in conduct with respect to the payment system or payment instrument that results or is likely to result in systemic risk; (b) persons are engaging in conduct that might compromise the integrity, effectiveness, efficiency or security of the payment system or payment instrument; (e) national financial stability. Following a consideration of the suggested aspects, the NPSA further empowers the CBK to issue written directives requiring persons to: (a) cease or refrain from engaging in the act, omission or course of conduct, or perform such other acts as are necessary to remedy the situation; (b) perform such acts as are necessary to comply with the directive or to effect the changes; or (c) provide the CBK with such information and documents relating to the matter as specified in the directive. Non-compliance with such a directive is an offence.[55] Again we consider that this is a useful provision that could be applied to diverse products in the payments domain.

[54] NPSA s 22(2).
[55] NPSA ss 22(3) and 22(7).

3.2.1.2.2 Roles and powers of the Communications Authority

The power to grant operating licences to MNOs is vested in the Communications Authority (CA) as the telecommunications regulator, and not the CBK. On this aspect of licensing the main provision is that telecommunications providers should hold the necessary licenses to permit their use of telecommunications channels. Aside from the licensing aspect, the CA does not have much say in the regulation of MFS. Commentators have highlighted the need to distinguish between these two regulators and to clearly delineate what their powers are. In particular, although CBK has assumed the role of lead regulator in respect of MFS, Safaricom had initially approached the telecommunications regulator (referred to as CCK before the name change). Considering the unique circumstances surrounding the delivery of MFS, a question that is still up for debate is how both regulators should more appropriately manage the interconnection and convergence of the telecommunication service and the financial services they offer.[56] Notably, CBK reportedly acknowledged that mobile money is regulated by both the CA and CBK.[57]

It is expected that, as with mobile money, these licensing requirements would apply equally to MC, whether offered by banks in partnership with MNOs, and to cases where banks engage in solo offering of MC via MNO channels. However, given that MNOs and service providers who use USSD to provide services (i.e. bank & MNO partnership and non-bank lender and MNO partnership) are licensed by the CA, the telecoms regulator could theoretically be able to impose consumer protection requirements to services offered by these licensees, including the provision of MC.

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[56] For licensing provision see Kenya Information and Communications Act (KICA) s 24; Malala, *Law and Regulation of Mobile Payment Systems* (n 8) 128; Niall Hayes and Chris Westrup, 'Context and the Processes of ICT for Development' (2012) 22 *Information and Organization* 23; Alliance for Financial Inclusion, 'Enabling Mobile Money Transfer: The Central Bank of Kenya's Treatment of M-PESA' (2010) <www.afi-global.org/en/phoca-publications-case-studies> accessed 16 November 2018.

[57] Charles Wokabi, 'Bill Backs CCK on Mobile Cash Deals' Daily Nation (9 July 2013). <https://www.nation.co.ke/lifestyle/smartcompany/Bill-backs-CCK-on-mobile-cash-deals-/1226-1908848-tm92e1/index.html> accessed 7 September 2017.

Another question is that of the CA's role in respect of pricing. The CA's mandate covers pricing of telecommunications voice and data.[58] Still, it is unclear whether this can be interpreted as including charges relating to mobile payments or even to products like MC.

3.2.1.2.3 Consumer Protection under the Payments Regulatory Framework

The payments law, the NPSA, and accompanying regulations, the NPSR, provided for the first formal legal framework for mobile money and specific provisions to address the innovations introduced by the mobile payment system launched initially by Safaricom and later other MNOs.[59] The old payments laws that were in force prior to the enactment of the NPSA offered some protection, but were inapplicable to categories of non-cash payments, including electronic and mobile payments, hence the need for new laws to address this gap. The NPSA also paved the way for increased interoperability across payments providers. It stipulates provisions for the licensing and oversight of payment service providers, designation of payment systems, designation of payment instruments, some provisions on consumer protection, and Anti-Money Laundering measures.

An example of a provision that addresses consumer protection concerns in MFS and that may be beneficial also in the regulation of MC is the provision on misleading advertisements. This example is highlighted as providers of short term high cost short lending have been found to use aggressive sales tactics to entice consumers to takes loans. The NPSA stipulates restrictions on misleading advertisements[60] or representations. These relate to inviting persons to participate in a payment system or in the issuance and usage of a payment instrument which: (a) falsely represents that he is designated to operate the payment system or issue the payment instrument under the provisions of this Act; (b) falsely represents that he is recognised to manage a

[58] KICA ss 23(2) and 27(2).
[59] The current mobile money transfer and mobile money commerce operators are Airtel (Airtel Money), Telkom (T-Kash), Finserve Africa Ltd (Equitel) and Mobile Pay Ltd (Tangaza).
[60] NPSA ss 29 (1) and (2).

payment system under the provisions of this Act; or (c) is issued contrary to the provisions of this Act. Contravention of this provision is an offence. The CBK can take action by directing persons to withdraw, amend or refrain from issuing advertisements, brochures, or circulars, or from making any other representation relating to participation in the payment system, or issuance of a payment instrument, which, in its sole discretion, it considers to be misleading. This provision can be employed to curtail advertising by MC providers who may pose a risk to consumers where they have no authorization to operate in the market or issue payment instruments. However, CBK powers would be limited to its licensees under the banking or payments framework. A connected provision is found in the NPSR. It stipulates that advertisements must be precise and easily understood, they must not be misleading, and they must be comprehensive enough to properly inform consumers about a product.[61]

The NPSA framework has been argued to be inadequate.[62] It does not sufficiently address the coalescing of MFS or indeed other kinds of intra-sectoral converged services.

3.2.1.3 Telecommunications Framework

The telecommunications legislation in the form of the Kenya Information and Communications Act (KICA) and accompanying regulations do not adequately address MFS as its provisions do not address the coalescing of mobile and financial services, or indeed other kinds of intra-sectoral converged services. KICA covers provisions on value added services but this is not enough to address the converged environment in which MFS operates in Kenya.[63]

KICA regulations, and specifically the Kenya Information and Communications (Consumer Protection) Regulations (2010), provide for consumer protection requirements. Examples of the provisions articulated in the regulations include: that customers have the right to receive clear and complete

[61] NPSR reg 37.
[62] Malala, *Law and Regulation of Mobile Payment Systems* (n 8) 140.
[63] Malala, *Law and Regulation of Mobile Payment Systems* (n 8) 168; See KICA Regulations reg 2—definition of value added services.

information about rates, terms and conditions for available and proposed products and services; and that customers also have the right to protection from unfair trade practices, including false and misleading advertising.[64] Also that licensees must provide a clear and understandable description of available services, rates, terms, conditions and charges for such services.[65]

These provisions may be interpreted as enforceable against MC providers who are licensed by the telecoms regulators but are non-banks. However, as the scope of KICA is limited to provisions on value added services,[66] it would require agreeing with the position that mobile money, and by extension MC, are categorisable as value add services, an approach that we consider limiting.

3.2.1.4 Consumer Protection under the Competition Framework

It is important to note that, in Kenya, the competition regulator, the Competition Authority of Kenya (CAK), has a wider reach in terms of its consumer protection mandate as this is exercisable across all sectors.[67] In contrast, the powers of other regulators are restricted; for instance, the CBK's mandate is confined to banks and regulated financial institutions. Relatedly, the Communications Authority (CA) can only oversee telecoms licensees.

The Competition Act addresses aspects of consumer protection.[68] For example, section 56(3) forbids the imposition of charges and fees that are not brought to the attention of a customer prior to their imposition or the provision of services. This provision would be applicable to diverse provider categories, in the finance sector and beyond.

As part of the exercise of its non-sector specific powers, in 2016 CAK conducted investigations on disclosure and transparency practices by MFS providers. CAK found that price disclosure was weak in telecoms, banking, and among MC providers, which amounts to an infringement of section 56(4)

[64] KICA (Consumer Protection) Regulations (2010) reg 3.
[65] KICA (Consumer Protection) Regulations (2010) reg 10.
[66] Wokabi, 'Bill Backs CCK on Mobile Cash Deals' (n 57).
[67] Competition Act 2010 part VI.
[68] See generally Competition Act Part VI (Consumer Welfare).

of the Act. In response, CAK issued requirements to the various firms to address this issue, and more than 60% of providers reportedly implemented the new requirements by the end of the financial year, with the rest following suit later on account of technological challenges brought on by use of different systems.[69]

3.2.1.5 Consumer Protection under dedicated law—The Consumer Protection Act

Consumer protection is often a stated regulator objective and is incorporated in regulatory regimes to address the fact that consumers have been identified as encountering specific difficulties in their participation in financial markets. [70]

As the discussion above demonstrates, there are several consumer protection provisions that are to be found scattered in various different pieces of legislation under the different regimes of banking and telecommunications and competition. The fragmentation in the consumer protection framework has an impact on the MFS/MC market in Kenya. This aspect is discussed further below.

This section will analyse the dedicated Act that caters for consumer protection matters in Kenya, the Consumer Protection Act 2012 (CPA). As its provisions have an economy-wide application, they have a wider scope than the frameworks we have already discussed and perhaps the potential to resolve some of the inadequacies in those frameworks.

The Consumer Protection Act (CPA) gives effect to Article 46 of the Kenyan Constitution, in which consumer protection is referenced as one of the fundamental rights and freedoms. This signals its importance in this

[69] Competition Authority of Kenya, *Annual Report and Financial Statement (2016/2017)* 37.
[70] Joanna Gray and Jenny Hamilton, *Implementing Financial Regulation* (John Wiley & Sons 2006) 224.

jurisdiction.[71] The CPA attempts to provide comprehensive consumer protection provisions for Kenya.[72]

Of direct relevance to this work, the CPA contains provisions that restrict false, misleading, deceptive or unconscionable representations.[73] The provisions under part VII of the CPA are also pertinent. This part stipulates specific provisions on "credit arrangements".[74] However, section 53 indicates that part VII is only applicable to supplier credit arrangements. These are defined as consumer agreements where a supplier extends fixed credit to a consumer to assist the consumer in obtaining goods or services, other than credit or a loan of money, from the supplier.[75] This definition may suggest that the provisions on credit arrangements are inapplicable to conventional lending by banks and other financial institutions, or indeed mobile lending.

Another shortcoming in this legislation concerns enforcement, as it does not specify a regulator who has the mandate for enforcement. Instead, it provides for the institution of proceedings by consumers on behalf of a class of persons.[76] Another weakness that could present enforcement challenges relates to the lack of an active Consumer Protection Authority in Kenya. Although the CPA makes provision for the establishment of a Kenya Consumer Protection Advisory Committee (KECOPAC) that was set up in 2013, its activities remain largely invisible.[77]

While this Authority in theory has a multi sector-wide mandate over consumer protection issues, it must be mentioned that the CPA does not specifically indicate that its scope of applicability extends generally to the financial services sector. Notably, there are categories of financial products that are

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[71] The new Constitution was promulgated in August 2010.
[72] Prior to its enactment, there were piece-meal and inadequate provisions scattered in a number of different pieces of legislation.
[73] Consumer Protection Act 2012 (CPA) ss 12 and 13.
[74] CPA Part VII.
[75] CPA s 2
[76] CPA s 4.
[77] COFEK, 'Government Unveils the First Kenya Consumer Protection Advisory Committee KECPOPAC <http://www.cofek.co.ke/index.php/14-news/353-government-unveils-the-first-kenya-consumer-protection-advisory-committee-kecopac> accessed 26 November 2018; Charles Wokabi, 'New Team to Guard Rights of Consumers' *Daily Nation* (23 December 2013) <https://mobile.nation.co.ke/lifestyle/New-team-to-guard-rights-of-consumers/1950774-2123054-format-xhtml-g6og9qz/index.html> accessed 26 November 2018.

specifically stated as falling under the Act. It stipulates provisions on credit cards[78] and certain categories of leases,[79] and loan brokering.[80]

It may be possible to interpret this as suggesting that other finance related products not specifically mentioned are excluded, and so the CPA provisions might have limited efficacy for addressing concerns around the regulation of conventional banking and MFS products like MC. Nevertheless it is noteworthy that the aforementioned Committee's functions are framed very broadly and include:[81]

> *(b) formulation of policy relating to this Act and legislative proposals in the interest of consumers and the modification, consolidation or updating of legislation providing protection to consumers in the areas covered under, or related to this Act;*
>
> *(h) monitoring and keeping under review the trading and business practices relating to the supply of goods and services to consumers and to activities related or ancillary thereto;*
>
> *(j) monitoring the working and enforcement of laws that directly or indirectly affect the consumer;*

If the Act is interpreted as applying to multi sector consumer protection issues (including finance and MFS) then, empowered by this provision, it may be possible for the Authority to get involved in addressing some of the issues that have emerged in the regulation of conventional banking and finance and even of MFS in Kenya. According to sub-section (h) the board's functions include monitoring and review of trading and business practices connected to supply of goods and services. This could be interpreted as encompassing a wide array of goods and services, including in finance. Even then, it is doubtful whether KECOPAC would have a direct role in enforcing provisions as its role is suggested as being limited to that of advisory (from its name), and further

[78] CPA s. 54.
[79] CPA part VIII.
[80] CPA s 39.
[81] CPA s 89 speaks to establishment of the Committee, and s 90 details its functions.

sub-section (j) above speaks of "monitoring of working and enforcement of laws". We argue that this language does not give the committee any teeth as far as enforcement is concerned.

In all, an examination of the CPA casts doubt regarding the application of the Act to consumer protection concerns that could arise in MFS lending. The CPA may also need to be reformed to specify that it applies to other financial services and products. This will extend its application to conventional finance as well as including MFS and MC.

To enhance overall consumer protection in Kenya, and to specifically address consumer protection challenges and promote coherence in consumer protection and market conduct oversight, it is suggested that, as MNOs regulator, the Communication Authority (CA) should publicly commit to include in its mandate the need for consumer protection. Further, that the CBK, through its supervisory and oversight role, should ensure that it does what it can under existing statutory authority to ensure that existing consumer protection provisions are applied to new payment methods as well as novel products, such as MC.[82]

3.2.2 Credit Regulation

We will consider key legal provisions that are applicable to lending in an MFS context.

3.2.2.1 Prohibition against Lending

Of relevance to the MFS area are provisions that restrict lending activity. The NPSR prescribes that an e-money issuer, except an institution, shall not engage in any lending or investment activity other than that required under the regulations.[83] From this provision it is presumable that only e-money issuers who are institutions can lend. Further, institution according to NPSA[84] means

[82] Joy Malala, 'Consumer Protection for Mobile Payments in Kenya', KBA Centre for Research on Financial Markets and Policy Working Paper Series 16.
[83] NPSR reg 45.
[84] NPSA s 2 (interpretation).

a bank, mortgage finance company or a financial institution as defined in the Banking Act, or a microfinance bank as defined in the Microfinance Act, or any other body which the Minister may in consultation with the CBK declare to be an institution. This provision suggests that MC providers who do not fall within the definition of institution as stipulated, such as MNOs, but who issue e-money, are not permitted to engage in lending. It is perhaps due to this restriction on lending that the first MC product launched in Kenya was based on a model that involved partnership between a bank and an MNO. However, following this initial launch, other provider categories uncovered loopholes in the regulatory framework that enabled them to offer similar products. In further illuminating this point, the discussion that follows will consider several different models for the delivery of MC in Kenya.

3.2.2.2 Legal Challenges and Tensions in Mobile Lending

To understand the nature of legal challenges and tensions that MFS lending generates, we will examine the models under which MC is currently offered in Kenya. The models comprise partnerships that bring together different categories of providers from banks to non-banks, including MNOs and FinTech companies. These models include bank and MNO partnership, non-bank and MNO partnership, bank using MNO platform, and non-bank lending via smart phone apps.[85]

The first model we will consider is MC by Bank and MNO partnership. The initial MC product launched in Kenya was M-shwari. It is a product that combines mobile a savings account and a mobile credit account. This product is offered as a partnership between a licensed bank—Commercial Bank of Africa (CBA)—and an MNO, Safaricom. Due to the nature of the product, seeing as it delves into the realm of banking proper, the finance sector regulator (CBK) did not permit Safaricom to offer this product on a standalone basis. Consequently, the parties devised a workaround in the form of a co-

[85] For description of the MC models see Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25); For general discussion on MFS models, see Jeremmy O Okonjo, 'Convergence between Mobile Telecommunications and Financial Services: Implications for Regulation of Mobile Telecommunications in Kenya' (LLM Thesis, University of Nairobi 2013) 56-58.

branding and revenue sharing partnership to offer the product, M-Shwari. The partnership entailed customers opening accounts at the bank (CBA) and the MNO (Safaricom) providing the mobile platform to facilitate the operation of M-shwari.

In terms of the specific mechanics of delivery, on the MNO side, they provide access to the customer base and the mobile transaction data. On the bank side, they provide the algorithm that is used to make customer lending evaluations. Only the bank does the lending and the repayment risk and the losses resulting from any non-performing loans are borne by the bank. Loans are disbursed and repaid via the mobile money service (M-Pesa) platform. With regard to account opening, there is a departure from standard banking practise, as the normal KYC requirements that traditional banks have to comply with are not observed by the bank, which instead relies on the minimal KYC that the MNO performed at the point when the customer registered for an M-Pesa mobile money account. This is considered to be minimal as only the phone number and identification documents are collected. The accounts (savings and credit) thereby created are, from a regulatory perspective, deemed to be bank accounts.[86] Following the successful launch of M-shwari, other parties later launched similar products using the same model.[87] The interaction of the mobile accounts with other bank accounts is also notable. For most MC products, there is largely no connectivity with other bank accounts but some exceptions exist.[88]

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[86] For a detailed study on how M-Shwari works see Tamara Cook and Claudia Mckay, 'How M-Shwari Works: The story so far' (CGAP, FSD Kenya, April 2015) <http://www.cgap.org/sites/default/files/Forum-How-M-Shwari-Works-Apr-2015.pdf> accessed 14 October 2015; Mirzoyants-McKnight and Attfield, 'Value-added Financial Services in Kenya' (n 15); *InterMedia*, 'Digital Pathways to Financial Inclusion 2014 Survey' (February 2015) <http://finclusion.org/uploads/file/reports/InterMedia-FII-Kenya-2014-Wave-2-summary-report.pdf> accessed 8th February 2017.

[87] For example Kenya Commercial Bank (KCB) has a similar service called KCB M-pesa. It is the largest commercial bank in Kenya. By December 2015, it reportedly had an asset base of nearly USD 3.6 billion and USD 2.6 billion in customer deposits.

[88] Cook and Mckay, 'How M-Shwari Works' (n 86) <http://www.cgap.org/sites/default/files/Forum-How-M-Shwari-Works-Apr-2015.pdf> accessed 14 October 2015. KCB M-Pesa is an example of an exception where deposits can be made into an account from other KCB M-Pesa accounts or from a KCB branch.

The second model is MC by non-bank lender and MNO partnership. This model[89] is comparable to the Bank and MNO one, as it also leverages the mobile money service that the customer is already registered for, and MC is then offered as an add-on to this service. However, it is distinguishable from the first model by the fact that the lender is a not a bank. Lenders under this model are registered as non-deposit taking financial institutions.[90] Such a lender faces the constraint that they cannot offer savings products, for only licensed banks are permitted to engage in this activity and they fall outside the banking framework. It is also notable that CBK's oversight does not extend to this lender category as they do not take deposits. This is a critical weakness of the regime. Non-deposit taking (credit only) financial institutions in Kenya fall under the Microfinance framework and are considered to be informal, and their credit offering is largely unregulated in contrast to deposit taking microfinance banks that fall under CBK oversight. [91]

A third model is MC by non-banks via smart phone apps. Lenders in this category are exploiting the penetration of smart phones in the region and are employing smart phone applications (apps) to provide credit to consumers exclusively through mobile internet. It is reported that, as of 2015, use of smart phones had reached 19.4%, and it is projected that this number will continue to grow, so we can expect that with growth we will see many more people accessing MC offered under this model.[92] As these providers use the internet, they are able to by-pass channels such as SIM toolkit and USSD that are controlled by MNOs. Further, they have no formal relationship with the mobile money service providers, except for connections to facilitate loan disbursement and repayment.[93] We must also distinguish between the smart phones apps made available by banks and lending under this model, which is only available through mobile internet. Some banks offering MC make their

[89] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25).
[90] An example of such a product is Kopa Cash, which is offered as a partnership between Jumo (non-bank lender) and Airtel Kenya (MNO).
[91] Microfinance Act 2006 applies to non-deposit taking MFIs.
[92] GSMA, *State of the Industry Report: Mobile money* (2016) 32.
[93] Examples of mobile credit products offered using this model are those offered by Branch and Tala, both of which are deemed to be unregulated lenders falling outside the banking regulatory framework and CBK oversight. Note that they also operate in other jurisdictions in sub-Saharan Africa including parts of East and West Africa.

service accessible via smart phone apps in addition to mobile channels, but the difference is that they still rely on MNO controlled channels.[94] For non-bank MC providers in this category, they offer loans that are available only via an Android app. These apps sweep vast amounts of customer information from a prospective borrower's phone. The app permissions allow the collection of GPS data, contact information, call patterns, data from SMS and email, M-pesa data, social media activity including data from Facebook and Twitter. Following collection, the data dump is then evaluated using proprietary algorithms that are used to analyse the data, assess customer creditworthiness and determine disbursement amounts.[95]

The final model for MC provision entails a bank employing the MNO platform to offer MC. There is no partnership with the MNO or other mobile money service providers. The products offered under this model are arguably not MC products in the strict sense, as they do not embody the elements of mobile credit discussed at the outset.[96]

3.2.2.3 Reckless lending

Reckless or imprudent lending is a concern with the rise of digital lending. The Banking Act and the CBK Prudential Guidelines on Prohibited Business bars institutions from conducting their business in a reckless manner,[97] and there is a specific restriction against lending recklessly or negligently in the CBK Prudential Guidelines on Consumer Protection.[98]

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[94] For example in the case of a product called MCo-op Cash

[95] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25); Branch is reported to have disbursed close to 1 million USD of loans in its first 6 months of operations. Tala on its part reportedly disbursed almost 10 million USD of loans by end of May 2016. For further information on this see David Herbling, US-Based Mobile app Lends Kenyans Sh 1 bn Under One Year Business Daily (30 May 2016) <http://www.businessdailyafrica.com/US-based-mobile-app-lends-Kenyans-Sh1bn-under-one-year-/539552-3225328-isus4sz/index.html>; also see John Aglionby, 'Fintech Takes off in Africa as Lenders Tap Mobile Money Technology' *Financial Times* (17 May 2016) <https://www.ft.com/content/6f5453d6-1b69-11e6-8fa5-44094f6d9c46> accessed 20 October 2017; Lee Mwiti 'Why that Facebook Post May Give or Deny You a Loan' (Standard Digital 14 February 2016) <https://www.standardmedia.co.ke/business/article/2000191608/why-that-facebook-post-may-give-or-deny-you-a-loan> accessed 20 October 2017.

[96] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25).

[97] Banking Act s 11(1) (h) and CBK/ PG/ Prohibited Business 3.2.4 (a) and (b).

[98] CBK PG/Consumer Protection 3.2.1 (c) (ix).

"Reckless" includes—[99]

(a) transacting business beyond the limits set under this Act or the Central Bank of Kenya Act;

(b) offering facilities contrary to any guidelines or regulations issued by the Central Bank;

(c) failing to observe the institution's policies as approved by the Board of Directors; or

(d) misuse of position or facilities of the institution for personal gain.

The CBK has also stipulated guidelines for institutions detailing how they can ensure prudent lending. Institutions are required to carry out assessments that consider aspects such as: a consumer's general understanding and appreciation of the risks and total cost of the proposed credit agreement, and their rights and obligations under the agreement; debt repayment history for credit; and existing financial means. They are also to consider whether entering into the credit agreement would make the consumer over-indebted, and there is further guidance on how institutions can determine this. [100]

This aspect of reckless lending is important to examine because it links to a concern raised by the rise of High Cost Consumer Credit, namely predatory lending. Both of these are problematic for the regulation of financial services, because they could lead to mis-selling of credit. Though these two are linked, they are not the same thing. We would argue that it might be possible for an institution to act recklessly without being predatory. It is also possible for an institution to be both reckless and predatory. Even the CBK provision on prudent lending would not be appropriate to address this concern as measures prescribed to ensure prudent lending would be insufficient to address and restrict conduct that could be interpreted as predatory. We would interpret predatory lending as applicable to lending behaviour that unfairly targets and

[99] Banking Act s 11 (1) A.
[100] CBK PG /Consumer Protection 3.2.1 (d) on the assessment process; 3.2.1(e) explains when a consumer is considered to be over indebted.

exploits consumers who are vulnerable and includes misconduct that facilitates mis-selling. It would entail for instance the use of high pressure sales techniques, use of rollovers, and exorbitant Annual Percentage cost of loans. These are problematic as they often result in consumers being entrapped in a cycle of debt. Accordingly, the types of rules that would be suitable for addressing predatory conduct are those that target this kind of exploitative behaviour.

3.2.2.4 Credit Information Sharing Systems

Credit Information Sharing systems (CIS) are another important element in the delivery of traditional lending and also MC. In general, they are considered advantageous for financial markets. Where they work well, they can reduce the cost of borrowing, often minimizing information asymmetries between lenders and borrowers, as they provide lenders with objective information that can be used to determine their creditworthiness in a manner that is both efficient and cost effective, and thereby lower portfolio risks. CIS can also have a positive impact on financial inclusion, as a customer can borrow from a lender even where they have not had past dealings. It allows a customer to rely on the prior history of their repayment ability, which is accessible to reporting institutions under the CIS framework.[101] We would likewise argue that, because of the gains described, well-functioning CIS systems can also help to curb product risks, such as mis-selling in a lending context. A provider in possession of objective information about a borrower is more likely to make the best decision about how much credit to advance to them.

The framework for CIS in Kenya is found in the Credit Reference Bureau Regulations 2013 (CRBR). The current position is that the regulations are only applicable to institutions licensed by the CBK, which has the sole responsibility for regulatory oversight.[102] They are thus non-mandatory for certain MC

[101] International Finance Corporation, *Credit Reporting Knowledge Guide* (2012) <https://openknowledge.worldbank.org/handle/10986/21545>; World Bank *General Principles for Credit Reporting* (2011) <https://openknowledge.worldbank.org/handle/10986/12792> accessed 8 February 2017.

[102] The authorized users of credit reports issued by the licensed CRBs is restricted to institutions licensed under the Banking and Microfinance Act—this means commercial banks, mortgage finance

providers, such as those licenced as credit only MFIs, or providers lending via internet apps, unless falling within the exceptions which we highlight below.

The scope of CIS in Kenya falls into two main categories. One is the mandatory submission of data on NPLs. Under the regulations, it is a mandatory requirement for commercial and microfinance banks to report both positive and negative information relating to their entire loan books—that is, on their customers with CRBs—every month. In other words, they are obliged to share both up to date and overdue repayment data relating to borrowers.[103] The other category in scope for CIS is the voluntary sharing of positive credit information. The purpose of voluntary sharing was to allow for the inclusion of non-bank sectors as part of the CIS framework.[104] One of the direct benefits of including banks and non-banks was to reduce information asymmetries.

On the other hand, there is no mandatory requirement for non-bank lenders to report to the CRB. Instead, they have the option of electing to submit positive or negative data on NPLs, but this is subject to: (i) approval by the CBK; and (ii) receiving consent from a customer. Consequently, we can conclude that the CIS framework in Kenya does not impose similar reporting requirements on all the providers of credit. It would therefore apply only to MC products that are offered by banks on a mandatory basis. This means that other providers of MC may not report, as they are not obligated to. As a result, the benefit that was described at the outset regarding CIS frameworks helping to minimize information asymmetries may not be realized for all providers, and this in turn has an impact on the cost and availability of credit for consumers. The lack of uniform reporting requirements would also make the task of monitoring over indebtedness a challenge, as there are many institutions who are advancing credit but do not fall under CBK oversight. It is further possible to argue that the existence of these differences might encourage new entrants to develop

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companies, non-bank financial institutions, and microfinance banks and third parties with express authority from the customer.

[103] CBK, CRBR 2013 (CRBR) r 18.

[104] Gabriel Davel, Tshangwane Serakwane and Mark Kimondo, 'Kenya Credit Information Sharing Initiative-a Progress Report' (*FSD Kenya* February 2012) <http://ciskenya.co.ke/wp-content/uploads/2018/10/12-02-2013-KCISI-A-Progress-Report_2008-2011_Challenges-and-Opportunities.pdf> accessed 8 February 2017.

products that avoid these reporting requirements, in a bid to lower the cost of regulatory compliance for their business.

3.2.2.4.1 Shortcomings in Credit Information Reporting Systems and impact on Mobile Credit delivery

The key shortcomings within CIS relate to the lack of standardized rules for all providers of MC and, relatedly, the fact that some providers are not obliged to comply with CIS rules. This raises a number of concerns. One is whether to require all providers to report to CRBs. As customers in Kenya generally borrow from multiple sources, we can conclude that it is likely that some are borrowing from conventional lenders with mandatory CBK reporting obligations as well as from an array of other lenders who are not required to report to the CRB. Imposing uniform requirements would be advantageous, as it would bring previously excluded customers into the CIS system. We would further argue that imposing uniform CIS rules would give a more complete picture of a customer's debt level, as it would also bring previously excluded data into the CIS system. This would apply to customers whose data is not available through traditional providers, like banks, and who are advanced loans by lenders who rely on non-traditional data—for instance in the form of mobile money history or other smartphone data—to make lending decisions. As customers build a credit history over time, as a result of being brought under the CIS, it can be accessible, not just to non-traditional providers, but to the entire universe of lenders, including conventional ones, like banks. These lenders are then better able to make conclusions about the credit worthiness or otherwise of the borrower based on the available repayment history.

The creation of uniform reporting obligations for all providers will require reflection on what the appropriate rules should be. This may simultaneously present challenges. For instance, CIS frameworks traditionally cater for long term loans, with requirements for lenders to make periodic reports to the CRB, usually on a monthly basis. Adapting to a short term credit reporting environment might prove difficult, as some of these loans only last a few days and a customer can borrow multiple times in one month. Moreover, changing

the current practice to accommodate more frequent reporting might prove technically challenging. Regulators will need to consider how to design suitable rules, while at the same time trying to minimize the imposition of undue compliance burdens on firms. Perhaps the use of RegTech might be an avenue to explore to address this challenge.[105]

The CBK has also acknowledged that the operationalisation of the CIS framework has presented challenges in the form of data quality weaknesses, low uptake of credit scoring by banks, and negative public perception. To address these, they engaged the World Bank Group to provide Technical assistance, and have jointly been running a project aimed at reforming CIS.[106]

CBK has also reported that CRBs have taken steps to enrich the credit information database by collaborating with non-mandatory data providers. As of 31 December 2018, 2,118 third party data providers had been approved by CBK.[107]

3.2.2.5 Some Progress: regulatory initiatives relating to credit products

3.2.2.5.1 Launch of Total Cost of Credit website portal

In order to promote transparency in pricing of credit, CBK, together with the Kenya Bankers Association (KBA) developed an on-line website portal with the objective of providing information on lending rates and charges offered by licensed banks. The portal is designed to enable users to compare the price of credit from various banks.[108] The website portal specifically provides total cost of credit disclosure tools, including an Annual Percentage Rate (APR) Loan Calculator, the Repayment Schedule (RS), and the Total Cost of Credit

[105] RegTech is short for 'regulatory technology'. It comprises a subset of FinTech firms providing technological solutions to help financial institutions to comply with regulatory requirements efficiently and inexpensively. It uses data processing to allow firms to combine the objectives of meeting compliance requirements into business processes and that of improving their governance and management. Additionally, it is considered of benefit as it offers scalable solutions resulting in reducing entry barriers and firm costs.
[106] CRBR regs 23 (1) and (2); CBK, *Banking Supervision Annual Report* (2018) 43-45.
[107] CRBR regs 23 (1) and (2); CBK, *Banking Supervision* ibid.
[108] See <https://costofcredit.co.ke/> accessed 11 September 2019.

(TCC) schedule. This initiative was launched in an effort to promote transparency and enhance competition in the sector. The website features both a simplified and an advanced Total Cost of Credit calculator, which not only enables consumers to estimate the total cost of credit of bank loan facilities, but also provides the public with a list of five comparable loan options for their consideration. The portal was successfully launched on June 22, 2017 with a limited range of products to initiate engagement by the general public with the facility. As the usage of the portal slowly picks up, CBK and KBA have stated that they will continue to review its functionality with a view to enhancing consumer experience, and gradually introduce new products and features for enhanced comparison of products across the banking sector. The products that are currently in scope are: personal loans (both secured and unsecured), and mortgages. CBK and KBA monitored the operation of the portal in 2018 and, as part of this, a survey was conducted to assess uptake and usage, and to identify any challenges the project presented for banks. The survey results indicated that uptake was low, and the regulator has suggested that this might be improved if there was more publicity created about the portal's existence. The need to develop calculators for other products has also been acknowledged.[109]

As the above portal is for use by licensed banks, this creates a gap. This portal will no doubt add great utility to the financial sector and support CBK's regulatory and supervisory activity. We would argue, however, that it is also important to expand its use to non-bank credit providers as well. Another alternative is for the latter category to also launch a similar portal. This is especially important, given the setting in which credit is now being offered, that is, via mobile phones and even over the internet.

3.2.2.5.2 Disclosure of APR

There are also self-regulatory mechanisms that have been introduced by players in the banking industry that address consumer protection aspects of

[109] CBK, *Bank Supervision Annual Report* (2017) 16-17; CBK, *Bank Supervision Annual Report* (2018) 13.

MC delivery in the banking industry. KBA[110] agreed to disclose an annual percentage rate (APR) pricing mechanism framework that includes information on interest rates, bank charges and fees, and third party costs, in order to provide loan applicants with a rate that can be compared across banks. With effect from July 2014, all commercial banks in Kenya were obligated to disclose APR for loans as part of their required disclosure of total cost of credit.[111] Again, this initiative does not apply to non-bank providers of credit.

3.3 The current regulatory regime—risks, challenges and limitations

The risk society propositions (discussed in chapter 2), as exemplified by the experience of the GFC, provide important lessons on risk management and regulation. These should be borne in mind by financial firms and regulators in Kenya. Chiefly, this includes the need to understand risks in the sector, as well as the limits of risk measurement and control.

The overarching risk that we consider in this work is that of harm that the financial sector can suffer as a consequence of the lack of effective regulation. Ineffective regulation can create harm to consumers from loss of investment, for example, or, in the case of credit, harm can result from debt stress or over-indebtedness. Systemic risk and its effects can also generate harm to financial markets.

With a view to a greater understanding of the sector risks, we will examine risks and challenges that arise in the context of regulating mobile payments, as these intersect the regulation of mobile credit. This arises due to the nexus between mobile payments and MC. In the context of MFS provision in Kenya, Malala considers whether mobile payments have now become systemically important payment systems that need specific regulatory oversight. She argues that there should be a regulatory framework that considers the

[110] This is an industry group that brings together all commercial banks; See <https://www.kba.co.ke/> accessed 11 September 2019.
[111] KBA, *Banks Adopt Percentage Rate Calculation Method for Consumer Loans* <https://www.costofcredit.co.ke/site/news-article?id=1> accessed 11 September 2019.

consumer protection mandate specific to mobile payments due to the systemic importance of MNOs in the payments system in Kenya.[112] This view has been challenged by commentators who ask whether the failure of a mobile money scheme would have any systemic impact on Kenya's financial system. These commentators analysed data from CBK, comparing mobile money with other payment systems to establish the contribution of mobile money to the National Payment system in terms of value. The analysis revealed that, although the volume of transactions via mobile money is high, from a value perspective, the Kenya Electronic Payment and Settlement System (KEPSS) is more dominant. On this basis, they conclude that KEPSS is the systemically important payment system in Kenya, and that mobile money though important, does not pose systemic risk.[113]

We query this position, and are more inclined to support Malala's conclusion that MNOs are systemically important in Kenya's payment system. Our view is informed by an examination of the guidance form the Bank for International Settlements (BIS) Committee on Payments and Settlement Systems (CPSS) regarding the determinants of systemic importance. Although systems that handle high value payments are generally considered systemically important, other systems that do not handle comparable values but which have the capacity to trigger or transmit systemic disruption by virtue of certain segments of its traffic, can equally be considered as systemically important. The Committee further advises that the distinction between those payment systems which are systemically important and those that are not is a grey area, and central banks are asked to reflect carefully on where to draw the boundary.[114] It should be noted at this point that we are not asserting that

[112] Malala, *Law and Regulation of Mobile Payment Systems* (n 8) 11 and chapter 5.
[113] Claudia McKay and Rafe Mazer, '10 Myths about M-PESA: 2014 Update' (CGAP Blog, 1 October 2014) <https://www.cgap.org/blog/10-myths-about-m-pesa-2014-update> accessed 29 January 2020; See also GSMA, 'The Kenyan Journey to Digital Financial Inclusion' <https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2014/09/MMU_2014_Kenya-Pathway_Infographic_Web.pdf> accessed 29 January 2020— for comparison of mobile money volume vs. transaction value.
[114] BIS-CPSS 'Core Principles for Systemically Important Payment Systems' (2001) <https://www.bis.org/cpmi/publ/d43.pdf> accessed 29 January 2020.

KEPSS is not systemically important—it certainly is—but MNO's should also be considered as qualifying.

Systemic risks are said to have several major causes. These include 'Too Big To Fail' problems, and situations in which the provision of non-substitutional (infrastructure) services is affected.[115] With regard to the latter, we would argue that the mobile money payments infrastructure is relied on by a vast majority of market participants in Kenya. As mentioned at the outset, mobile money innovations have contributed immensely to the enhancement of financial inclusion in Kenya. Additionally, this infrastructure has also become vital for financial sector firms. When we consider the identity of the various providers of MC under the different models, it is notable that MNOs are involved in some way. They are providing MC either in partnership with bank or with non-bank lenders. The only exception is for those providers using apps. MC relies on the infrastructure of the mobile payments system in order to deliver the product. As explained before, the only providers who do not depend on its infrastructure are those who provide credit over the internet via lending apps. However, even for this category of lender, they still ride on the payments system to obtain alternative data on a potential customer. Given that the majority of lenders in Kenya depend on the payments system infrastructure, its stability is crucial, as the continued delivery of this product depends on the payments system remaining stable. In other words, mobile payments are the bedrock that supports the delivery of MC, and if the underlying infrastructure is not anchored on a stable regulatory framework, then delivery of the product can be hampered. Malala has urged that Kenya implement an appropriate legal framework to ensure the stability of the payments system in Kenya.[116] We would support this as well, especially in light of the ongoing innovations connected to MFS. The expansion of the customer base for MC also reinforces the need for enhanced regulation. Lenders initially offered small amounts, and it was largely seen as serving lower income groups in Kenya. The loan

[115] Peter O Mülbert, 'Managing Risk in the Financial System' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press 2015) 383. Author discusses additional causes.
[116] Malala, *Law and Regulation of Mobile Payment Systems* (n 8). See discussion on the legal and regulatory challenges of mobile payment systems.

amounts have since increased. This, coupled with ease of access, is driving greater uptake of these loans by other income groups, particularly the middle income classes in Kenya. This warrants regulatory scrutiny and action, as it may heighten the risk of systemic shocks from financial instability.

We will now discuss specific risks challenges and limitations of the current regime.

3.3.1 Product Specific Risks

Loan products typically present risks to consumers and lenders. For consumers, there is the risk of exploitation. It is suggested that consumers can collectively be likened to a classic commons, whereby every consumer is a potential source of revenue for different lenders, with individual lenders seeking to extract as much value from the same consumer. This may result in consumers being exploited and, where they take on several exploitative loans, this may push them to default. This informs the need for regulation. In the mobile lending environment, consumers are facing similar dangers of exploitation: hence the need for regulation.[117] For lenders, risks can emanate from consumer default. In traditional lending, lenders seeking to reduce the risk of default can look to credit reports that ordinarily capture information, including amounts borrowed, payment track record, and names of other lenders. Credit reports are imperfect, however. As the recorded information is a summary, it provides only a snapshot, and there is likely information that is omitted that could indicate the possibility of customer default that could only be derived by reviewing the actual loan contract. Inevitably, asymmetry persists between the different lenders, which may result in reaching incorrect judgements about consumer repayment ability.[118]

[117] Erik F Gerding, 'The Subprime Crisis and the Link between Consumer Financial Protection and Systemic Risk' (2009) 4 *Florida International University Law Review* 456.
[118] ibid 459. Credit reports may not capture contract clauses, such as complex interest rates, fees and penalties or other or unfavourable provisions that could push consumers towards default. This may be further complicated where loan contracts are non-standardized, which means terms vary for different borrowers.

Conventional lending presents a number of product risks, including over-indebtedness, mis-selling, and insufficient transparency and disclosure.[119] MFS/MC could exacerbate these risks.[120] MC raises a number of additional risks for consumers. Some of these may arise since the consumers it targets have had little or no access to formal financial services, or may be due to the nature of the product itself. One potential risk area relates to the ease of access of MC. Whereas this may be a boon from a financial inclusion standpoint, this easy availability, coupled with aggressive marketing techniques that have resulted in customers receiving targeted advertisements on their phones, may prove dangerous for borrowers who are inattentive and who may additionally not be financially savvy, as it might lead them to make impulse credit purchases. There are already reports of fears that some MC providers are shackling Kenya's poor in debt,[121] which points to worries about the development of an over-indebtedness crisis as a result of this type of lending.[122]

MC also presents further challenges that are linked to the nature of the product itself, namely credit. MC has been categorised under what is termed Short Term High Cost Consumer Credit (STHCCC).[123] It has also been shown to demonstrate aspects similar to payday lending. The risks generated by products under the umbrella of STHCCC are therefore similar. These risks to

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[119] See FinCoNet, *Report on the Digitalisation of High Cost Short Term Consumer Credit* (November 2017) for discussion on how to manage the risks brought on by Digitalisation of High Cost Short Term Consumer Credit.

[120] ibid 39.

[121] James Ngunjiri, 'Mobile Lending Platforms Shackling Kenya's Poor, Report Says' *Business Daily* (Nairobi, 26 October 2016) <http://www.businessdailyafrica.com/Mobile-lending-platforms-shackling-Kenya-s-poor--World-Bank/1248928-3431024-gaf9f5z/index.html> accessed 28 October 2016.The World Bank research affiliate CGAP argues that these mobile loans are expensive and hurt the needy; See also Brian Ngugi 'Suicide that Jolted CBK: Inside Plan to Rein in Digital Lenders' *Daily Nation* (Nairobi 18 February 2020) <https://www.nation.co.ke/lifestyle/smartcompany/Suicide-that-roused-CBK-digital-lenders-law-regulation/1226-5459554-15sjb5o/index.html> accessed 18 February 2020— Other worrisome concerns that have been raised include consumers reportedly committing suicide following harassment from digital lenders.

[122] Jessica Schicks, 'Microfinance Over-Indebtedness: Understanding Its Drivers and Challenging the Common Myths' (2010) Centre Emile Bernheim Working Paper No.10/047. <http://www.solvay.edu/sites/upload/files/CEB/CEB_WorkingPapers/LastUpdate/wp10048.pdf> accessed 10 February 2017 discussing the consequences over-indebtedness can have for borrowers and for other stakeholders; Jessica Schicks,'From a Supply Gap to a Demand Gap? The Risk and Consequences of Over-Indebting the Underbanked' (2011) Centre Emile Bernheim Working Paper No.11/046 <https://www.microfinancegateway.org/library/supply-gap-demand-gap-risk-and-consequences-over-indebting-underbanked> accessed 10 February 2017.

[123] FinCoNet, *Digitalisation of High Cost Short Term Consumer Credit* (n 119).

consumers from MC and connected products involve aspects like high cost, inadequate transparency of pricing terms, extensions and rollovers, multiple loans and cross-selling.[124]

These features may be known to the lenders but not consumers (information asymmetry), and, in some cases, lenders may have deliberately incorporated certain risky features into the products, often to exploit their customers and, in other cases, to hedge their risks in the event of customer default. In the Kenyan market, mobile credit products also exhibit a number of these risky features and some of these problems are already observable. For instance, it is reported that late repayment of digital loans has become widespread. Aside from rollovers and additional fees that these attract, they can also generate other negative consequences for borrowers.[125] For MC products, like M-Shwari, the balances held in the accompanying deposit account are frozen until the loan and fees are repaid. Additionally, the frozen balances cannot be accessed by a borrower to repay the loan as this is held as collateral. Further, the provider reserves the right to close a borrower's account for failure to repay within sixty days of disbursement.[126] Defaulters are also listed with CRBs for a period of five years.[127] In 2016, more than 400,000 Kenyans were listed in the CRB for outstanding loans of less than 2USD; these are suspected to be MC related.[128]

Problems may also arise where consumers lack understanding about the mechanics of MC. For example, qualitative research findings indicate that some consumers do not understand the implications of late or non-repayment.[129] Some wrongly believe that if they switch off their mobile phones,

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[124] FinCoNet ibid; Ngugi, 'Suicide that Jolted CBK' (n 121).
[125] See Michelle Kaffenberger Edoardo Totolo and Matthew Soursourian, 'A Digital Credit Revolution' Insights from Borrowers in Kenya and Tanzania (October 2018) CGAP, FSD Kenya Working Paper, 19-20; Authors state that 47% of digital borrowers have reportedly paid late.
[126] CBA, 'Terms and Conditions for the Opening and Use of the M-Shwari Account' <https://www.safaricom.co.ke/images/Downloads/Terms_and_Conditions/M-SHWARI_TERMS_AND_CONDITIONS.pdf> accessed 12 September 2019.
[127] CRBR reg 33 (1) A (listing durations) and 50 (reporting obligations of institutions).
[128] George Ngigi, 'Pain of Kenyans Blacklisted for Amounts as Small as Shs. 100 in Mobile Loans, Bank Fees' (Daily Nation, 9 September 2016); <https://www.nation.co.ke/business/Pain-of-Kenyans-blacklisted-for-amounts-as-small-as-Sh100/996-3374952-k2dkdvz/index.html> accessed 12 September 2019.
[129] Mustafa Zeituna and others, 2017 'Where Credit is Due: Customer Experience of Digital Credit in Kenya' Nairobi, Kenya: Micro-Save. <http://www.microsave.net/wp-

the MC providers will be unable to contact them and therefore will not list them with CRBs in the event of default. This suggests a lack of financial savvy and also a lack of appreciation of the far-reaching repercussions that could result from mobile borrowing. Customers of this kind fail to realise that mobile borrowing could affect future borrowing, and that this could even extend to traditional lending, as when customer credit history becomes accessible to conventional lenders through the credit reporting mechanisms in place and customers are later denied credit because of negative reporting.

Findings from qualitative research further suggest that the privacy and the absence of human interaction that underpins MC provision makes repayment a lower priority for borrowers in comparison to other loan types, where non-repayment or lateness would negatively affect their reputations. [130]

Other risks of MC are linked to system problems on account of the operational risks pertaining to the technology used. [131] The operation of MFS/MC is dependent on the quality of services offered by multiple parties as the telecommunications service and the financial provider are often different parties. The legal and regulatory framework needs to address these product related risks.

3.3.1.1 Financial product mis-selling risk

A look at global markets reveals that the problem of financial product mis-selling is a key risk for financial markets, and presents a recurrent problem that can have far reaching and harmful effects.[132] Mis-selling has been defined as "a failure to deliver fair outcomes for consumers", including providing consumers with misleading information or recommending that they purchase

content/uploads/2018/10/Where_Credit_Is_Due_Customer_Experience_of_Digital_Credit_In_Kenya.pdf> accessed 11 September 2019; it is noteworthy that credit-reporting requirements would only be applicable to regulated mobile lenders.

[130] ibid.

[131] Malala, *Law and Regulation of Mobile Payment Systems* (n 8) 83-87.

[132] The effects of financial mis-selling have been observed in various markets. Examples of mis-selling drawn from the UK illustrate the magnitude of the problem and include the mis-selling of collateralised debt obligations, mis-selling of Payment Protection Insurance, sale of Unregulated Collective Investment Schemes (UCITS) and mis-selling in respect of the sale of contingent convertible securities.

unsuitable products.[133] A number of different products have been the subject of mis-selling, ranging from insurance and consumer credit, to bank accounts and investments.

The GFC is informative if we want to understand the probability of this risk materialising in markets. A prominent example is the mis-selling of Collateralized Debt Obligations.[134] The sub-prime mortgage lending in the United States similarly arose from the same type of misconduct.[135] With regard to the latter, a combination of factors are identified as having contributed to the bust: (i) innovation led to the creation of some toxic products that ought not to have been sold; (ii) how the mortgages were sold exhibited aspects of predatory lending; (iii) Suitability concerns arose because of the persons the products were sold to; (iv) the large quantities of products that were sold magnified the problem and meant it had far reaching effects.[136] The Payment Protection Insurance (PPI) scandal in the U.K further illustrates the prevalence of this problem, and supports the need for closer regulatory vigilance. Ferran characterises the PPI scandal as the "stand-out systemic issue in retail financial markets" in the UK.[137] The FCA (and its predecessor the FSA) pursued compensation for consumers who were improperly sold PPI for years. They issued numerous enforcement notices targeted at errant firms[138] and, as

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[133] FSA, *Final Guidance: Risks to Customers from Financial Incentives* (January 2013).

[134] CDOs were innovations for risk diversification; See Ronald J Gilson and Charles K Whitehead, 'Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets' (2008)108 Columbia. Law Review, 231.

[135] Sub-prime mortgages were sold with inducements and without proper documentation to unsuspecting borrowers, often resulting in them owing more on the mortgage than the house was worth.

[136] John R Boatright, *Ethics in Finance* (3rd edn, John Wiley & Sons Inc 2014) 102—discussing toxic products in relation to the financial crisis.

[137] Eilís Ferran, 'Regulatory Lessons from the Payment Protection Insurance Mis-selling Scandal in the UK' (2012) 13 *European Business Organization Law Review* 247. The author examines the FSA's handling of the mis-selling scandal and to what extent it influenced a change in its regulatory approach, and whether, as a consequence, the UK is closer to finding regulatory solutions to clamp down on such problems; For a detailed discussion of personal pensions mis-selling see Julia Black and Richard Nobles, 'Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure' (1998) 61(6) *The Modern Law Review* 789.

[138] For examples of enforcement notices see: FSA final Notice to HFC Bank Ltd' (16 January 2008) <https://www.fca.org.uk/publication/final-notices/hfc_bank.pdf> accessed 10 May 2017; FCA final notice to Lloyds Banking Group (4 June 2015) <https://www.fca.org.uk/publication/final-notices/lloyds-banking-group-2015.pdf> accessed 10 May 2017; FCA final notice to Alliance and Leicester (6 October 2008) <https://www.fca.org.uk/publication/final-notices/alliance_leicester.pdf> accessed 10 May 2017.

of February 2017, repayments totalling 235.3 million pounds had been made.[139]

The detrimental effects of financial product mis-selling are three-fold. It is injurious to consumers who suffer harm when they purchase inappropriate products. Further, it dampens public confidence in the financial sector and in regulators and public bodies. Finally, it poses a risk to financial stability.[140] It is on account of these effects that we ought to be concerned about it, and regulator attentiveness is required to identify and address it. In terms of how to identify mis-selling risks, a number of circumstances can contribute to it, including weaknesses in a firm's internal governance structures, poor product design practices, firm behaviour (comprising facets like bonus structures), cultural norms and aggressive sales processes that foster or permit it, market forces that steer managers towards attainment of short-term sales, and ineffective regulation.[141]

Mis-selling is a potential risk area for the Kenyan market as well, and we argue in this work that, given the nature of MC, the likelihood of it being mis-sold is heightened. The recommendations made in this thesis are aimed at targeting this risk as well.

3.3.2 Architecture challenges

3.3.2.1 Regulatory Overlap

The prior examination of the regulatory architecture revealed that we have multiple regulators with different roles and responsibilities. The existence of a multiplicity of regulators operating in a sector often results in regulatory

[139] See FCA website for reports on monthly PPI funds and compensation <https://www.fca.org.uk/consumers/payment-protection-insurance/monthly-ppi-refunds-and-compensation> accessed 10 May 2017. The repayments have been ongoing since January 2011.
[140] National Audit Office Report, *Financial Services Mis-selling: Regulation and Redress* (24 Feb 2016) 17.
[141] ibid 14.

authority being dispersed, and generates relationships of interdependence negotiated between the various actors.[142]

The rise of new innovations, like MFS, that do not conform to conventional banking raises questions about who should regulate, or, in the case of shared regulatory responsibility, who should assume the role of lead regulator,[143] and what roles the others will assume. Advancements such as MC reinforce the need for a clearer definition of roles.

As was explained before, the powers of the CA under the current framework applicable to MNOs is restricted to licensing of entities in the communications sector.[144] Regarding the pre-requisites for such licensing, all the MNO has to do is list the services in their license agreement. The challenge this presents from a regulatory perspective is that CA powers do not extend to financial services and, if the MNO provider included MC (or other financial product) as a service in their list, then this would create regulatory inconsistencies resulting from traditional separation. The traditional separation existed because telecommunications and financial services (payments) were regulated under separated regimes, the former by the CCK (now CA) and the latter by CBK.[145] The emergence of the mobile payments system and mobile money, and now additional products including MC means that the provision of MFS is being conducted in an interconnected space where the convergence of financial services and mobile financial services has created regulatory overlap.[146] Such overlap creates challenges and may express itself in the form of 'turf wars', which arise as each regulator attempts to define the reach of its jurisdiction, as in the case of cross-sanctioning.[147] In the MFS context, the

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[142] Colin Scott 'Analysing Regulatory Space: Fragmented Resources and Institutional Design' (2001) *Public Law,* 327 <https://researchrepository.ucd.ie/bitstream/10197/6785/2/AnalysingRegSpace.pdf> 20 September 2019.
[143] Michael U Klein and Colin Mayer, ' Mobile Banking and Financial Inclusion: The Regulatory Lessons (2011) World Bank Policy Research Working Paper No. 5664<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1846305>accessed 20 September 2019.
[144] Licensing comprises-telecommunications, postal/courier and broadcasting systems and services.
[145] Malala, 'Consumer Protection for Mobile Payments in Kenya' (n 82)16.
[146] Okonjo, 'Convergence between Mobile Telecommunications and Financial Services' (n 85) 108-113.
[147] Scott 'Analysing Regulatory Space (n 142) 283.

CBK has emerged as the chief regulator and the CA has been more passive.[148]

It is important to address weaknesses in the architecture to support the delivery of regulatory objectives and responsibilities. This will entail a clear definition of roles and responsibilities. Additionally, regulators will need to co-ordinate to effectively address sector wide issues where they have overlapping mandates, such as in consumer protection or competition.[149]

Another challenge in respect of regulatory responsibility is the fact that Kenya does not presently have a single regulator for its non-financial institutions that perform financial functions.[150] This may yet be remedied by reforms in the pipeline that propose the establishment of a Financial Markets Conduct Authority.[151] The Authority is to have oversight over both regulated financial institutions and non-financial institutions performing financial functions (including MNOs and Fintech firms) for issues related to market conduct.

A different approach with respect to the architecture that the Kenyan regime may want to consider is that of having a separate payment systems regulator, as in the UK. In April 2015, the FCA established a separate body called the Payment Systems Regulator (PSR).[152] The goal of the PSR is stated as being "to promote competition and innovation and to ensure payments systems are operated and developed in the interests of the people and businesses that use them."[153] Their regulatory mandate extends to monitoring, investigations and the enforcement of designated payments systems. In this regard, they coordinate with other regulators and competition authorities, including the

[148] Okonjo, 'Convergence between Mobile Telecommunications and Financial Services' (n 85) 109-110.
[149] Klein and Mayer 'Mobile Banking and Financial Inclusion (n 143).
[150] Malala, 'Consumer Protection for Mobile Payments in Kenya' (n 82)139; Nzomo Mutuku, 'Case for Consolidated Financial Sector Regulation in Kenya' (2008) Retirement Benefits Authority <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1837354> accessed 20 September 2019.
[151] See chapter 4 in the thesis.
[152] Financial Services (Banking Reform) Act 2013 s 40.
[153] PSR, 'Why we Regulate' <https://www.psr.org.uk/payment-systems/who-we-regulate> accessed 20 September 2019.

Bank of England, PRA, FCA and CMA, to help them achieve their goals and have MOUs in place with them.[154]

This might be an approach to consider with regard to adequately addressing the challenges to stability and consumer protection brought about by payments systems in Kenya. Having a central body responsible for regulating and supervising is worth contemplating in view of the systemic importance of payment systems in Kenya. Such a body might be tasked with *inter alia* oversight over products that rely on the infrastructure of payments systems, such as mobile money, mobile credit, mobile insurance and other future deployments.

3.3.3 Challenges emerging from shortcomings in legal and regulatory scope

3.3.3.1 Lack of Uniformity in rule application

A key weakness in the regime is the lack of uniform application of existing legal provisions. The examination above demonstrates that there are existing consumer protection provisions in dedicated legislation (the CPA), while others are to be found scattered in legislation applicable to banking, payments, competition, and telecommunications regimes. These provisions do not apply to all credit providers uniformly, although the product is basically the same. With regard to product regulation, treatment from a regulatory perspective, and specifically the applicability of rules, is dependent on whether a provider is caught by specific regulation, and the relevant regulator has authority or can be construed to have oversight over a particular provider.[155]

This presents challenges. In the specific case of the offering of MC, one challenge entails MC being accorded different treatment, in comparison to conventional lending. The upshot is that this might result in many providers (including regulated banks) opting to focus on this kind of lending, to escape more stringent requirements (arbitrage). Relatedly, rules under certain

[154] PSR, 'Working with other Regulators' <https://www.psr.org.uk/how-psr-regulates/working-other-regulators> accessed 20 September 2019.
[155] Such conclusions can be reached on the basis of provisions that tacitly confer authority.

frameworks may be seen as being more permissive and providing added room for flexibility, for instance, the NPSA.[156] Also significant is the fact that, even where similar rules apply to the same category of provider, they may still face disparate treatment. More established providers may be accorded greater leeway to launch new innovations, as they are often deemed lower risk.[157] This may be explained by regulator assumption that they have sound internal controls in place. However, as we saw with the GFC, even established firms may misjudge or alternatively not fully comprehend the risks their products pose.[158]

Further, our analysis reveals that some provider categories are not caught by the existing framework. This is specifically the case for non-bank providers who deliver credit using smart phone apps. The banking, payments and telecommunications regulatory frameworks are not applicable to them. However, there are consumer protection rules that could potentially be construed as applying to them. These are those that have an economy-wide reach, such as those in the Competition Act.[159] Even then, we would argue that these provisions do not adequately address the risks posed by a product like MC due to its distinctiveness.

In the current environment, which lacks uniformity, this has an impact on whether a consumer will be treated fairly or not. It will depend on the provider that the consumer purchases the product from and the legal regime applicable to that provider. Consequently, the rule application challenges raise several questions for regulatory consideration. Regulators need to contemplate whether to have similar consumer protection provisions across all providers and models. On this aspect, our view is that there is need for standardization. This will help create a more level playing field and also minimize complaints from other providers about more onerous requirements being imposed on them. Secondly, it will hinder the occurrence of regulatory arbitrage,[160]

[156] Sarah Ombija, Interview with Respondent 2 (2019).
[157] ibid.
[158] Discussed in chapter 2.
[159] Competition Act, Part VI.
[160] Okonjo, 'Convergence between Mobile Telecommunications and Financial Services' (n 85) 108-113.

whereby providers exploit loopholes and develop innovations using business models in which rules are non-existent, or where provisions exist that are more lax or are not strictly enforced. Such models would, in turn, likely offer inadequate protection for MFS and MC customers. We further argue that more lax frameworks, or where there is an absence of governing rules, would enable mis-selling of financial products like MC.

3.3.3.2 Fragmentation

Kenya's financial sector regulation has been argued to be fragmented.[161] The fragmentation in the current legal framework for finance, which includes MFS and mobile payments,[162] poses challenges because of the complexity it introduces. The consideration of the various applicable laws that was undertaken reveals that it is often unclear what provisions apply to which provider in this converged space. There is an urgent need to manage this complexity, especially in view of arguments proffered by scholars, who argue that regulatory complexity should be seen as a source of systemic risk.[163] It is suggested that when regulations are complex, it is more difficult for market actors to understand what is proscribed or permitted, and the means for obtaining the best-compliance outcomes.

Another concern is that, because regulators tend to be as boundedly rational as market participants, they are as equally challenged as market participants by rule complexity. As a result, they may ultimately develop compliance heuristics (shortcuts) to evade complexity and simplify monitoring processes.[164] On this basis, it may be possible to understand Kenya's more lax regulatory response to the launch of innovations in mobile payments, particularly at inception, as a manifestation of the adoption of compliance

[161] See generally Radha Upadhyaya, 'Analyzing the Sources and Impact of Segmentation in the Banking Sector: a Case Study of Kenya' (PhD thesis, University of London, School of Oriental and African Studies 2011).
[162] As discussed in the section on regulatory scope.
[163] Emilios Avgouleas, 'Regulating Financial Innovation' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press 2015) 685.
[164] Emilios Avgouleas, 'Cognitive Biases and Investor Protection Regulation: An Evolutionary Approach' (September 2006), unpublished paper, available at <http://ssrn.com/abstract=1133214> accessed 20 September 2019.

heuristic to address the new environment that was inadequately understood, and which did not fit neatly into the regulatory framework that was in place at the time. It is also cautioned that, as a consequence of regulatory group-think, the opportunity to test the potential erroneousness of these compliance heuristics might only arise in the follow up to a crisis.[165] Regulators should be mindful of this and do their best to uncover erroneous heuristics prior to the development of crises.

3.3.4 Rule Design Problems

According to Black a rule can be vague or its meaning obscure even where there is common acceptance of the meaning of a word it employs.[166] This is because there may be instances where it is unclear whether it applies to a particular object or arrangement. For example, one of the gaps identified in examination of the national framework governing the provision of MFS relates to questions that revolve around whether a particular activity falls within the ambit of banking.

3.3.4.1 Shadow Banking

We are increasingly seeing non-traditional firms offering innovative financial products and services. Some of the biggest players in this area are technology firms and telecommunications companies. They offer products such as payments and money transfer platforms, digital currencies, and credit extension, which are offered either on a standalone basis or in partnership with regulated entities like banks. Their emergence has created further complexities in the financial services market, and their operations generate externalities that will continue to require regulatory intervention. The main purpose of regulation in the case of externalities is to compel the producer or consumer to bear full costs of production, rather than pass them on to third parties or society. Addressing externalities in the financial markets can help curb potential systemic problems.

[165] Avgouleas, 'Regulating Financial Innovation' (n 163) 685.
[166] Julia Black, *Rules and Regulators* (Clarendon Press 1997) 23.

Additionally, and from both a domestic and global perspective, concerns continue to be voiced about the rise of shadow banks. In this regard, debates abound relating to how their activities should be regulated, given that for the most part these institutions—although engaging in bank-like activities—are generally not subject to the same level of regulatory and supervisory requirements imposed on banks, and largely operate outside the regulatory perimeter, without a support mechanism against risks like liquidity runs. This role is often taken up by Central Banks, which function as lenders of last resort in the formal banking sector.[167] It is recognised that the shadow banking sector, market infrastructures, market participants and financial instruments can all pose a significant systemic threat to domestic (and transnational) financial stability. In view of this it is recommended that the macro-prudential policy toolkit also encompass tools for the entire financial system—including areas that fall outside the perimeter of the regulatory radar.[168]

In the absence of an appropriate legal framework that addresses risks from regulated and unregulated providers (shadow banks), we might end up with a market for lemons. This could lead to adverse selection, whereby the bad providers drive out the good, and eventually only unscrupulous providers are left in the sector. Akerlof attributed the rise of a market for lemons to information problems that result in buyers being uncertain about the quality of products in a market.[169]

An adequate response would entail focusing, not just on regulated activity, but also shadow banking activity. The grey areas present risks and knowable uncertainties, and need to be addressed to ensure the continued safety and soundness of the financial sector and the protection of consumers. While this thesis highlights shadow activity in MFS/MC, the broader question regarding how to regulate other categories of shadow banking activity in Kenya is also

[167] For a discussion of shadow banking in the context of financial innovation see for example Avgouleas, 'Regulating Financial Innovation' (n 163) 672-675.
[168] Rosa Lastra, 'Systemic Risk and Macro-Prudential Supervision' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), The Oxford handbook of Financial Regulation (Oxford University Press 2015) 317.
[169] George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', *Uncertainty in Economics* (Academic Press 1978) 235.

an important one to address. The latter question bears reflection, but is beyond the scope of this thesis.

3.3.4.1.1 Who is a bank, and what is 'banking business'

One of the key pieces of legislation that is of relevance for the financial services sector is the Banking Act. It prescribes what banking business is,[170] as well as the persons who can carry it out.[171] However, it is challenging to apply these provisions to financial service providers in the current environment who engage in activity that can be described as banking business, but are not banks (including MNO and other non-bank financial institutions—NBFIs).

Indeed, the MNOs in Kenya avoided being classified as 'banks', as they were interpreted as not falling within the definition of bank provided in the Banking Act and not carrying out banking business.[172] One of the key aspects in the definition relates to the taking of deposits, which MNOs arguably do in the form of stored value payments. There remains a lack of clarity on whether these are deposits, and this has created a gap in which MNOs can carry out 'banking business', without meeting the prescribed requirements, such as licensing and capital adequacy.[173] This gap is widening, with the rise of Fintech companies who are not considered payment service providers, and would also not be considered banks, (on the strength of the interpretation that was applied to MNO activity) but nonetheless can be argued to be engaging in banking business, as they offer digital/mobile credit. Under the current legal framework

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[170] Banking Act s 2(1).
[171] Banking Act s 3.
[172] The CBK Act defines a bank as follows—"bank" means a body corporate or other body of persons, carrying on, whether on their own behalf or as agent for another, banking business within the meaning of the Banking Act, whether in Kenya or elsewhere; Gerald Nyaoma, 'Mobile Payments Regulatory Framework Perspectives in Kenya' (2010) <https://www.efina.org.ng/wp-content/uploads/2018/12/Mobile-Payments-Dissemination-Workshop-CBKG-Arita-Presentation2.pdf> accessed 16 November 2018.
[173] Malala, 'Consumer Protection for Mobile Payments in Kenya' (n 82)145-149; Ragnar Gudmundsson, Kethi Ngoka-Kisinguh and Maureen T Odongo, 'The Role of Capital Requirements on Bank Competition and Stability: The Case of the Kenyan Banking Industry' (2013) 02/2013 <https://www.kba.co.ke/downloads/Working_Paper_WPS_05_12[2].pdf> accessed16 November 2018; Claudio E Borio and Renato Filosa, 'The Changing Borders of Banking: Trends and Implications' (1994) BIS Working Paper No 23 <https://www.bis.org/publ/work23.pdf> accessed 16 November 2018; Mark Pickens, David Porteous and Sarah Rotman, 'Banking the Poor via G2P payments' Focus Note 58 (*CGAP-DFID* December 2009). <http://documents.worldbank.org/curated/en/534801468154783011/pdf/566240BRI00Box353729B01PUBLIC10FN58.pdf> accessed 16 November 2018.

non-bank financial institutions (NBFIs) are permitted to offer financial services, such as currency and payment services, without being construed as carrying out banking services as defined. However, the challenge is that the Kenyan legal framework has a limited characterisation of MNOs—they are defined as telecommunications firms that are authorized to offer payment services. They are only categorised as payment service providers or mobile payment service providers as defined under NPS framework,[174] and not as NBFIs. There is a further limitation in this definition, in that in the original construction, MNOs (and payment systems providers in general) were seen as a conduit for funds, and therefore, arguably not taking deposits. The diversification into lending by MNOs and NBFIs, no doubt further muddies the waters and underscores the need for clarity of definition.

The question of the appropriate definition should take into account the changed (and evolving) nature of banking business, from its initial conception to the present day. In the course of this change, not only has the range of services provided by banks increased, but banks are progressively being side-lined. This is happening both as they lose their monopoly over the provision of services that were traditionally only provided by banks, and NBFIs gain ground spurred on by financial sector technological innovation.[175] This matter of what comprises 'banking business' (and indeed financial intermediation in general) remains unsettled, but a new understanding of the parameters of banking is necessary in order to appropriately address risks connected to banking and bank-like activity. Common law may kick in to fill in any statutory gaps in terms of definition,[176] but even in the context of English law, which has been adopted and integrated into Kenyan law, there is no comprehensive definition of what banking entails.[177] Therefore, it is asserted that there exists a gap between

[174] Defined in NPSA s 2 and NPSR reg 2.
[175] Rhys Bollen, 'Recent Developments in Mobile Banking and Payments' (2009) *Journal of International Banking Law and Regulation* 454; Alan L Tyree, *Banking Law in Australia* (Butterworths 1998); Joy Malala, *Law and Regulation of Mobile Payment Systems: Issues Arising 'Post' Financial Inclusion in Kenya* 145-146.
[176] Joan Wadsley and Graham Penn, *Law Relating to Domestic Banking* (2nd edn, Sweet and Maxwell 2000) 91. Indeed Kenyan jurists often rely on common law to guide them in the interpretation of Kenyan law, where the latter may be deficient, e.g., in terms of clarity, or where there is a legal gap.
[177] This started as a by-product of the colonisation process, and the transplantation has continued over time, e.g., where aspects of English law are adopted to aid interpretation where there are gaps in existing law or where aspects are adopted as a basis of best practice standards.

banking law and practise, and it is argued that what constitutes banking business remains a matter of fact, not law.[178] This gap manifests itself once again in the face of innovations in MFS in Kenya, including mobile payments,[179] and, of significance to this thesis, MC.

Another area of concern is the lack of a formal definition of MC. This is an important issue as it informs the regulatory approach to be adopted. This absence is of concern because, not only does it affect how the product is treated from a regulatory perspective, it also raises a fundamental question: who regulates MC, and how should it be regulated? This classification issue goes beyond trying to agree on a definition. It also relates to questions such as whether this product is to be categorised as micro-lending or whether it is an add-on to mobile money services. We start to see that classification has important implications, as it shapes the regulatory approach to be adopted. It is notable here that micro-lending in Kenya is overseen under a different legal framework, and the finance sector regulator has no oversight over micro-lenders from a prudential perspective, except where they take deposits.

We would further argue that classifying this as micro-lending, and therefore perhaps lower risk, is limiting and does not show a recognition of the potential growth of this innovation and the kinds of risk that it could present to the financial market (including to consumers). As we can expect that MC will enjoy a trajectory of success similar to mobile money services, and as more people access this product, it becomes significant to the financial services regulator, from a prudential perspective.[180] Already in Kenya, it is reported that the number of mobile accounts linked to the mobile savings and credit accounts has already surpassed the number of traditional accounts that banks have in their books. As such, we can appreciate the kind of money we are talking about

[178] Leon Perlman, 'Legal and Regulatory Aspects of Mobile Financial Services' (PhD thesis, University of South Africa 2012). He argues that the nature of such business must in case be a matter of fact, and, accordingly cannot be treated as if it were a matter of pure law; Malala, 'Consumer Protection for Mobile Payments in Kenya' (n 82) 145-148; Robert Chorley, Law of Banking (6th edn, Sweet and Maxwell 1974) 23—asserts the impossibility of coming up with an all-embracing definition for banking.

[179] The Banking Act at s16 (2) defines a deposit taking business as one that takes deposits and lends part or all of the money received on deposit.

[180] There is also the more general risk to the financial sector resulting from the lack of oversight over the monies circulating in the country from external sources.

here. The upshot is that an insistence on categorising this as micro-lending will result in a significant section of the financial market not getting adequate oversight. In our view, this product should not be classified merely as micro-lending. This is because, even though the individual amounts might seem small, when taken cumulatively, they represent large amounts. We must also consider what these seemingly small amounts represent, especially for individual poor households living on meagre incomes. Regulators should also bear in mind lessons from the GFC with respect to the treatment of seemingly low risks, especially in the context of the application of approaches like RBA. Low risks can go unnoticed, but can build up to cause systemic events.[181] The seemingly small amounts, may be seen by some as low risk now, but we assert that attention needs to be paid to them for the aforesaid reasons.

When thinking about classification, another issue that is debated is whether MC should be looked at merely as a new development in the area of banking and microcredit products, or indeed as a value added service to mobile money services, including bulk payment, bill payment and international remittances. Commentators have pointed out that, since MC has key differences from traditional banking and microcredit products, it should be looked at as a different product and a different approach should be applied to its regulation.[182] Furthermore, that it cannot be viewed as a mere value add to mobile money services, because MC products can be delivered independently by providers who are neither MNOs nor mobile money service providers.[183] We support the view that MC has unique features and introduces novel regulatory questions to this rich area of MFS provision, and would therefore advocate for the tailoring of a specific approach.

The weakness that can be summarised from the discussion is that there are a number of institutions that are offering MFS, including MC, which do not fall

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[181] Julia Black, 'Learning from Regulatory Disasters', LSE Law Society and Economy Working Papers 24/2014, 10 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2519934> accessed 20 November 2018.

[182] They argue that consumer borrowing via digital platforms is different, and hence the need for tailored regulatory rules. See Rafe Mazer and Alexandra Fiorillo, Digital Credit: Consumer Protection for M-shwari and M-pawa Users (*CGAP*, 24 April 2015) <http://www.cgap.org/blog/digital-credit-consumer-protection-m-shwari-and-m-pawa-users> accessed 8 May 2017.

[183] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25).

within the definition of "bank", as prescribed under the Kenyan legislation, although they engage in banking business. Even where they are regulated, as in the case of MNOs, which are regulated by the Communications Authority in respect of their telecommunications business, this supervisory authority has no mandate and likely no capacity to oversee financial services related activity. As such, it would not be able to adequately oversee these types of activities. Furthermore, for MNOs, whereas the CBK supervises their payments activity, this is not categorised as banking, which means their risk treatment is different, which may pose a risk for financial stability and integrity.[184]

3.3.4.1.2 The scope of payments instruments

The definition of payments instruments in the NPSA is also imprecise in our view. Payment instrument is defined as "any instrument, whether tangible or intangible, that enables a person to obtain money, goods or services, or to otherwise make payment."[185] It is unclear whether MC can be interpreted as being covered by this definition, that is, whether they are payments instruments to which the Act could apply.

In our view, it may be possible to make the argument that MC is an instrument (accessible via mobile payments systems like M-pesa), as it is intangible and, moreover, enables consumers to obtain money–on credit. If this is the case, then it would bring this product under the purview of the CBK for purposes of regulation.

The European Central Bank recognises that payment instruments and schemes are a vital part of payment systems. The ECB list cards, credit transfers, direct debits and e-money as non-cash payment instruments with which end users of payment systems transfer funds between accounts at banks or other financial institutions.[186] The inclusion of e-money and credit

[184] On financial stability and integrity risks relating to MNO and payments systems see generally Malala, 'Consumer Protection for Mobile Payments in Kenya' (n 82) chapter 3.
[185] NPSA s 2.
[186] ECB, Payments Instruments <https://www.ecb.europa.eu/paym/pol/activ/instr/html/index.en.html> accessed 18 November 2018.

transfers in this list could support the prior argument that MC could be construed as falling under the category of payment instruments.

3.3.5 Data Protection Risks

At the commencement of this research, Kenya lacked a comprehensive law on data protection. However, there was a draft Bill that had been discussed for several years, and had gone through several iterations. This absence of this law was a significant shortcoming in this regime, and with the rise of MFS and MC, the data related risks were especially exacerbated as product and service delivery in this environment is even more dependent on digital data. In the absence of specific legislation, reliance was placed on a patchwork of provisions found firstly in the constitution that guarantees the right to privacy,[187] and also in other laws that stipulated broad provisions that could be construed as applicable to the MFS environment, which would include MC.[188] Significantly, the Data Protection Act was finally signed into law in November 2019.[189] While it remains to be seen how this law will be enforced to ensure protection for data subjects—including those in the finance sector—it is undoubtedly a much anticipated and welcome development.

To ensure protection for data subjects, regulators should keenly monitor the activities of financial service providers to determine whether they are complying with the new rules. Providers in the MFS and MC sector are collectors and processors of vast amounts of consumer data and this presents opportunities and risks. Data collected comprises transaction value or loan amount, identifying information for the payer and payee, time and date of transaction, geographical location, purchases made. These types of data can be referred as transactional data—this is data that relates to the transaction

[187] The Constitution of Kenya 2010 art 31(c) provides that every person has the right not to have "information relating to their family or private affairs unnecessarily required or revealed" and article 31 (d), the right not to have "the privacy of their communications infringed".
[188] These provisions largely apply to banking and financial services as well as telecommunications and are to be found in up to 14 different pieces of legislation.
[189] Data Protection Act 2019 <http://kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/2019/TheDataProtectionAct__No24of2019.pdf > accessed 30 January 2020—its commencement date was 25 November 2019.

and what can also be accessible through the mobile device. Considering the large amount of data they collect and process, providers in mobile finance pose a huge risk to consumer data privacy, whether as consequence of data breaches or in the event of provider misuse of personal data.[190] From a global perspective, wider controls are being urged for large tech companies like Facebook, Google and Amazon. The recent Facebook scandal in connection with Cambridge Analytica highlights the need for strong legal protections as a result of the risks that technology can present for consumers in the digital age.[191]

The data collected is used for various purposes. However, one of the most interesting developments concerns providers of MC using non-traditional data to make lending decisions. It is also noteworthy that alternative data scoring has become one of the main Fintech businesses, along with alternative data for identity checking (eKYC).[192] This development may be considered to be radical because it offers a solution to the problem of obtaining a credit history, as well as providing a more efficient method for undertaking KYC checks. There are two main categories that will be discussed here, and they present different challenges for regulators.

The first category are lenders who rely on MNO held data and have access to this data based on agreements or partnership with an MNO. MNOs are a particularly rich source of non-conventional data, which is collected from: (a) a customer's mobile phone subscription history (including their airtime purchase, call times, airtime extended by credit); and (b) mobile money transaction history (payments, transfers, bill pay). This information has proven of value for determining consumer credit risk as it tracks data on payment commitments, frequency and amount of cash flow, and extensiveness of social

[190] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25).
[191] Carole Cadwalladr and Emma Graham-Harrison, 'Revealed: 50 Million Facebook Profiles Harvested for Cambridge Analytica in Major Data Breach' *The Guardian* (17 March 2018) <https://www.theguardian.com/news/2018/mar/17/cambridge-analytica-facebook-influence-us-election> accessed 20 November 2018.
[192] Gregory Chen and Xavier Faz, 'The Potential of Digital Data: How Far Can It Advance Financial Inclusion?' (CGAP Focus Note 100 January 2015) <http://www.cgap.org/sites/default/files/Focus-Note-The-Potential-of-Digital-Data-Jan-2015.pdf> accessed 10 February 2017.

network. MNOs currently treat this data as proprietary and are not obliged to share it with other lenders, save for cases where there is an agreement with a specific providers. In Kenya, the MC models that leverage MNO-held data are bank and MNO partnership, and MNO and non-bank lender.[193]

In terms of opportunities, this is a clever work-around for lenders with no prior relationship with a customer (first time lending) and with no access to CRB data. With regard to risks, we would argue that the use of non-traditional data in MC, including for making lending decisions could introduce a mis-selling risk. Where it is the only data source relied on by a lender, for example those lenders who do not have access to CRB data, then there is the risk that what they are using is an incomplete customer profile that might also contain errors. It is important to note here that, since this is data that is not subject to legal reporting requirements, there are no measures in place to ensure its accuracy or completeness (for example, opportunities to review, challenge and correct), as specified under the CIS framework. Consequently, a lender placing their full reliance on this data could make wrong/unfavourable decisions and this would result in unfair outcomes for customers, whether it is advancing them loans they do not actually qualify for and might have difficult repaying (which could be argued to be mis-selling), or denying them loans that they would qualify for with the full information in hand. Denial of MC without full information could mean that some customers remain excluded from accessing financial services, thereby frustrating policy-based efforts to increase financial inclusion.

International best practice that addresses some of the issues raised by the use of big data in credit assessments can be drawn from the example of the United States Federal Trade Commission (FTC).[194] The U.S Fair Credit Reporting Act requires consumer reporting agencies (CRAs) who collate or sell consumer reports employed for credit and other decisions, to put in place procedures that guarantee the utmost accuracy of these reports and give consumers the

[193] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25).
[194] ibid.

opportunity to correct any errors.[195] Further, the FTC explained that companies that collate non-traditional data, such as from social media, would be viewed as CRAs and hence these provisions would be equally applicable to them.[196] Other firms to whom the FTC provisions apply are those who access and employ the reports for making lending decisions. Such firms would, for instance, have to send an adverse notice to a consumer where the decision to grant the credit is made through reliance on such data. Regulators in Kenya should consider including similar obligations to govern the collection and usage of non-traditional data in a credit context.

Another category of lender that uses non-traditional data are those who lend over the internet and deliver credit via smartphone apps. They are able to extract data on mobile money transaction history, and voice and text messages directly from a consumer's phone. Additionally, it may also be possible to extract information about prior loan advances from competing MC providers that have partnered with MNOs, through SMS records on a customer smartphone.[197] This extraction is subject to receiving a customer's consent. Leaving aside the question of whether such consent is indeed properly obtained or is informed, the point is that CRB data (if at all reported) or MNO data would be inaccessible to these lenders directly, so this is a brilliant way to build a customer profile for purposes of assessing credit risk. The same concerns about mis-selling arising from reliance on incomplete or inaccurate information might also be applicable to these lenders. However, it must be noted that smart phone usage in the Sub-Saharan Africa region is still low,[198] which may reduce the risk of mis-selling for customers accessing loans via smartphones apps. But the number of users is anticipated to grow

[195] Federal Trade Commission, Big Data: a Tool for Inclusion or Exclusion? Understanding the Issues' (Washington DC 2016) <https://www.ftc.gov/system/files/documents/reports/big-data-tool-inclusion-or-exclusion-understanding-issues/160106big-data-rpt.pdf> accessed 10 February 2017.
[196] ibid.
[197] Blechman, 'Mobile Credit in Kenya and Tanzania' (n 25).
[198] GSMA, 'The Mobile Money Economy, Sub-Saharan Africa 2019 <https://www.gsmaintelligence.com/research/?file=36b5ca079193fa82332d09063d3595b5&download> accessed 7 February 2020.

exponentially,[199] which means that regulators need to think about addressing the risks presented by smartphone use in a lending context.

Additionally, as leveraging of data in this way usually requires the application of algorithms, such decision-making may be problematic; for instance this may be the case where the lend/deny decision is biased or discriminatory. Where used, providers should be required to build in checks or monitoring of the decision-making process to ensure fair outcomes for consumers.

3.4 The Risk Based Approach in Kenya

The CBK has explicitly stated that it adopted the Risk-based Supervisory (RBS) approach in 2004. It claims to have done so in cognisance of the limitations inherent in the traditional approach, which prescribed a common supervisory approach to all institutions, irrespective of differences in business activities conducted and risk appetites adopted.[200] In its application of Risk Based Supervision, CBK is further guided by the Basel Core Principles for Effective Banking Supervision. This is explained in the Risk Management Guidelines issued by the CBK, where it is stated that the Basel Core Principles for Effective Banking Supervision make it a requirement for all banks and banking groups to have comprehensive risk management processes.[201] Further, the guidelines provide that it is a requirement that each institution prepare a comprehensive Risk Management Programme (RMP), and also that they should create a risk management department with responsibility for the supervision of institutional management of risk.[202] Institutions are to use the guidelines as a source of minimum requirements to draw from with respect to risk management systems and frameworks.

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[199] GSMA, *State of the Industry Report on Mobile Money* (2018) <https://www.gsma.com/r/wp-content/uploads/2019/05/GSMA-State-of-the-Industry-Report-on-Mobile-Money-2018-1.pdf> accessed 23 October 2018. According to GSMA, smartphone usage in Sub-Saharan Africa was 39% by end of 2018 but is anticipated to rise to 66% by 2025.

[200] CBK, *Risk Based Supervisory Framework* <https://www.centralbank.go.ke/wp-content/uploads/2016/08/CBKs-Risk-Based-Supervision-Framework-May-2013-1.pdf> (accessed 20 March 2019).The document describes the CBK's approach to Risk Based Supervision.

[201] CBK, Risk Management Guidelines 2013, 3<https://www.centralbank.go.ke/wp-content/uploads/2016/08/risk-management-guidelines-january-20131.pdf (accessed 6 January 2020).

[202] ibid.

The guidelines single out certain risk categories as critical in financial institutions and provide details regarding the things the institution should take into account when dealing with these risk categories. The categories include strategic, credit, liquidity, market, operational, ICT, reputational, compliance, and country and transfer risk. Taking credit risk as an example, the guidelines stipulate that sufficient research should be undertaken for new products or activities to ensure that all risks are appropriately identified and managed. Further, it is mandatory that such products are approved by the Board.[203] The guidelines further stipulate a more general requirement—that management must have a good understanding of products on offer and must carry out a detailed review of existing and possible risks they present. The guidelines offer some comfort with regard to the methodology of risk based supervision that is being applied. At the same time the study identified some concerns.

3.4.1 Shortcomings

Kenya's application of RBS may not be appropriately capturing certain areas of risk and uncertainty. It is notable that the framework is stated as beneficial for firms, as 'regulatory effort is more focused on high-risk areas and provides for more efficient supervision'.[204] This is a key weakness and begs the question as to how much attention is being given to low-risk areas. A lesson from the GFC with regard to the treatment of low risks, especially in the context of the application of approaches like RBA, is that low risks can go unnoticed, but can build up to cause systemic events.[205] CBK may want to pay attention to this aspect so that, even where resource constraints may require high risk areas to be prioritised, measures should be put in place to monitor low risks as well. In chapter 5, we have suggested cost effective ways this might be done.

Another area of concern is that the RBS framework is not applied uniformly across the different categories of financial sector providers. Financial institutions operating in Kenya can be considered as falling into two main

[203] ibid.
[204] CBK, *Risk Based Supervisory Framework* (n 200) 4.
[205] Black, 'Learning from Regulatory Disasters' (n 181).

groups. One is those that fall within the purview of the Banking Act and CBK Prudential Guidelines—the Risk Management guidelines are part of these guidelines.[206] The other group fall within the scope of the NPSA and accompanying regulations (NPSR). The NPSA/R only cover payment service providers (PSPs) and e-money issuers.[207] It is notable that the approach to risk management in these two frameworks is different. For PSPs, the applicable provisions is found in the NPSR. The regulations stipulate that PSPs are to comply with technical standards issued by the CBK from time to time, and other international standards as prescribed in the third schedule of the NPSR, and risk management guidelines as required by CBK from time to time.[208] The stated schedule merely lists international standard setting bodies and outlines their role, including Bank of International Settlements (BIS), International Organisation of Standards (ISO), and Financial Action Task Force (FATF). The risk management framework provided for under the Banking Act and the Prudential Guidelines is clearly more prescriptive in comparison to the payments one. Moreover, it is unclear whether the CBK has issued specific technical standards to PSPs to augment the very general provision that requires compliance with international standards.

3.5 Conclusion

The interrogation of the legal and regulatory framework has revealed several shortcomings, risks, and challenges. The fact that MC is offered by a number of different entities who straddle a variety of regulatory frameworks creates complexities, including a multiplicity of regulatory authorities (hence regulatory overlap), disparate or conflicting laws, more onerous requirements for some providers, lack of rules to govern some providers, legal and regulatory gaps and unclear provisions, inappropriate and outmoded provisions, and incentives for regulatory arbitrage.

[206] This includes Microfinance banks.
[207] NPSR reg 2—"E-money Issuer" is defined as a payment service provider authorized to issue E-money under the Regulations.
[208] NPSR s 24 (a) and (b).

With respect to the architecture, the CBK's position as regulator in chief of the financial sector has been revealed to be an area fraught with challenges in terms of the extent of its powers and its capacity to regulate MFS in general. Therefore, in addition to the need for greater clarity around rules, regulators need to define and agree on their respective roles and responsibilities in this converged space, including on areas where there may need to coordinate their activities with other regulators in order to ensure effective regulation. This may include explicit agreement about which regulator has the overall mandate over regulation of products like MC, which straddle diverse domains, namely banking, payments and telecommunications.

In terms of rule design challenges, regulators will need to clarifying the provisions in the current legal framework that are problematic, for instance due to vagueness or problems of interpretation. Additionally, in other cases, appropriate action will constitute amending or updating current rules, or introducing new ones that more cohesively address risk areas.

The limitations that have been examined above, both in the architecture and the scope of legislation make clear that there is need for more appropriate regulation that addresses these challenges in terms of clarifying grey areas, removing inconsistencies and plugging in the undeveloped aspects in the current framework.

Another key challenge that emerges from the analysis in Kenya relates to the lack of a cohesive financial product regulation regime. With respect to the specific question of MC, the key question is: what is the best approach to regulating this product that takes into account its unique aspects and the mode of delivery? In particular, that it is offered in an instant, automated and remote manner which presents new risks for the economy and for consumers. These risks include money laundering, and potential systemic risk for the former, and the risk of falling into a cycle of debt for the latter. The difficulties considered call for reflection with a view to crafting and implementing a suitable regulatory approach comprising more coherent and comprehensive rules and the adoption of regulatory strategies that not only promote effective and efficient development of consumer credit provision, but also adequately address the

risks presented in this novel environment of “on demand” credit. Of significance for this thesis is the question of how to minimize the risk of mis-selling of credit to retail consumers in Kenya and also how to avoid creating systemic risk.

4. Financial Product Innovation—Regulation and Governance, and the future

4.1 Introduction

A financial product is a contract or package of contracts that may be simple or highly complex and that enables the purchasing party to satisfy a financial need.[1] The contracts under which they are offered are either negotiated or standardized. It is suggested that the greater the disparity in asymmetry of expertise between the contracting parties, the more likely it is that the contract will be standardized.[2]

One of the rationales for financial product regulation or intervention is to protect consumers. This is necessary because financial providers tend to hold much more information than is the case with goods and non-financial services.[3] According to Kingsford and Dixon, even with basic financial products "there is enough intangibility, complexity, opacity, and time before performance, to distinguish the financial consumer interest from that for goods".[4]

To meet the objective of consumer protection that is expressed in many financial regulatory regimes, jurisdictions are increasingly adopting a stance that is progressively paternalistic and protective. This signals a shift in the assumptions that underpin consumer protection regulation, and a move to

[1] John Armour and others, *Principles of Financial Regulation* (Oxford University Press 2016) 245.
[2] ibid 246.
[3] Kay John, *Culture and Prosperity: The Truth about Markets, Why Some Countries Are Rich and Others Remain Poor* (Hachette 2005).
[4] Dimity Kingsford-Smith and Olivia Dixon, 'The Consumer Interest and the Financial Markets' in , Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press 2015) 697.

more explicit public interest and social justice rationales.[5][6] The main justifications for the adoption of more paternalistic interventions beyond disclosure; for instance, in the form of pre-contractual consumer protection measures, is information asymmetry and inequality of bargaining power between consumers and financial institutions.[7] As the chapter develops we will interrogate several other examples.

Kenya does not have an explicit financial product regulation and governance approach. As was shown in the chapter analysing the Kenyan regulatory framework, there are some piecemeal provisions that speak to aspects of product regulation and governance, but we argue that these are inadequate for the purposes of effective product regulation and conduct regulation in respect of products. These are to be found in general law as well as financial regulation. Of interest for this work are the provisions that fall under the category of financial regulation, as these have been argued to be more market oriented than general/substantive law.[8] The inattention to conduct aspects of regulation in Kenya is revealed by CBK's *prudential guidelines* (emphasis added).[9]These are equivalent to the rule books issued by the UK's FCA, but, as their title suggests, they are focused on the *prudential*, and there are no specified rules to address the conduct side. With a view to remedying the identified shortcoming, we will in this chapter consider various themes relevant to the structuring of a financial product regulation and governance regime in Kenya—one that effectively addresses consumer protection and innovation risks and other weaknesses in the current regime, and that is appropriate for MFS/MC in particular. Further, as will be discussed in the course of the chapter, a regulatory strategy that focuses on a pre-emptive approach is recommended for adoption in the Kenyan product regulation and governance

[5] This observation has been made in the UK and EU. Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility* (Routledge 2014) 238.
[6] ibid 239.
[7] Andromachi Georgosouli, 'Investor Protection Regulation: Economically Rational?' (March 2006) < https://ssrn.com/abstract=893451> accessed 16 September 2019.
[8] Alastair Hudson, *The Law of Finance* (1st edn Thomson Reuters 2009) 56.
[9] CBK Prudential Guidelines for Institutions Licensed under the Banking Act <https://www.centralbank.go.ke/wp-content/uploads/2016/08/PRUDENTIAL-GUIDELINES.pdf> accessed 23 September 2019.

context, as, in our view, this is one of the key vulnerabilities of the existing regulatory framework.

4.2 Risk Regulation—Institutional vs. Risk-based models

One of the key premises that will guide the discussion in this chapter is Heidi Schooner's position on whether it is best to adopt an institutional based approach to regulation[10] in the finance sector, or a risk-based based model. Calling for the regulation of risk, and not function, she posits:

> *[T]hat a more appropriate model for the future should be risk based, focusing on the risks that we seek to regulate through the laws affecting finance. Under a risk based model, the breadth of laws and the division of regulatory responsibility is determined by the risk to be regulated, i.e., bank insurance fund risk, systemic risk, and risk of unfairness. A risk based model, because it does not depend on product or entity definitions, can abide the development of new products through technological advances and other market innovations, and the changes in the character of financial institutions through consolidation. Moreover, because the risk based model focuses directly on the purpose of financial regulation, it proves more effective and efficient than the current system*[11]

In support of the above argument, the proposals in this thesis for structuring an appropriate financial product regulation and governance regime for Kenya draw on Schooner's position, which calls for targeting risks and formulating appropriate regulation that addresses them, as opposed to focusing on whether the provider of the product is a bank, an MNO or other provider of finance. An appropriate model can thus be summarised as exhibiting the following features: a) earmarks risks in finance; b) extensiveness of laws and

[10] See Heidi M Schooner and Michael W Taylor, *Global Bank Regulation: Principles and Policies* (Academic Press 2009) 260-265 for discussion on institutional structures of regulation.
[11] Heidi M Schooner, 'Regulating Risk Not Function' (1998) 66 *University of Cincinnati Law Review* 441, 443.

division of responsibility is driven by risk to be regulated;[12] c) not dependant on product or entity definitions.

Targeting risks such as those generated by financial products calls for a holistic understanding of the process for the risks being regulated.[13] Two main risks areas will be examined below. The first is innovation risk, and the second is product risk. In the financial product environment, these present as separate but overlapping risks as they can stand on their own but sometimes one can create another as in cases in which innovation risk generates product risk.

4.3 Financial Innovation in Lending

One of the sources of risk or threat in terms of financial products arises from financial innovation. The financial services sector has experienced accelerated technological innovation, both in product and service delivery, which has led firms to adopt new technologies and business models. Financial innovation is not a recent phenomenon. Humanity has benefitted from it for millennia. This being said, an examination of the history of financial innovation in the last two decades reveals it to be chequered and dominated by manifestations of greed, avarice, and rent-seeking.[14] These innovations are often driven by changes in tax, regulatory frameworks or opportunities generated by novel technology.[15]

We will consider the global context to highlight examples of the advancements made and specifically innovations in lending. These are included for their direct relevance to MFS/MC.

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[12] For mobile finance these include: systemic, consumer protection, unfairness (which is also linked to consumer protection).

[13] Julia Black and Richard Nobles, 'Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure' (1998) 61 *Modern Law Review* 818. Authors identify this as one key lesson from the personal pensions mis-selling scandal in the UK.

[14] Emilios Avgouleas, 'Regulating Financial Innovation, in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds)' *The Oxford Handbook of Financial Regulation* (Oxford University Press 2015) 687.

[15] William L Silber, 'The Process of Financial Innovation' (1983) 73(2) *American Economic Review* 89;
Peter Tufano, 'Financial Innovation', in George M Constantinides, Milton Harris, and René M Stulz (eds), *Handbook of the Economics of Finance* (Elsevier 2003) 307.

4.3.1 P2PL Lending in the UK

The consumer credit market in other countries has likewise been undergoing transformation. Along with the introduction of enhanced capital controls on lenders post the GFC, there has been exponential growth in peer-to peer lending (P2PL).[16] The experience of the UK will be considered briefly in this regard. The UK market has seen the growth of non-bank innovative lending such as online P2PL platforms. These comprise websites that enable borrowers to solicit funds from investors. This direct lending between lenders and borrowers online began with the launch of the P2PL platform Zopa in 2005, with a focus on consumer credit. The business models under which the loans are offered vary, but they work mostly in the same way: the platform acts as broker between borrowers and lenders, bypassing traditional banking intermediation. In this way, a single loan is generally funded by several different investors. This process has been likened to syndicated lending and parallels have been drawn between this and online 'crowdfunding'.[17] [18] Additionally, P2PL has also been called de-centred lending[19] and marketplace lending.[20] In respect of online crowdfunding, distinctions have been drawn between charity or non-commercial and commercial platforms.[21] Another commonality among the P2PL models is that, even where there are intermediaries, they do not take deposits, and thus neither the regulatory capital nor the deposit insurance requirements apply to their business.

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[16] Peter Baeck, Liam Collins, and Bryan Zhang, *Understanding Alternative Finance: The UK Alternative*
Finance Industry Report 2014 (Nesta/University of Cambridge 2014) 28, 40.

[17] Ulrich Atz and David Bholat, 'Peer-to-Peer Lending and Financial Innovation in the United Kingdom' (April 2016), Staff Working Paper No. 598, 1-36. Zopa was the first P2PL platform in the world. Other platforms that were launched later include Rate Setter and Funding Circle.

[18] See Armour and others, *Principles of Financial Regulation* (n1) 254. The P2PL models differ in terms of their borrower selection processes. For some lenders scrutinize borrower's applications directly and others rely on credit scores and platforms offered by the P2PL. Another differentiator is whether the platform takes on the role of intermediary, taking funds from investors onto its own balance sheet and then loaning forward to borrowers or by brokering loans made directly by investors to borrowers.

[19] Andy Haldane, 'Banking May be on the Cusp of an Industrial Revolution' (*Wired*, 29 August 2013), <https://www.wired.co.uk/article/a-financial-forecast-from-the-bank-of-england> accessed 19 August 2019.

[20] John Hill, *Fintech and the Remaking of Financial Institutions* (Academic Press 2018) 150.

[21] Such as Kiva.org. See Bachmann A Becker and Others 'Online Peer to Peer Lending – A Literature Review' (2011) 16(2) *Journal of Internet Banking and Commerce* 4-5.

However, this exposes retail investors to less liquidity and a higher investment risk than they would get from a deposit account. [22]

Greater transparency in data disclosure (open data) is regarded as one of the more innovative features of UK P2PL platforms, and there are cases where data is open by default; that is, loan contracts are made public as downloadable datasets. [23] With encouragement from the government, this increased transparency has resulted in UK banks, agreeing to share some of their lending data.[24] This openness can help to deal with the asymmetry of information that is often present in conventional bank lending. However, one of the challenges of open data is found in situations in which there are non-standardized fields, which can make comparability difficult.[25] In general, P2PL is characterised by heavy digitalisation of processes, such as technological support for credit analysis and settlement of payments.[26]

The attraction of P2PL lies in its convenience as well as the fact that it offers a viable source of credit. This is especially so for consumers who are unable to borrow from conventional banking/finance. [27] A notable departure has occurred in markets such as Kenya. In these cases, where P2PL may have been initially targeted at the unserved or underserved, the current reality is that it is now an alternative source of credit, even for those for whom traditional bank credit is easily accessible.

P2PL presents a number of risks. Lenders (investors) may lose the amount lent in the event of borrower or platform default.[28] Borrowers, on the other hand, may encounter difficulties repaying loans where either no or inadequate

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[22] Armour and others, *Principles of Financial Regulation* (n1) 254.
[23] Atz and Bholat, 'Peer-to-Peer Lending and Financial Innovation in the United Kingdom' (n 17) 9.
[24] ibid 12.
[25] ibid 12-13.
[26] International Financial Consumer Protection Organisation (FinCoNet), *Report on the Digitalisation of Short-Term, High-Cost Consumer Credit* (November 2017) 20.
[27] European Parliament, *Mis-Selling of Financial Products: Consumer Credit* (June 2018) 17.
[28] ibid; European Banking Authority, *Opinion of the European Banking Authority on Lending-based Crowdfunding* (26 February 2015) 12; Eugenia Macchiavello, 'Financial-return Crowdfunding and Regulatory Approaches in the Shadow Banking, FinTech and Collaborative Finance Era' (2017) 14 *European Company and Financial Law Review* 662, 669.

credit assessments were undertaken prior to disbursement.[29] Additionally, it is suggested that, in the context of P2PL, the risk of mis-selling may affect both lenders and borrowers. This presents a new twist, as in financial product mis-selling malpractice typically originates with the lender. However, in P2PL, lenders may also be deceived by platforms through such means as false advertising or the provision of unverified information upon which to base the decision to invest.[30] Yet another risk is that of insolvency of the lending platform itself.[31]

The growth of P2PL in the UK has been driven by two main factors: monetary interest and regulator and public sector support. The UK's FCA began to regulate the sector in 2014, and regulation has had a positive signalling effect to the market as it has enhanced consumer participation and thereby contributed to the sector's growth.[32] The FCA has since issued rules on mandatory disclosure of information to investors, client money protection, capital adequacy rules, which control the creation of loans, and a requirement to ensure that current loans will continue to be administered, even if the platform's operations are discontinued.[33] It is also notable that as recently as mid-2019, the FCA issued new rules to govern the sector that are aimed at protecting investors from harm.[34] Regulators in Kenya can have their confidence bolstered by such regulatory advances, which demonstrate that regulatory intervention in credit markets can improve the market through fostering greater engagement by market participants.

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[29] European Banking Authority, *Opinion of the European Banking Authority on Lending-based Crowdfunding*, ibid 16, 20. See also FinCoNet, *Report on the Digitalisation of Short-Term, High-Cost Consumer Credit* (n 26) 21.

[30] European Parliament, *Mis-Selling of Financial Products* (n 27) 17; European Banking Authority, *Opinion of the European Banking Authority on Lending-based Crowdfunding* (n 28) 17.

[31] In the UK, the FCA resolved not to include P2PL under the Financial Services Compensation Scheme thus investor money does not receive a comparable level of protection as money in a savings account.

[32] Atz and Bholat, 'Peer-to-Peer Lending and Financial Innovation in the United Kingdom' (n 17) 19-20.

[33] Iris H-Y Chiu and Joanna Wilson, *Banking Law and Regulation* (Oxford University Press 2019) 184-185.

[34] See FCA Press Release, *FCA Confirms New Rules for P2PL platforms* (4 June 2019) <https://www.fca.org.uk/news/press-releases/fca-confirms-new-rules-P2PL-platforms > accessed 20 August 2019.

The rise of P2PL has led to ruminations about its possible impact on the traditional banking sector. Atz and Bholat, for example, made several prescient statements in this regard. In the first place, there have been concerns that, in the face of competition from these platforms, particularly in the consumer credit space, banks would respond by lowering their unsecured lending rates. This would be advantageous for consumers, since it would lower loan prices. However, it would also decrease bank profitability with regard to this category of lending. Secondly, there have been worries that banks would adopt different distribution models, moving away from brick and mortar branches into mobile and internet services, to save on operational costs.[35] [36] Indeed, it was reported in 2015 that there was an increase in unsecured personal loans from banks and that these were offered at markedly reduced quoted interest rates.[37] These effects have similarly been observed in the Kenyan MFS/MC market, especially the closure by banks of physical branches accompanied by forays into mobile services through offerings such as MC, and the push for customer adoption of alternatives like internet banking. It is also notable that as P2PL has developed the business models under which loans are offered have also evolved. For instance, there are now models where platforms partner with traditional banks.[38]

As in Kenya, concerns have been raised in the UK about the upsurge of P2PL platforms. In this regard, Lord Turner is reported as warning that P2P lenders will encounter major losses in the near future.[39] This prediction has been accurate in view of reports pointing to rising defaults and business failures in P2PL markets.[40] This underscores the need for regulation and close

[35] Atz and Bholat, 'Peer-to-Peer Lending and Financial Innovation in the United Kingdom' (n 17) 20.
[36] See Haldane, 'Banking May be on the Cusp of an Industrial Revolution' (n 19)
[37] Bank of England, *Financial Stability Report* (July 2015) Issue 37, 50 <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2015/july-2015> accessed 20 August 2019.
[38] See Bachmann A Becker and Others 'Online Peer to Peer Lending' (n 21), 6.
[39] Sean Farrrell, 'Former City Regulator Warns of Potential Peer-to-Peer Lending Crisis' *The Guardian* (10 February 2016) <https://www.theguardian.com/money/2016/feb/10/former-city-regulator-warns-peer-to-peer-lending-lord-turner> accessed 20 August 2019.
[40] Bryan Zhang and Others, 'Sustaining Momentum – The 2nd Annual European Alternative Finance Industry Survey' (2016) 21, 47; Bryan Zhang and Others, 'Pushing Boundaries: The 2015 UK Alternative Finance Industry Report' (2016) 34.

supervision to ensure that detriment to consumers is minimised, and to manage risks that could pose a threat to market integrity.

In view of the global reach of these platforms, which is a consequence of the interface with the internet, regulation has to be contemplated both from a domestic and trans-boundary perspective. Technology companies like Google—on whose Play Store a number of lender apps are available for download—have recently published policies targeted at personal loan apps, with the objective of reigning in predatory lending.[41] This is a step in the right direction. It will be interesting to see how the introduction of these rules impacts the P2PL sector.

4.3.2 Pay Day Lending

Pay day loans share some common features with MC. They are both small high-cost instalment loans with short repayment periods, usually 'payday', and both have been categorised as high-cost short-term credit.[42] Majority of customers who access these loans have been shown to be those with limited credit options at the time they take up the loan.[43]

Their attraction for consumers lies in their ease and speed of access. In the past, customers had to visit lenders' places of business (such as the high street), to obtain credit but, with the growing digitalisation of the loans process, it is now possible to obtain them over the internet and even via SMS. Several effects of digitalisation have been observed, with markets like the UK providing some revealing examples. It has been observed that, not only do more consumers borrow online in comparison to the high street, but they borrow noticeably larger amounts.[44]

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[41] Ryan Whitwam, 'Google Publishes Play Store Polices for Personal Loan Apps' (*Android Police*, 21 August 2019) <https://www.androidpolice.com/2019/08/21/google-publishes-play-store-policies-for-personal-loan-apps/> accessed 23 August 2019.

[42] Andrea Fejõs, 'Achieving Safety and Affordability in the UK Payday Loans Market' (2015) 38 *Journal of Consumer Policy* 181.

[43] Competition and Markets Authority, *Payday Lending Market Investigation: Final Report* (24 February 2015) 10, 22; Hill, *Fintech and the Remaking of Financial Institutions*, (n 20) 147.

[44] Competition and Markets Authority, ibid 3. It was reported that 83 % of payday loan customers had taken out a loan online, while only 29 % of customers took loans on the high street. The average

The concerns about these loans stem from the exorbitant interest rates charged for them, and high additional costs that accrue for late repayments. These loans are also characterised by recurrent rollovers that attract additional costs to the original loan. The ease of access is thought to encourage this, with consumers electing this option when unable to pay the initial payday loan. As the rollovers rack up extreme profits for lenders, this disincentivises them from undertaking proper consumer creditworthiness assessments prior to credit disbursement or rollover.[45] It has even been suggested that some lenders target customers who are likely to rollover the loan.[46]

Pay day loans can result in consumer detriment, and especially for more vulnerable consumers. Reports from EU countries, including the Czech Republic, Slovakia, Slovenia, Ireland, Romania, and Poland, indicate that rollovers are often used to cater for costs of prior loan default and this has contributed to consumers finding themselves in a cycle of mounting over-indebtedness.[47]

This is not to say that payday loans do not have their benefits. As was said before, they provide access for many vulnerable consumers. Indeed, in a US study examining the impact of bans on payday loans in Georgia and North Carolina, it was found that following the ban, there was an upsurge in bounced cheques from households, and the rate of bankruptcy protection filing also rose. This finding, it is suggested, supports the premise that, while payday lending is problematic, it is superior to alternative credit sources such as fringe lending.[48]

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amount borrowed online was GBP 290 and that borrowed on the high street GBP 180; European Parliament, *Mis-Selling of Financial Products* (n 27) 12.

[45] European Parliament, ibid 12-13; Competition and Markets Authority, ibid 3-5.

[46] Therese Wilson, 'Responsible Lending or Restrictive Lending Practices? Balancing Concerns Regarding Over-Indebtedness with Addressing Financial Exclusion' in Michelle Kelly-Louw, James P Nehf and Peter Rott (eds) *The Future of Consumer Credit Regulation: Creative Approaches to Emerging Problems* (Ashgate Publishing 2008) 96.

[47] European Parliament, *Mis-Selling of Financial Products* (n 27) 13; Udo Reifner and Others, 'Study on Interest Rate Restrictions in the EU: Final Report for the EU Commission DG Internal Market and Services (Brussels/Hamburg/Mannheim, 2010) 124; European Parliament, *Consumer Protection Aspects of Financial Service*s: *Study* (February 2014) 59.

[48] Richard Tooth, 'Behavioural Economics and the Regulation of Consumer Credit' (August 2012) *New Zealand Law Foundation* 18; Donald Morgan and Michael Strain, 'Payday Holiday: How Households Fare After Payday Credit Bans' (2008) FRB of New York Staff Report No. 309.

Poor regulation of payday lending gives rise to concerns about safety and soundness, and infringement of consumer protection laws.[49] It has been argued that to address the risks they pose requires a coherent regulatory strategy that does not merely result in consumers shifting from these loans to substitutes that are equally problematic and similarly under-regulated or even unregulated.[50] Such a strategy should encompass multi-faceted approaches that go beyond limiting rollovers, capping interest rates, or providing standardized price disclosure.[51]

4.4 Regulating Financial Innovation Risk

Financial innovation has, in many jurisdictions, impacted financial regulation by creating a minefield for regulators who continue to contemplate the implications of these changes on the regulatory environment. Regulators are having to balance between measures that encourage innovation, while simultaneously ensuring that firms adequately address the risks these advancements pose. Achieving the right balance can help avert systemic problems and consumer detriment.

The post-GFC years have been characterised by reforms, particularly in developed countries. The main aim of reform legislation has been to address financial consumer safety and financial stability. These reforms—criticised as bulky, complex and far-reaching—have targeted market structure, opacity, and complexity, and striven to block entry of harmful financial products, particularly into financial consumers' markets.[52] The amendments are undoubtedly necessary, but there are concerns that reforms targeted at the regulation of financial innovation may only have limited effectiveness over time for two main reasons. Firstly, their bulk and complexity might make

[49] Elizabeth R Schiltz, 'The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation' (2004) 88 *Minnesota Law Review* 518, 594.
[50] Robert L Clarke and Todd J Zywikci, 'PayDay Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau' *Review of Banking and Financial Law* 279.
[51] Mary Spector, 'Payday Loans: Unintended Consequences of American Efforts to Tame the Beast' in Michelle Kelly-Louw, James P Nehf and Peter Rott (eds) *The Future of Consumer Credit Regulation: Creative Approaches to emerging problems* (Routledge 2008) 128.
[52] Avgouleas, 'Regulating Financial Innovation' (n 14) 687.

enforcement challenging. Secondly, their impact will largely be felt only in the regulated sector, while the biggest new risks to financial stability are posed by the unregulated sector.[53] The need to simultaneously address the new threats in the unregulated sector; for instance, shadow banking,[54] in order to ensure financial stability and consumer protection must be emphasized.

According to Emilios Avgouleas, contemporary reforms in the regulation of financial innovation, which have largely involved standardisation and homogenization, do not distinguish between good and bad innovation.[55] He further asserts that bans and tight controls may not be the answer to every question. In agreeing with this view, we would say that both good and bad innovation need to be regulated, and the appropriate response depends on the risks to consumers or to financial stability. Whereas it is possible to say that the appropriate response to bad innovation may well be bans or restrictions, even where innovation is good, it may still need to be subjected to tougher responses. For example in order to protect certain categories of consumers such as retail consumers or to address concerns about systemic risk.[56]

The innovations in the MFS/MC credit context under consideration in this thesis are undoubtedly good and have benefited millions, but still pose threats as a consequence of the shortcomings in the current regulatory framework. Kenyan regulators can learn from events such as the GFC and other product related financial scandals and act to pre-empt similar problems. In structuring or re-structuring the regulatory regime, they do well to reflect on what to do and what to refrain from when responding to new innovations or to situations

[53] ibid. A zest for enforcement may gradually be replaced by regulatory inertia, and it may be more challenging at that stage to enforce complex or bulky legislation.
[54] For overview of shadow banking see, Tobias Adrian and Adam Ashcraft, 'Shadow Banking: A Review of the Literature (2012), FRB of New York Staff Report No 580; Allen Franklin and Douglas Gale , *Financial Innovation and Risk Sharing* (MIT Press 1994).
[55] Some have argued that extreme homogeneity can be dangerous, stifles innovation and hurts customers. See for instance, Fintech Futures 'Regulation is Holding Back Innovation Says Building Society Chief' (8 May 2014), <https://www.fintechfutures.com/2014/05/regulation-is-holding-back-innovation-says-building-society-chief/> accessed 30 September 2019.
[56] Avgouleas, 'Regulating Financial Innovation' (n 14) 684.

of crisis; for instance how to be proportionate and also how to avoid creating complexity in the process of implementing reforms.

4.5 Regulating Risks in Consumer Financial Products

The focus on risk necessitates the adoption of an appropriate approach to risk regulation at the regulator level and also internally within firms in terms of their internal controls and governance. It is important to stress here that careful thought needs to be given when crafting a suitable regulatory approach. This is in keeping with cautions from authors like Brownsword and Yeung who, in discussing the approach to regulation of technologies, assert that technologies occupy distinctive and dynamic spaces and that simple transplantation of a particular regulatory response to another is not always appropriate.[57]

Legal transplantation is considered one of the most prolific sources of legal development.[58] In developing countries this may be a continuation of post-colonial frameworks,[59] or they may adopt this approach when designing reforms. Transplantation of this kind has been criticised for failing to account for the contextual nature of regulatory reform.[60] Using the Kenyan Mobile Money success as an example, there are Kenyan context-specific reasons that explain the success of M-pesa in Kenya. As such, even countries that adopted Kenya's initial 'watch and learn' stance did not necessarily record similar success stories.[61] In light of the discussion, Kenyan regulators should

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[57] Roger Brownsword and Karen Yeung, 'Regulating Technologies: Tools, Targets and Thematics' in Roger Brownsword and Karen Yeung (eds) *Regulating Technologies, Legal Futures, Regulatory Frames and Technological Fixes* (Hart 2008).

[58] See Alan Watson, *Legal Transplants: An approach to comparative law (*2nd edn, University of Georgia Press 1993) for genesis of the term.

[59] Eugene Cotran, 'The Development and Reform of the Law in Kenya' (1983) 27 *Journal of African Law* 42–61.

[60] Investment Climate Advisory Services of the World Bank Group, 'Better Regulation for Growth Governance Frameworks and Tools for Effective Regulatory Reform Regulatory Capacity Review of Kenya' (2010) <http://documents.worldbank.org/curated/en/543401468176979961/pdf/556450WP0Box0349461B0GovReg01PUBLIC1.pdf >accessed 24 September 2019.

[61] International Finance Corporation, 'IFC Mobile Money Study 2011—Summary Report' (2011), 18 <https://www.ifc.org/wps/wcm/connect/df0c2aa4-55f9-4f6c-ad23-55525cda841a/MobileMoneyReport-Summary.pdf?MOD=AJPERES&CVID=jk-MEs-> accessed 27 September 2019; See generally David S Evans and Alexis Pirchio, 'An Empirical Examination of Why Mobile Money Schemes Ignite in Some Developing Countries but Flounder in Most' (2015) Coase-Sandor Working Paper Series in Law and Economics 723/2015.

be wary of blindly ‘borrowing’ regulatory responses from elsewhere. Where they do, they ought to keep in mind that these may need to be tweaked to work in the Kenyan regulatory context.

In envisioning what regulatory approaches would be appropriate to address the financial product related risks in MFS/MC, and more generally to ensure consumer protection and financial stability, this section explores various themes, as well as approaches that have been applied by finance sector regulators in other jurisdictions.

4.5.1 Responsible Lending

The subject of responsible lending is of specific relevance to MC. An examination of the Kenyan regime points to gaps in the treatment of risks that could give rise to reckless or predatory lending. From an industry practice perspective, one of the issues financial sector regulators are presently struggling with relates to the proliferation of unlicensed and unregulated financial services and products. To try to address this regulatory action has recently been taken, in the form of public warnings and notices to consumers. Another initiative that seeks to improve the lending environment is the recent launch of a total cost of credit website to provide information on lending rates and charges offered by licensed banks. More needs to be done to address this issue, including developing a comprehensive supervisory approach as well as introducing legislative amendments to tackle existing gaps.

The weaknesses present in the Kenyan credit regulation may be addressable by considering the subject of responsible lending. We submit that it is in the interest of firms to lend responsibly, as irresponsible lending could contribute to financial instability or the creation of systemic risk which could adversely affect other financial markets participants and reduce confidence.

First, let us consider some reasons why lenders may be incentivised to extend loans that borrowers will be unlikely to repay. They may do this, for instance, where they are able to pass on the risk of non-repayment to third parties through sale of the loan portfolio. Alternatively, their actions may be explained

by temptations to take shortcuts. Under the weight of competition from other lenders, and with the objective of fast tracking loan approvals in order to make sales, it may be decided that, on balance, undertaking assessments of borrower creditworthiness offers limited benefits.[62] [63]

Some business models may also be reliant on irresponsible lending. An example is what is termed the 'sweatbox' model of credit card lending, whereby the most profitable borrowers are often the ones most unlikely to repay their debt in full. Unable to keep up with monthly repayments they make minimum payments, accumulating interest rates and penalty charges. The objective of this model is to hold customers to ransom in the 'sweatbox' for as long as possible to permit maximum profit extraction before default ensues.[64] [65]Although the 'sweatbox' model was described by Mann in the context of credit card lending, it could also be applicable to the MFS/MC lending that is the focus of this thesis.

Therese Wilson asserts that the practice of lending to people who are not in a position to repay a loan in accordance with its terms will undoubtedly lead to problems of over-indebtedness. She draws on empirical evidence from Australia demonstrating that this is happening in the fringe market. However, at the same time, she considers *(inter alia)* the extent to which irresponsible lending causes over-indebtedness. She argues that, in fact, mainstream financial institutions not lending to low income customers on fair and reasonable terms is an important structural cause of over-indebtedness. This is because it leads consumers to access credit through the more expensive fringe market. She therefore champions the need to encourage small amount lending on fair and reasonable terms to people on low incomes by mainstream

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[62] Karen Fairweather, 'The Development of Responsible Lending in the UK Consumer Credit Regime' in James Deveney and Mel Kenny (eds) *Consumer Credit, Debt and Investment in Europe*, (Cambridge University Press, 2012) 88-89.
[63] European Commission, *Public Consultation on Responsible Lending and Borrowing in the EU* (2009) para. 3.1 available at <http://www.eurofinas.org/uploads/documents/policies/consultation_en.pdf > accessed 21 August 2019.
[64] Fairweather, 'The Development of Responsible Lending in the UK Consumer Credit Regime' (n 62) 89.
[65] Ronald J Mann, 'Bankruptcy Reform and the "Sweatbox" of Credit Card Debt' (2007) *University of Illinois Law Review* 384, 386-7.

financial institutions, as an important strategy in combating the problem of over-indebtedness.[66]

4.5.2 Information based strategies

The informational model has shaped many of the traditional regulatory approaches. Under these, the purpose of financial regulation has been seen as comprising the provision of sufficient information to consumers to enable them to make informed decisions when they purchase products.[67]

The Kenyan regime similarly emphasises information disclosure. This presents several challenges. First is the fact that markets in sub-Saharan Africa have been characterised as bearing low levels of financial literacy [68] and, as being low on transparency and disclosure requirements. [69] MC also introduce other complexities for ensuring transparency; for example, many lenders provide access to loan terms and conditions only through a web-link, and this would make such information inaccessible for borrowers without internet access.[70]

Another difficulty presented by information disclosure is linked to the aspect of responsible borrowing. The latter has been raised in discussions related to responsible lending, discussed above. Its underlying premise is that borrowers are rational, and hence, when presented with adequate information, will make responsible borrowing decisions. This has been challenged by findings from Behavioural Science that suggest that lenders may exploit consumer biases and thus contribute to irresponsible borrowing and over-indebtedness. [71]

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[66] Therese Wilson, 'Responsible Lending or Restrictive Lending Practices?' (n 46) 92.
[67] Hudson, *The Law of Finance* (n 8) 224.
[68] Djibril Maguette Mbengue, 'The Worrying Trend of Interest Rate Caps in Africa (CGAP 2013) <https://www.cgap.org/blog/worrying-trend-interest-rate-caps-africa> accessed 10 September 2019.
[69] Katharine McKee, Michelle Kaffenberger and Jamie M Zimmerman, 'Doing Digital Finance Right: the Case for Stronger Mitigation of Customer Risks' (CGAP, June 2015) Authors identify disclosure and transparency as a shortcoming in digital finance.
[70] Rafe Mazer and Kate McKee, 'Consumer Protection in Digital Credit' CGAP Focus Note 108 (2017).
[71] Fairweather, 'The Development of Responsible Lending in the UK Consumer Credit Regime' (n 62) 89-90; For BE insights see Cass R Sunstein, 'Homo Economicus, Homo Myopicus, and the Law and Economics of Consumer Choice: Boundedly Rational Borrowing' (2006) 73 *University of Chicago Law Review* 249; Susan Block-Lieb and Edward J Janger, 'The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided ''Reform'' of Bankruptcy Law' (2006) 84 *Texas Law Review* 1481; Emilios Avgouleas, 'The Global Financial Crisis, Behavioural Finance and

Overall, these findings have raised concerns about the shortcomings of the informational model as a regulatory tool for delivering adequate consumer protection.[72] Reliance on the informational model is also insufficient in view of the debates in the literature on decision-making and behaviour.[73] Indeed, in the case of consumers, behavioural biases in consumer decision-making are regarded as potential market failures.[74]

How to achieve the right balance between responsible lending and responsible borrowing remains an important point for regulatory consideration. Product regulation is suggested as a solution for addressing the limits of information disclosure,[75] as well as conduct regulation in the form of product governance. These approaches will be examined below. Additionally, as a broad theme of this work, an approach that applies behavioural insights to the design of regulatory interventions can also be beneficial for addressing behavioural risks.

4.5.3 Product Regulation

Product regulation is another approach that could be beneficial for addressing product risks. Product regulation is more targeted than general law. The

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Financial Regulation: In Search of a New Orthodoxy' (2009) 9 *Journal of Corporate Law Studies* 23; Oren Bar-Gill, 'The Law, Economics and Psychology of Subprime Mortgage Contracts' (2009) 94 *Cornell Law Review* 1073; Geraint Howells, 'The Potential and Limits of Consumer Empowerment by Information'(2005) 32 *Journal of Law and Society* 349.

[72] Emilios Avgouleas, 'The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform' (2009) 6 *European Company and Financial Law Review* 440; Hans W Micklitz, 'The Paradox of Access to Financial Services for Consumers' (2010) *European Journal of Consumer Law* 7; Yesim M Atamer, 'Duty of Responsible Lending: Should the European Union Take Action?' in Stefan Grundmann & Yesim M. Atamer (eds), *Financial Services, Financial Crisis and General European Contract Law: Failure and Challenges of Contracting* (Kluwer Law International 2011) 179; Catherine I Garcia Porras & Willem H van Boom, 'Information Disclosure in the EU Consumer Credit Directive: Opportunities and Limitations', in James Devenney & Mel Kenny (eds), *Consumer Credit, Debt and Investment in Europe* (Cambridge University Press 2012) 21; Iain Ramsay, 'Consumer Credit Regulation after the Fall: International Dimensions' (2012) 1 *Journal of European Consumer and Market Law* 24; Sarah Nield, 'Mortgage Finance: Who's Responsible?', in James Devenney & Mel Kenny (eds), *Consumer Credit, Debt and Investment in Europe* (Cambridge University Press 2012) 160; Niamh Moloney, 'The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors?' (2012) 13 *European Business Organization Law Review* 169.

[73] ibid; See also Joanna Gray and Jenny Hamilton, *Implementing Financial Regulation* (John Wiley & Sons, 2006) 212.

[74] Armour and others, *Principles of Financial Regulation* (n 1) 246 and ch. 10.

[75] Gray and Hamilton, *Implementing Financial Regulation* (n 73) 213.

inclusion of more targeted regulation in respect of financial products and services in a number of jurisdictions is explained by the fact that general law is considered to be insufficient for regulating the conduct of business as it often provides a lower level of prescription than regulation. Another weakness of general law is tied to the nature of judicial process, the generality of legal concepts and weaknesses in judicial expertise. This causes general law to respond in a sluggish manner to the need for adjustments to address evolutions in market structure and practices, and technological advancements.[76]

Product regulation entails regulating the substantive terms of financial contracts, and not the contracting process, which is what information disclosure is anchored in.[77] In structuring product regulation, it is suggested that restrictions could be positioned as applicable to terms of specific types of financial contract, and would require or prohibit the inclusion of particular provisions. An alternative approach would involve framing restrictions as "permitting or not permitting certain type of financial contract to be offered to consumers".[78] How to arrive at these restrictions often poses some difficulty for regulators. We will consider later some ways regulators can handle this.[79] Suffice to note here that, in the absence of careful consideration, this may make certain contracts inaccessible to consumers who might have wanted them. Despite the difficulties, regulators have issued mandatory rules to govern certain categories of consumer financial products. Examples in the US, UK and across the EU are rules incorporated in credit card agreements.[80] Further, UK reforms introduced under the Financial Services Act 2012 empower regulators to prohibit the offering for sale of financial products in the

[76] Andrew F Tuch, 'Conduct of Business Regulation' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) 541.
[77] Armour and others, *Principles of Financial Regulation* (n1) 261.
[78] ibid.
[79] See further discussion on this aspect in the regulatory nudging chapter. This is considered in the discussion on default contract terms.
[80] These are captured in legislation such as Truth in Lending Act 1968, as amended (US); Consumer Credit Act 2006 (UK); Consumer Credit Directive 2008/48/EC [2008]referenced in Armour and others, *Principles of Financial Regulation* (n 1) 262.

interest of ensuring the achievement of regulatory goals including consumer protection.[81]

The UK reforms in respect of the regulation of payday lending are also instructive for MFS/MC. The FCA was required by parliament to issue rules capping charges imposed by lenders engaged in high-cost short term lending.[82] The rules were implemented by the FCA from 2015.[83] The introduction of the cap saw a fall in pay day lender numbers.[84]

Product regulation presents several difficulties for regulators. The fact that consumer preferences are heterogeneous makes it difficult for regulators to identify what consumers want. Additionally, the imposition of interventions demands sensitivity to context. These difficulties introduces the risk that some consumers end up worse off following the intervention, and the magnitude of risk may not be easily subjectable to regulatory measurement prior to deployment.[85]

4.5.3.1 Simple Products

It is also worth considering the possibility of introducing product regulation in the form of a simple products regime for Kenya, whereby mandatory product features are defined by the regulator, and providers can add discretionary elements subject to disclosing these in a way that enables comparability.[86] Proposals for the adoption of plain vanilla products have been made in the

[81] Financial Services and Markets Act 2000 (UK) ('FSMA 2000') (as amended by Financial Services Act 2012), ss 137C, 137D.
[82] Financial Services (Banking Reform) Act 2013 s 131(1), amending FSMA 2000 s 137C.
[83] FCA Handbook, CONC 5A. See also FCA, 'Detailed Rules for the Price Cap on High-Cost Short-Term Credit', PS14/16 (2014); See John Armour and others, *Principles of Financial Regulation* (n 1), 264 for additional discussion on pay day lending and sector reforms.
[84] Emma Dunkley, 'Payday Lender Numbers Shrink by a Third in Response to New Rules' *Financial Times* (11 June 2015) <https://www.ft.com/content/65e06802-0f7c-11e5-897e-00144feabdc0> accessed 10 September 2019.
[85] Armour and others, *Principles of Financial Regulation* (n 1) 246.
[86] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5) 258.

US[87] and the UK.[88] Although criticised for the likelihood of reducing innovation, and creating moral hazard because products in scope may be seen as having regulator endorsement, the argument in support of such a regime is that it would "contribute to meeting the needs of social utility in banking and finance".[89]

While we recognise that the main focus of this work is MC, a fairly simple product, we submit that, as MFS continues to expand into other domains, the complexity of products is likely to increase, and this option might be worth contemplating in the longer term. Significantly, mobile insurance[90] [91] has already been launched in Kenya, as well as investment products such as bonds.[92]

4.5.4 Conduct Regulation

Conduct of business regulation is an important avenue for reducing uncertainty about financial products and services.[93] Conduct regulation is distinguishable from conduct of business regulation (also referred to as 'business conduct' or 'market conduct' regulation), which generally comprises registration or licensing requirements, rules on sales and marketing, other

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[87] See Joshua D Wright and Todd J Zywicki, 'Three Problematic Truths about the Consumer Financial Protection Agency Act of 2009' (September 2009) George Mason Law and Economics Research Paper <https://ssrn.com/abstract=1474006> accessed 17 September 2019. Authors discuss proposals for introduction by the Consumer Financial Protection Bureau of provisions that forbid exposing consumers to complex products, and prescribe exposure to plain vanilla products. The proposals were dropped in light of concerns about impact on innovation and choice.

[88] HM Treasury, *Simple Financial Products: A Consultation* (December 2010). https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/81570/simple_financial_products_consultation.pdf accessed 17 September 2019; Sergeant Review of Simple Financial Products: Final Report (March 2013). https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/191721/sergeant_review_simple_products_final_report.pdf accessed 17 September 2019. Products in scope are savings and life insurance to start with.

[89] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5) 258.

[90] See Tellez Camilo and Peter Zetterli,'The Emerging Global Landscape of Mobile Microinsurance' (CGAP Brief, January 2014) < http://www.cgap.org/sites/default/files/Brief-The-Emerging-Global-Landscape-of-Mobile-Microinsurance-Jan-2014.pdf> accessed 8 February 2017 for discussion on mobile insurance;

[91] GSMA, *'Mobile Insurance, Savings and Credit Report'* (2016), 24.

[92] Government Targets Sh500m During Third Re-open of M-Akiba Bond, *Daily Nation (*30 August 2019) <https://www.nation.co.ke/brandbook/MAkiba-reopen-3-target/3488912-5254534-10cd1lu/index.html.> accessed 18 September 2019.

[93] Andromachi Georgeosouli, 'The Debate Over the Economic Rationale for Investor Protection Regulation: A Critical Appraisal' (2007) 15 *Journal of Financial Regulation and Compliance*, 239.

business practices, and modes of enforcing duties imposed.[94] The conduct of business is viewed as being central to financial regulation, and as being a means to achieve market integrity, as financial services are offered in an environment in which the inexperienced or unduly enthusiastic could be easily deceived by expert financiers.[95]

Of significance is the fact that product regulation is not considered part of the conduct of business regulation, due to its focus on conduct, except "to the extent that such rules shape financial intermediaries conduct toward their clients".[96] In light of this, the discussion of conduct regulation in this part will be limited in scope. The discussion will examine two main elements within conduct regulation.

4.5.4.1 Embedding Principles

The adoption of product intervention requires careful evaluation to ensure that the interventions are effective.[97] But this could prove to be difficult if interventions are applicable only to specific types of financial contract.[98] Product regulation is considered to be susceptible to arbitrage; for instance, where manufacturers deliberately characterise their products as falling into an unconnected category.[99] To address this challenge, a different approach is recommended: one that entails focusing on the behaviour of the firm, instead of the content of the information that the consumer is provided with. This can be considered conduct regulation for consumer products, and its emphasis is the activity of financial firms *vis-a-vis* their consumers. The conduct in scope would cover all pre-sale and post-sale activity, product design, and behaviour during the time the contract is in operation.[100] It would involve requiring firms to adhere to high level principles, for example acting in accordance with the

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[94] Tuch, 'Conduct of Business Regulation' (n 76) 538; Author notes that the term 'conduct of business' is not in common use in some jurisdictions.
[95] Hudson, *The Law of Finance* (n 8) 61.
[96] Tuch, 'Conduct of Business Regulation' (n 76) 538.
[97] Armour and others, *Principles of Financial Regulation* (n 1) 264.
[98] Veerle Colaert, 'European Banking, Securities and Insurance Law: Cutting through Sectoral Lines?'
(2015) 52 *Common Market Law Review* 1594.
[99] Armour and others, *Principles of Financial Regulation* (n 1) 264.
[100] ibid 265.

‘treating customers fairly’ (TCF) standard. Under this approach, firms would have responsibility for interpreting and implementing principles via their internal governance processes, and this would be subject to regulatory supervisory oversight.[101]

The UK’s TCF policy, instituted prior to the GFC, was grounded on an assumption that firms were aware of consumer vulnerabilities, including consumer illiteracy, biases, and heuristics, and a big part of the requirements were about getting firms not to design and sell products that exploit these vulnerabilities.[102] With regard to the application of a principle-based approach, this is considered to be of interest given the push in the UK to create a legal framework that supports principles-based regulation. This is established on the grounds that principles can be enforced even in the absence of the breach of a specific rule. This was the finding made in the case of *R. (on the application of British Bankers’ Association) v Financial Services Authority,*[103] in which the court supported the independent enforcement of FSA principles in the context of the mis-selling of PPI Insurance. The regulator’s reliance on the principles-based approach was beneficial as it enabled customers who had been mis-sold PPI to get redress. In this case, the FSA relied on principle 1 on integrity,[104] principle 6 on customers’ interests and TCF,[105] principle 7 on communication with clients,[106] and principle 9 on suitability of advice.[107]

The importance of careful contemplation and selection of regulatory technique, and the impact of the application of broad rules (principles) has also been emphasised by Black and Nobles in their review of the PPI scandal. Further, they add that consideration should also be given to the relationship between

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[101] ibid.
[102] FCA, *Applying Behavioural Economics at the Financial Conduct Authority* (2013) 21; Oren Bar-Gill, and Elizabeth Warren, ‘Making Credit Safer’ (2008) 157(1) *University of Pennsylvania Law Review* 1; Michael S Barr, Sendil Mullainathan, and Eldar Shafir, ‘Behaviorally Informed Financial Services Regulation’ (New America Foundation, 2008).
[103] [2011] EWHC 999 (Admin).
[104] Principle 1 – Integrity—A firm must conduct its business with integrity.
[105] Principle 6 – Customers’ interests—a firm must pay due regard to the interests of its customers and treat them fairly.
[106] Principle 7 – Communications with clients—a firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair, and not misleading.
[107] Principle 9 – A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

firms and regulators in ensuring compliance with conduct rules.[108] This can provide useful lessons for addressing the limitations in the Kenyan MFS/MC regime.

The authors assert that there was a failure to contemplate the implications of the broad duties outlined in the regulation and additionally that, although regulation imposed general rules relating to 'know your customer' and suitability of advice, their specific application to the case of pensions was not thought out. They stress that since such rules require the exercise of judgment, to be effective, there has to be a common understanding, both on the part of the regulator and the regulated, on what exactly is required. As such, the take-away here is that regulators should carefully consider the kind of general rules that they issue, as well as how these rules are to be applied. In addition to the above, on the aspect of general rules, the writers firmly acknowledge the advantage of general rules—that they give freedom and flexibility to determine the conduct required in a given situation. However, they caution that with this freedom and flexibility comes responsibility. When it comes to contemplating the conduct necessary to ensure compliance in a specific scenario, they advocate for a balancing of responsibilities between the regulator and the regulated. They call for firms to make their own interpretations regarding how to comply, and to weigh the advantages and disadvantages of their interpretations, as well as making accommodations for the fact that their views could be defective. On the part of the regulator, they call for them to make a judgment and to give clear and definitive answers to regulated firms on matters of conduct.[109] We recall the discussion of the JBR approach and how its application requires a similar exercise of judgement. Whereas the incorporation of a PBR approach is advocated in light of the advantages highlighted, a coherent regulatory strategy will require looking beyond PBR to the other approaches within the new governance paradigm as necessary.[110] When looking at the application of principles for example, regulators often

[108] Julia Black and Richard Nobles, 'Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure' (1998) 61 *Modern Law Review* 818.
[109] Black and Nobles, ibid 818-820; See also Sarah Ombija, 'Understanding the Causes of Financial Misselling' (2018) 21(3) *Financial Regulation International* 11-15—this published article by the author captures several arguments on the subject of mis-selling that are discussed in this thesis.
[110] See chapter 2 for discussion on New Governance approaches.

need to strike the right balance between principles and rules, as there a situations that demand greater prescription.

4.5.4.2 Product Governance

In the post-GFC years, there has been a push for amendments to product regulation regimes.[111] Product governance is proposed as an alternative approach to product regulation and has been defined as systems and controls in relation to product design, product management and distribution strategies,[112] the objective being to ensure that products are sold to consumers in the most appropriate way. It is a conduct-based intervention strategy that centres on the behaviour or conduct of the firm in relation to the consumer. Instead of direct regulatory action to improve consumer outcomes, or action that results in consumers improving their own outcomes, the objective is to dissuade firms from taking advantage of consumers or making things worse for them. It entails the co-optation of product manufacturers' vast expertise about consumer behaviour—which has been made even easier with the surge of 'big data' analytics—in order to contribute to the indirect promotion of better consumer choice and the manufacture of welfare enhancing consumer products.[113]

Product governance departs from approaches like information disclosure and product regulation by ceding control over design choices to manufacturers, instead of regulators. The regulator's role is limited to oversight over the firm's process in approaching the relationship between manufacturer's (firms) and consumers,[114] and consequently the onus of proof is shifted.[115] From the

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[111] The UK's experience in this regard is notable and will be referred to extensively in this discussion. The US is another key jurisdiction which introduced changes in this area. These changes will not be discussed in detail but of note is the establishment under the Obama administration of a Consumer Financial Protection Bureau (CFPB) to address the failures in relation to financial products as it was thought that these failures contributed to the financial crisis. Financial products within the bureau's purview include: mortgages; all consumer credit products—even small loan products like pay-day lending and pawnshops; and non-lenders like mortgage brokers and debt collectors. For more on this see – Department of the Treasury, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (17 June 2009).
[112] FSA, *Product Intervention Discussion Paper DP 11/1* at 6. <https://www.fca.org.uk/publication/discussion/dp11_01.pdf> accessed 17 September 2019.
[113] Armour and others, *Principles of Financial Regulation* (n 1) 246.
[114] ibid 255.
[115] ibid 266.

foregoing, it can be concluded that product governance relies on the meta-regulation of the firm and will also necessitate the application of judgement, as it logically requires firms to contemplate how to structure their processes to meet regulatory approval. Furthermore, product governance, in shifting the onus, captures the spirit of 'new governance' by departing from top down rule issuance and prescription, and instead giving firms responsibility for designing and implementing rules relating to products.[116]

In the jurisdictions that have adopted product governance, the approach is framed as oriented towards the entire life cycle of the product and comprises the following main stages: identification of the target market and product design to meet needs of identified target customers; stress testing of new products as part of design process; the establishment of robust product approval processes for new products; provision by manufacturers of suitable information to distributors and end customers; and ongoing monitoring of progress to the end of the product life cycle to curb risks like mis-selling.[117] [118]

The effectiveness of this approach is reliant on expansive regulatory oversight over the entire life cycle of the product, through the supervision of the internal processes established by the firm to verify that they are meeting requirements for giving consumers interest precedence. It requires regulators to be attentive to risk distribution through the various stages, from production to distribution. This includes a consideration of the diversity in financial market business models, which takes various forms. For instance, where financial products are manufactured by multiple actors, the product traverses several steps to get to the consumer. In the process, additional aspects are integrated, including warehousing in special purpose vehicles, third party validation via credit rating

[116] See chapter 2 detailed discussion of New Governance approaches.
[117] See FCA, *Structured Products: Thematic Review of Product Development and Governance* (March 2015) <https://www.fca.org.uk/publication/thematic-reviews/tr15-02.pdf> accessed 23 September 2019.
[118] For example in the UK the FSA initiated, and the FCA continued, the implementation of a product governance regime; See FSA, *Treating Customers Fairly (TCF) in Product Design* (July 2007); FSA, *Finalised Guidance, Retail Product Development and Governance-Structured Products Review* (March 2012) for detailed background.

agencies, or the embedding of an added insurance product, such as a credit default swap.[119]

An additional element to ensure effectiveness is the fact that the strategy is dependent on sector regulators having broad enforcement powers, which are exercisable where a firms product approval processes are judged ineffective. These powers include the imposition of product withdrawal or bans, restricting use of specific product features, or even mandating that products should not be promoted to some or all customer categories.[120] To ensure accountability, the exercise of intervention powers to ban products are required to be evidence-based and supported by a cost benefit analysis showing that intervention is in the public interest. Alternatively, regulators should be able to build evidence that would be considered cogent if it were submitted to a court as part of a possible judicial review.[121]

A significant limitation of the product governance approach concerns the question of how to identify the target market. The impact of behavioural challenges mentioned before might make it difficult for firms to determine what products would be appropriate for consumers. Solutions to address this are not straightforward, but the complexities are minimised under a product governance approach as the solutions are firm, as opposed to regulator driven (as in product regulation).[122] Moreover, it is envisaged that the identification of a target market will result in different firms having different target markets and running diverse stress tests, and, consequently, providing assorted products to consumers which can enhance competition, and would be less confining than the imposition of regulatory prescriptions.[123]

The adoption of a product governance approach by sector regulators will involve the stipulation of a specific obligation directed at firms to develop

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[119] Examples here are packaged products for retail markets and structured products for the wholesale market. See also discussion in The British Academy Forum letter to the Queen, 'The Global Financial Crisis – Why Didn't Anybody Notice?' (22 July 2009) <http://www.britac.ac.uk/sites/default/files/03-Besley.pdf > accessed 10 May 2017.
[120] Armour and others, *Principles of Financial Regulation* (n 1) 266; FSA, *Product Intervention* (n 112).
[121] Armour and others, ibid 266.
[122] ibid.
[123] ibid 267.

robust product governance. Once established, these processes should be subjected to frequent firm internal risk reviews, or via avenues like regulatory inspection to test continued effectiveness. Firms should be required to promptly address any problems that are identified.

4.6 Designing Regulatory Approaches to Enforcement

The CBK's approach to enforcement is captured in the prudential guidelines on the enforcement of banking regulations.[124] The legal and regulatory challenges in the regulation of MFS–from payments to products like credit—point to overall challenges in the enforcement of regulation in Kenya.

To better address regulatory enforcement challenges, it is important to consider the design of enforcement strategies. The maintenance of a separation of conduct regulation from general law is one aspect of the design process, and the main argument underlying this demarcation is that it supports public enforcement by regulators.[125]

Aside from this, a coherent enforcement approach necessitates the adoption of ex-ante approaches in addition to ex-post. Most product intervention measures are typically implemented *ex-post*, after harm has occurred. This is too late. We also need *ex-ante* intervention, and early intervention via product intervention rules address this as they attempt to withdraw products before harm to consumers becomes a material problem. This then forms the basis of a coherent enforcement strategy as we have a strategy that addresses both the *ex-ante* and *ex-post* environments where harm could potentially arise. Shavell's guidance on this is instructive; for instance, his proposal that enforcement can happen at the product development stage. The use of product withdrawal/bans, as an early intervention technique prior to launch is an example of an *ex-ante* approach to enforcement.[126]

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[124] CBK/PG/13.
[125] Ian MacNeil, 'Rethinking Conduct Regulation' (2015) *Journal of International Banking and Financial Law* 416.
[126] Robert Baldwin and others, *Understanding Regulation* (2nd edn, Oxford University Press, 2012) 244. Authors discuss Shavell's distinction of three stages of intervention in which actions are preventative, act-based and harm based, and also his analysis regarding the situations that support

Related to the anticipatory stance to enforcement is the 'insurable interest' doctrine—a solution suggested by Posner and Weyl. They propose use of *ex-ante* testing measures to control financial innovation, similar to the manner for testing medicines.[127] However, Avgouleas points out the doctrine's limitations. He argues that this approach would be impracticable and that the best way to test performance of a new product and the risks it presents is by means of a long period of use by the market. He additionally expresses reservations about the test proposed by Posner and Weyl and others, which provides a first approach to the question of how to measure the potential welfare impact of a new financial product, mostly based on the ability of new financial products to reduce overall risk.[128] He argues that this is excellent in terms of its analytical value, but would be difficult to apply as a regulatory tool on account of its complexity. We would challenge this view, and suggest that interventions such as regulatory sandboxes[129] or the establishment of innovation hubs[130] attempt to provide the environment for the testing of financial innovations prior to their launch. Indeed, in recent years, a majority of regulatory sandboxes in developed countries have been designed to accommodate or even stimulate FinTech innovations.[131] In a number of developing countries where regulatory sandboxes have been or are being established, they have overtly listed financial inclusion among their key objectives in establishing the same. There are different approaches to the design of regulatory sandboxes and other approaches supporting innovation that have been employed successfully. One

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particular stages of intervention; See also Steven Shavell, 'The Optimal Structure of Law Enforcement' [1993] *Journal of Law and Economics* 255.

[127] Eric A Posner, and Glen E Weyl, 'An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets' (2013) 107 *Northwestern University Law Review* 1307.

[128] Test borrows heavily from Stefano G Athanasoulis and Robert J Shiller, 'World Income Components: Measuring and Exploiting Risk-Sharing Opportunities' (2001) 91(4) *American Economic Review* 1031. Thinking in this area seeks to measure the welfare effect versus riskiness effect of financial products.

[129] See Ivo Jenik and Kate Lauer, 'Regulatory Sandboxes and Financial Inclusion' (October 2017) *CGAP Working Paper* <https://www.cgap.org/sites/default/files/Working-Paper-Regulatory-Sandboxes-Oct-2017.pdf> accessed 24 November 2018; discussing the potential for sandboxes to enhance financial inclusion

[130] Such as the one established by the UK's Financial Conduct Authority.

[131] See Jenik and Lauer, 'Regulatory Sandboxes and Financial Inclusion' (n 129) .FinTech innovations have the capacity to contribute to more affordable products and services, new distribution channels that reach excluded groups, operational efficiencies that allow for serving low-margin customers profitably and support compliance and risk-management approaches (e.g., simplified customer due diligence and alternative credit scoring).

example is the 'test-and-learn' approach, which facilitates the formulation by a regulator of an ad hoc framework within which firms can test new innovations in a live environment, with safety measures and key performance indicators in place. Another is a 'wait-and-see' approach, which enables a regulator to observe the development of a new innovation prior to intervening.[132] Even while recommending the use of interventions like regulatory sandboxes, it must be noted that the recency of their application in many jurisdictions precludes any conclusions as to their long term effectiveness. However, their potential can be appreciated.[133] Such mechanisms can facilitate enhanced understanding of new innovations and products by both innovators and regulators. They can also help to foreground the risks they pose and allow for the development of collaborative risk management processes between innovating firms and regulators.

Ex-ante approaches will require regulators to be more proactive as they generally demand taking action before harm from a financial product is even visible in the market. Such approaches involve employing tools such as mandated audits, informal regulatory guidance or advice, and private warnings to financial product providers, as well as issuing public statements. Informal guidance may be beneficial; for instance when new regulatory requirements are introduced. Private warnings could be issued to entities in the market whose products may be posing risks to financial stability and or consumer protection. Investigative powers could be relied on to permit financial sector regulators to request audits or information, or to initiate investigations proactively where there are concerns that financial products could be causing harm.[134]

Ex-ante approaches need transparent, communicative regulatory leadership. This communication can be private or public. The public communication of the level and escalation of regulatory measures serves a signalling role to the

[132] ibid; Wait and see approach has for instance been applied to person-to-person lending in China.
[133] ibid; some of the countries include: Bahrain, India and Malaysia.
[134] Malavika Raghavan, 'Before the Horse Bolts' (*Dvara Research*, 15 January 2018) <https://www.dvara.com/blog/2018/01/15/before-the-horse-bolts/> accessed 26 June 2018.

market that non-adherence is extremely costly.[135] Per Ayres and Braithwaite's analogy of the 'benign big gun', the regulatory system has to be seen to speak softly but carry a big stick.[136] Such an approach applies softer measures in the first instance, and imposes high fines and the threat of license revocation at the apex of the chain of escalation.

In addition to the above suggestions, the use of soft approaches in the form of nudges that harness behavioural insights, and their application in a products context is explored in chapter 5 of this thesis. There we also consider an additional proposal for regulators of the financial sector to apply regulatory nudging as a strategy for reframing the enforcement approach in the financial sector.

With the above discussion in mind we will turn to an examination of product intervention.

4.7 Product Intervention

Product intervention is another approach that can be applied to the regulation of product risks. It refers to measures adopted by regulators that are centred on shaping the design, marketing, distribution and sale of products. Ferran describes it as embodying a more pro-active and interventionist regulatory strategy, as opposed to non-intrusive and ex-post reactions. It comprises aspects such as greater supervisory intervention earlier in the value chain, rules targeting product features, rules limiting the sale of products and setting down specific conditions of sale, and ensuring firms embed robust product governance arrangements.[137] From this description, it can be seen that it

[135] Graham Greenleaf, *Asian Data Privacy Laws-Trade and Human Rights Perspectives* (Oxford University Press, 2014) quoted in Malavika Raghavan, 'Before the Horse Bolts' (*Dvara Research*, 15 January 2018) <https://www.dvara.com/blog/2018/01/15/before-the-horse-bolts/> accessed 26 June 2018.
[136] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992) ch. 2.
[137] Eilis Ferran, 'Regulatory Lessons from the Payment Protection Insurance Mis-selling Scandal in the UK' (2012) 13 (2) *European Business Organization Law Review* 264-267; See generally FSA, *Product Intervention* (n 112).The discussion of product intervention in this section draws from this FSA discussion paper.

involves the combining of elements of product regulation and product governance.

The case for product intervention has been explained via a market failure analysis. Regulatory intervention in markets is generally considered warranted in the case of market failure. In respect of products, one example of a common market failures is that of information asymmetry. This could result in consumers lacking the information necessary to help them make decisions about what to purchase if their choice is made on the basis of price (because of opaque charging structures for example). It could also make it difficult for them to make quality comparisons. Alternatively, it may be the case that they are furnished with information but they do not use this to make suitable purchases. To address this instance of market failure, one of the responses most commonly applied by regulators has been the mandating of disclosures. In this regard, a number of specific measures are often required, including appropriately targeted disclosure rules to cover aspects such as price, product features and conflicts of interest.[138]

Product intervention may also be supported by the fact that retail consumers have been shown to experience considerable challenges with regards to protecting themselves or paying attention to advice. Additionally, interventions that emphasise disclosure or advice will have limited effectiveness, given evidence suggesting that, even where disclosure is mandated, certain product features and sales techniques adopted by firms or consumer behavioural biases can result in harm to consumers.[139] Consequently, this informs the need for additional strategies to protect consumers from detriment. Attacking the problem at the source by intervening early could act as an important backstop. In developing countries such as Kenya, consumers face other pressures due to scarce financial resources, which means they often have limited access to financial products and services as providers generally consider them to be a higher risk. Although offering a needed service, providers who are willing to deal with them might offer exploitative pricing or

[138] FSA, *Product Intervention* (n 112).
[139] See discussion on information-based strategies and their limits.

other unfair terms as a condition for their custom, and hence there is a need for greater regulatory vigilance via intervention to thwart such conduct.

The presence of market failures or other underlying problems that result in harm to consumers, does not necessarily mean that the suitable response is product intervention. Regulators would need to undertake a detailed assessment to determine whether product intervention is merited in the circumstances. This would first require a consideration of the significance of the problem. In making the assessment they could draw from various information sources including firm data, press data and whistle-blower reports.[140] In determining the magnitude, factors that could be relevant might include a consideration of questions such as whether harm could be especially damaging to more vulnerable customer segments, such as consumers facing financial hardship.[141] In Kenya, where most people are poor, product related problems that could contribute to additional financial precariousness for struggling citizens would, by dint of this, be in scope for regulatory attention by way of product intervention.

An examination of products is a vital part of the assessment process, as it may reveal problematic features that could point to products being potentially harmful for consumers. The presence of one or more problematic features would not immediately lead to the conclusion that a product could cause consumer detriment. Regulators are to subject this to an analysis that considers products separately by examining their individual peculiarities. On the basis of this, they may then make a judgment about the level of concern and the most appropriate response. Consequently, it is possible for a product to exhibit concerning features and for the regulator to recommend that the right action is for a firm to enhance its product governance measures to mitigate identified risks. For instance, a firm may be required to implement targeted distribution strategies so that a product judged risky for retail customers would be required to be distributed only to more sophisticated consumers.[142]

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[140] FSA, *Product Intervention* (n 112) para 4.5.
[141] Ibid.
[142] ibid 29-31—for examples of problem features that regulators should look out for.

4.7.1 Supervisory approaches to product intervention

In this section we will examine supervisory approaches to product intervention. There are different approaches to product intervention and regulators can even decide that a particular approach is most appropriate for a specific market segment, such as for retail consumers. As this thesis focuses on retail financial customers, the product intervention options considered in this section are those that have relevance for this particular segment.

Regulators have the option of adopting either a proactive or a reactive approach to product intervention. A proactive approach is one that would see regulators endeavouring to anticipate and avert consumer harm before it arises, or recognising it in the early stages and taking steps to minimise possible detriment. The approaches adopted could also vary in their level of invasiveness. In the years following the GFC, in the course of which a number of toxic financial products were sold, there has generally been a push for the adoption of more interventionist supervisory approaches, including for financial products. This has been informed by post-crisis assessments that exposed weaknesses in some of the pre-crisis approaches. The FSA, for instance, acknowledged that their approach for managing mis-selling had focused inordinately on the point of sale, comprising aspects such as financial promotions, product disclosure and sales practices, and this had contributed to some customers suffering great harm.[143] They had viewed their role as limited to supervision and rulemaking to address the latter stage of the product process, as opposed to earlier in the value chain, such as at the product design/development and marketing/distribution stages.

This approach was later judged faulty and there is now an appreciation that several problems could emerge earlier in the product cycle. At the development stage, these might include exploitative pricing and design features, unfair terms and conditions in contracts, and indifference to how products might function. Issues could also arise at the distribution stage,

[143] FSA, *Product Intervention* (n 112)— Information disclosure rules have been pointed out to be problematic with customers responding to them not paying attention to them, not giving them any weight, or responding to them in unpredictable ways.

where firms may take advantage of consumer cognitive heuristics and behavioural biases. Smith and Dixon examine these in some detail, explaining how these impact consumers (characterised as financial citizens), resulting in them making choices that deviate from rationality. The cognitive heuristics that they argue could affect financial citizens include availability, representativeness and anchoring. With regard to the behavioural biases that affect financial citizens, they discuss overconfidence, risk tolerance, social influence and framing effects.[144]

The trend after the GFC has been to adopt a revised approach that is more interventionist, emphasising early intervention, and requiring sector regulators to be more proactive.[145] Furthermore, it also involves a deeper scrutiny of governance processes related to product design and distribution strategies in use by firms, as well as their post-sale governance procedures. These might cover continuous review of key elements, such as whether the product is reaching the proper consumer segment, customer interactions with it, and its continuing behaviour.[146]

Although an explicit supervisory approach governing product intervention has not been articulated by Kenyan sector regulators, there is a patchwork of rules stipulated in legislation, regulation and other guidance covering diverse aspects. These include disclosure of fees and charges, advertising and promotions, and review of product variations. As shall be demonstrated in the course of the discussion, an examination of the existing provisions reveals a greater focus on the latter stages, and much less on mechanisms for early intervention, which is a significant weakness that, if left unchecked, could lead to consumer detriment. This needs remedying to ensure the robustness of financial product regulation and governance.

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[144] For further details see Kingsford-Smith and Dixon, 'The Consumer Interest and Financial Markets' (n 4) 710-715.
[145] As adopted for example in the UK. See FSA, *Journey to the FCA* (October 2012).
[146] FSA, *Product Intervention* (n 112) 16-18.

4.7.2 Product Intervention Options

There are several supervisory approaches to product intervention that financial sector regulators could use. The discussion will now turn to an examination of these. The product interventions that are discussed in this section vary in their level of intrusiveness. We will consider specific product intervention options, starting with those considered most interventionist and gradually moving to less intrusive options. In the course of the discussion, references will be made to Kenya's legal framework to demonstrate the extent to which they capture these interventions.

4.7.2.1 Pre-Approval of products

Regulators may consider requiring that all firms have their products pre-approved. This usually involves the regulator being provided with product information and an opportunity to scrutinise the product beforehand. This allows them to assess systemic effects and social utility,[147] and to give the firm a nod to proceed to launch the product in the market. Pre-approval is typically an *ex-ante* measure.

The decision to choose this option necessitates that regulators consider the impact a requirement for pre-approval of all products could have on their regulatory activities. If the financial sector is a busy one, with regular product changes, then this would have a direct impact on regulatory resources, including staff and perhaps even systems. Another challenge with this approach is that it exposes regulators to the risk of being perceived as endorsing a product, and this in turn could generate moral hazard. Moreover, the intervention has been criticised for the possibility of impeding innovation and competition.[148]

[147] Bar-Gill and Warren, 'Making Credit Safer' (n 102); Posner and Weyl, 'An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to the Twenty-First-Century Financial Markets' (n 127) 1307; Saule T Omarova, 'License to Deal: Mandatory Approval of Complex Financial Products' (2012) 90 *Washington University Law Review*, 63.
[148] FSA, *Product Intervention* (n 112) 49-50.

In general, this approach is viewed as especially interventionist and therefore, if used, it should be employed with caution. Regulators may consider applying it to particular products where they have specific concerns; for instance, where a particular product has presented repeated problems to the market or where a problem is pinpointed with a product that could have system-wide negative effects.[149] Another approach could be to target the pre-approval requirements to specific firms selected on the basis of their dominance, or systemic importance, or where a firm has in the past been found to have launched problematic products in the market. Alternatively, this might be targeted towards those firms assessed as having weak product governance processes.

Kenya's regulatory framework requires pre-approval, but we argue that often this is applied in a very limited sense. For example, the Banking Act and the CBK's prudential guidelines make it mandatory for CBK to pre-approve increases in rate of banking or other charges.[150] There is no mention here of pre-approval of the actual product. However, such a check on pricing is also useful because it may permit regulators to identify problems linked to exploitative pricing.

Another example of pre-approval is in the CBK Prudential Guidelines on Corporate Governance. These specify that banks should have approval processes for new products. Moreover, it should include an assessment of the risks of new products, significant changes to existing products, the introduction of new lines of business, and entry into new markets.[151] Apart from the generality of this provision, the other issue of note is that it is only directed at banks and therefore would not apply to other financial providers. This represents a huge shortcoming for MFS/MC.

The NPS Regulations makes several references to pre-approval. The first concerns the process for applying for licensing/authorization for the payment of service providers. The application must be accompanied by information on

[149] ibid.
[150] Banking Act ss 44 and CBK/PG/Prohibited Business 3.10; Restriction on bank charges: No institution shall increase its rate of banking or other charges except with the prior approval of the Central Bank
[151] CBK/PG/Corporate Governance 3.8.6.

the type of services to be offered and the programme of operations to offer these services.[152] This suggests that the regulator examines this information to make a determination regarding the issuance of an authorization certificate. However, this cannot be said to be pre-approval of the product, but rather only an authorization for the provider to go ahead and begin operations. Second, there is specific reference to product pre-approval in the licensing process. The regulations provide that, for new products, the applicant shall submit to the CBK one or several proposed names for consideration and approval.[153] Again, this does not go to the core of the product itself. Another more explicit reference to pre-approval is the stipulation that, where a payment service provider plans to introduce substantial changes or enhancements in the designated payment system or payment instrument, the CBK must pre-approve these. Specifically, CBK approval is to be sought thirty days before the proposed implementation of the change or enhancement.[154] Taking the view that the referenced payment instrument is a product, this provision explicitly requires regulator pre-approval of substantial change or enhancements of said product.

4.7.2.2 Product bans

Product bans are typically applied to products that can potentially generate material harm. This could be the case where the product exhibits many problem indicators.[155] Banning can be used either as an *ex-ante* or an *ex-post* measure. The latter categorisation would apply where the product is already available in the market and a ban is imposed to arrest problems identified subsequently, and thereby reduce additional consumer detriment. The former categorisation could be used where harm has not yet occurred, so the ban is issued as a pre-emptory measure.

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[152] NPSR reg 4 2(c).
[153] NPSR reg 4 2 (o).
[154] NPSR reg. 54 (1); At 54(2) more details are provided on the meaning of substantial change or enhancement-one, which expands the scope or changes the nature of the designated payment system or payment instrument and may include: additional functionality of the designated payment system or instrument such as accessing new electronic channels.
[155] FSA, *Product Intervention* (n 112) 29-31— list of example indicators.

Product bans are another example of an option that is considered particularly interventionist. One disadvantage of using bans is that they could contribute to regulatory arbitrage, whereby, in response to the ban, firms deliberately design products that have features that mimic the banned one but are technically not caught by the ban. An advantage of bans (in comparison to pre-approval, which is similarly interventionist) lies in its ease of application, both for firms from a compliance perspective as well as for regulators with respect to ease of monitoring compliance. Bans also require a lower cost of resources to ease enforcement. As an alternative to banning a product in its entirety, bans could be applied to specific product features or combinations of features assessed as having the potential to cause harm to identified consumer segments; for instance, retail consumers. This alternative could additionally prescribe mandatory features that products must either carry or exclude.[156]

There is no specific reference to the use of bans in Kenya's regulatory framework. However, there is a provision under the NPS regulations stipulating that, in exercise of its enforcement powers, the CBK may prohibit a payment service provider from introducing new products.[157] This is listed as one of the possible remedial actions that the CBK may take against a payment service provider who has violated the regulations. Though not a ban and not directed at a specific product, the language has the effect of a ban, as it prevents any products from the affected provider from getting to market.

Bans are also distinguishable by their effects, and in some regimes regulator are empowered to issue temporary or permanent bans. The character of the ban can also change, so that bans can start off as temporary but end up permanent. Taking the example of the UK, the FCA, in exercise of its powers to ban products, has taken steps to intervene early and has taken enforcement action where it identifies products that pose the risk of mis-selling. For example, it halted the sale of contingent convertible securities (CoCos)—a

[156] FSA, *Product Intervention* (n 112) 50-52.
[157] NPSR reg 51(1). The other remedial actions listed in the regulations are not product related. They include: prohibiting payment service providers from offering payment services; prohibiting a payment service provider from engaging in new activities or from expanding existing activities; prohibiting or suspending a payment service provider from any other activity which the Bank perceives to be contributing to violation of these Regulations.

product deemed unsuitable for retail consumers. In 2014, the FCA issued temporary product intervention rules prescribing restrictions in relation to their distribution.[158] The ban became permanent in October 2015. This action, in their estimation, prevented consumer detriment of between £16 million and £235 million.

A more recent example of the use of bans in the UK is in the UK mini-bonds scandal. The FCA is empowered to make intervention rules banning specific financial promotions for being misleading or for preventing consumers arriving at informed investment decisions. In exercise of this power the FCA can demand the withdrawal of offending financial promotions.[159] This power recently invoked in connection with the highly publicised collapse of London Capital and Finance (LCF). Although LCF was regulated, the permission was in respect of the firm and not its products. The mini bonds were not being regulated and neither was their sale protected under the Financial Services Compensation Scheme (FSCS). Following a review by the FCA of LCF marketing of the bonds, the regulator's view was that the manner in which the firm was marketing them was misleading and unclear. To address this, the regulator intervened to ban the misleading promotions issued by LCF and it was directed through a supervisory notice —issued on 10 December 2018— to immediately withdraw its promotional material. Further, scrutiny in this area of the market also revealed that there was uncertainty in the investment community about whether there was FSCS protection for these products. To clarify this issue, the FCA issued a second supervisory notice on 17 January 2019. The notice stated that the ISA's which were being sold were not qualifying investments.[160]

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[158] FCA, *Temporary Production Intervention Rules* (August 2014). <https://www.fca.org.uk/publication/tpi/restrictions-in-relation-to-the-retail-distribution-of-cocos.pdf> accessed 11 May 2017; FCA Press Release, 'FCA Restricts Distribution of CoCos to retail investors (5 August 2014) <https://www.fca.org.uk/news/press-releases/fca-restricts-distribution-cocos-retail-investors> accessed 11 May 2017; for a summarized discussion on why CoCos are a problem see, Marion Dakers, 'Coco Bonds: Why Banks' New Debts are Spooking Investors' *Daily Telegraph* (9 February 2016) <http://www.telegraph.co.uk/business/2016/02/12/coco-bonds-why-banks-new-debts-are-spooking-investors/> accessed 11 May 2017.

[159] FSMA 2000 ss 137 R and S.

[160] FCA, Second Supervisory Notice to LCF (17 Jan 2019) <https://www.fca.org.uk/publication/supervisory-notices/second-supervisory-notice-london-capital-

LCF later fell into administration on 30 January 2019. In May 2019, the Treasury directed the FCA to undertake an independent investigation into the causes of LCF collapse. The firm's failure generated more intense investigation into the risks generated by the marketing of speculative illiquid securities pre and post LCF. In response to the consumer protection concerns that the investigation revealed, and particularly concerns about potential consumer harm materialising in the form of significant and unanticipated losses for less sophisticated consumers purchasing these products, the FCA drew on its early intervention powers. In exercise of these powers, the FCA imposed a temporary ban of twelve months, from 1 January 2020, on the marketing of speculative mini-bonds to retail investors. [161] The ban is applicable to firms that are not approved to promote speculative illiquid securities and will remain in force for the period indicated during which time the FCA will undertake a consultation to determine whether to introduce a permanent ban. The FCA explained that the basis for the ban was their concern regarding the risk of significant consumer harm that could arise from the mass marketing of these products, especially online. The FCA stated that the marketing attached to these products was misleading and were promoted with an emphasis on the high rate of returns and an under-emphasis on the underlying high level of risk. Moreover the products were considered too complex for retail investors who faced the risk of suffering unanticipated losses. The promotions were also judged misleading for being conducted in a manner that could suggest that the FCA (or HM Revenue Customs) offers protection or endorsement of the products. Further, the FCA explained that they considered the risk of consumer harm to be serious enough to warrant the introduction of temporary ban without consultation.[162] Although the FCA has conceded that it has limited powers in dealing with unauthorised users, it has stated that it can take action in relation to the marketing of products when

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and-finance-plc-2019.pdf.> accessed 27 January 2020. Sale of of mini-bonds per se is not protected by the FSCS because it is not a regulated activity. There are exceptions e.g., negligence.

[161] FCA, *Temporary Intervention on the Marketing of Speculative Mini-bonds to Retail Investors* (November 2019) < https://www.fca.org.uk/publication/tpi/temporary-intervention-marketing-speculative-mini-bonds-retail-investors.pdf> accessed 27 January 2020. The ban was announced on 26 November 2019; On LCF mini bonds scandal see FCA website<https://www.fca.org.uk/news/news-stories/london-capital-and-finance-plc#action> accessed 27 January 2020.

[162] ibid.

an authorised firm approves or communicates a financial promotion, or directly advises on or sells these products.[163]

In addition to the ban, the FCA indicated that it would launch a communications campaign to help subvert the misleading or overly-optimistic promotional material in circulation. The campaigns are intended to enhance consumer risk awareness and inform them of factors to consider prior to making high risk investments. They will also comprise measures to make FCA pages and warnings more accessible and visible to consumers, especially online. Another proposal is to target consumers' online searches for high risk investments and interrupt these with FCA warning messages. [164]

In the EU, there are legal provisions that allow the European Securities and Markets Authority (ESMA)—subject to the satisfaction of specified conditions—to temporarily prohibit or restrict the marketing, distribution or sale of particular financial instruments, or financial instruments with certain features, or a type of financial activity or practice.[165] This kind of decision would only be taken in instances in which there was a threat to investor protection, or to the orderly functioning and integrity of financial markets, or to the stability of the whole or part of the financial system in the EU and where regulatory requirements under EU legislation that are applicable to the relevant financial instrument or activity do not address the threat.[166]

4.7.2.3 Price interventions

Regulators in some markets have issued rules relating to excessive product fees and other charges. The nature of these rules vary. Some may be written so as to require regulators to review and pre-approve proposed product fees/charges before they are introduced. For instance, Kenya's Banking Act and the CBK's prudential guidelines make it mandatory for CBK to pre-

[163] ibid.
[164] FCA, *Temporary Intervention on the Marketing of Speculative Mini-bonds to Retail Investors* (n 161).
[165] See MiFIR Article 40(1); Under Article 41 of the Regulation extends these powers to the European Banking Authority in respect of structured deposits. For more on this see, Avgouleas, 'Regulating Financial Innovation' (n 14).
[166] MiFIR Article 40(2).

approve increases in the rate of banking or other charges.[167] Another example is a provision under the Banking Act prohibiting institutions from imposing any form of charges on a savings or fixed deposit account.[168] There are other implicit provisions on pricing, such as in the case of authorization of payment service providers. Under the NPS Regulations, billing information is part of the information that CBK requires applicants to provide as part of the application process. It is to be detailed by applicants in the business plan guidelines they submit to CBK.[169] It can be assumed that the CBK considers the appropriateness of the proposed billing in making the determination as to whether to authorize the payments service provider.

Other price interventions may take the form of price caps or ceilings established by regulators for specific products. On the spectrum of price interventions, price capping is viewed as one of the more stringent options. As an intervention, it presents challenges including how to determine a suitable price cap. Also, regulators generally fear the harmful effects that price caps could unleash on the market, including hampering innovation, or where firms respond by raising prices to match the regulator's stipulated ceiling. Price capping is often used in extreme cases, for instance to tackle instances where there is evidence of firms making supernormal profits by abusing deficiencies in customers' awareness or sensitivity to prices. Often it is used as a temporary measure, and may precede the development of other intervention strategies considered to be better suited to dealing with the identified problem.[170] Kenya's recent experience with interest rate capping for loans illustrates the complexity of implementing this intervention option.

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[167] Banking Act s 44 and CBK/PG/Prohibited Business 3.10 Restriction on bank charges: No institution shall increase its rate of banking or other charges except with the prior approval of the Central Bank.

[168] Banking Act s 16A. A similar restriction on charges for savings accounts is found in the CBK PG/ Prohibited Business at 3.7.

[169] NPSR reg 4 asks for applicants to provide the following billing information: 4.1. A description of the billing system to be deployed (and where applicable details of the software/hardware); 4.2. Description of how customers will be billed indicating whether billing shall be per transaction or according to value of transaction; 4.3 information on the proposed tariff for each service. The business plan guidelines in Annex 2 specifies the info to be included in the guideline, including billing details.

[170] FSA, *Product Intervention* (n 112) 52-56.

4.7.2.3.1 The Case of Interest Rate Capping in Kenya

The amended law capping interest rates in Kenya {the Banking (Amendment) Act, 2016} came into force on 14 September 2016, setting bounds to lending and deposit rates. It set the maximum lending rate at no more than four percent above the Central Bank base rate; and the minimum interest rate granted on a deposit held in interest earning accounts with commercial banks was set to at least seventy percent of the same rate. In line with the CBK Act section 36(4), the CBK set the Central Bank Rate (CBR) as the base rate. The law was implemented following concerns raised by the public regarding the high cost of credit in Kenya.[171] The goal of such caps is usually to incentivise lenders to increase access to credit and bring down lending rates.[172]

Following the passing of this law, there was disquiet in the formal banking sector. It has been suggested that banks' concerns were driven by self-interest, and that they were worried about the law's potential effect on their business bottom line.[173] Banks, for their part, explained that the law made it difficult for them to price risk to businesses and individuals.[174] There have also been concerns that it has had an adverse effect on financial inclusion, as banks are now even more unwilling to advance money, especially to lower income people who are generally considered higher risk. According to news reports, the impact of the capping law saw lending to the private sector drop from 9.3 percent in 2016 to 2.4 percent in 2017.[175] Even organisations like the IMF expressed opposition to the interest capping law.[176]

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[171] CBK, The Impact of Interest Rate Capping on the Kenyan Economy: Highlights (March 2018) <https://www.centralbank.go.ke/wp-content/uploads/2018/03/Summary-of-the-study-on-Interest-rate-Caps_February-2018.pdf> accessed 5 September 2019.
[172] Howard Miller, 'Interest Rate Caps and Their Impact on Financial Inclusion' (Economic and Private Sector Professional Evidence and Applied Knowledge Services 2013) 4.
[173] Souhir Mzali, 'How Has Interest Rate cap Affected Business in Kenya? (Oxford Business Group, 20 June 2018) <https://oxfordbusinessgroup.com/blog/souhir-mzali/obg-business-barometer/how-has-interest-rate-cap-affected-business-kenya> accessed 5 September 2019.
[174] John Ndiso and Humphrey Malalo, ' Kenya's Parliament Approves Retaining Interest Rate Cap, against IMF Wishes' *Reuters* (30 August 2018) <https://uk.reuters.com/article/uk-kenya-economy/kenyas-parliament-approves-retaining-interest-rate-cap-against-imf-wishes-idUKKCN1LF1L4> accessed 5 September 2019; 'Kenyan Lawmakers Say Interest Rate Cap Laws to Stay' *Reuters* (13 April 2018) <https://www.reuters.com/article/kenya-banking/kenyan-lawmakers-say-interest-rate-cap-laws-to-stay-idUSL8N1RQ1GW> accessed 5 September 2019.
[175] Ndiso and Malalo, ibid.
[176] ibid.

Providers of credit like M-shwari[177] tried to evade these new requirements, arguing that the capping law was only applicable to conventional banking and not to mobile lending. Indeed, the interest rate cap was not applicable to unregulated lenders, with the result that they could impose significantly different rates than other lenders.[178] This once again brings to the fore the point that a lack of clarity regarding applicability of provisions in the context of MFS creates potential for mischief among different categories of providers. As such, some providers will try to avoid being caught by regulation that they consider unfavourable for their business model. However, an interpretation in favour of mobile credit that absolves them of the need to comply with the rate law, because they offer credit over mobile phones, would encourage arbitrage, as conventional providers such as banks might choose to switch their offerings to mobile lending as well in order to enjoy the same exemptions.

There was a lot of pressure to scrap this law, but it remained in force for some time, in part due to parliamentarians holding their ground on this matter.[179] Although CBK had shown support for the law at the outset, after almost two years it issued a report indicating that interest rate caps had begun to produce negative effects on the Kenyan economy, including reduced financial intermediation by commercial banks,[180] a shift of lending to banks and large corporates, and an increase to loan fees to counterbalance decline in interest

[177] Offered by Commercial Bank of Kenya and Safaricom.
[178] Michelle Kaffenberger, Edoardo Totolo and Matthew Soursourian, 'A Digital Credit Revolution' Insights from Borrowers in Kenya and Tanzania (October 2018) CGAP, FSD Kenya Working Paper 7.
[179] Dominic Omondi, 'MPs Uphold Rate Cap Law, Scrap Interest on Savings' *The Standard* (30 August 2018) <https://www.standardmedia.co.ke/business/article/2001293862/mps-uphold-rate-cap-law-scrap-interest-on-savings> accessed 5 September 2019; Paul Wafula, 'Banks to Retain Interest Rates on Current Loans' *Daily Nation* (19 August 2019) <https://www.nation.co.ke/business/Banks-to-retain-interest-rates-on-current-loans/996-5240446-bw8lfs/index.html> accessed 5 September 2019.
[180] Anna Ellison and Robert Forster, 'The Impact of Interest Rate Ceilings: The Evidence of International Experience and Implications for Regulation and Consumer Protection in the Credit Market in Australia' (Policis, 2007) 32. According to authors when lenders cannot obtain the price for credit they judge proportionate to risk, they are unlikely to lend.

income.[181] Research by the World Bank Group also reported negative results based on the analysis of bank data and interviews conducted with banks.[182]

The implementation of the interest rate capping law remained controversial and eventually ended up before the courts in the case of *Boniface Odour vs AG & 2 others,*[183] in which the court considered the implications of the Banking Act provisions on interest rate capping. In a judgement issued in March 2019, the High Court held that sections 33B (1) and (2) of the Banking Act were invalid by virtue of ambiguity, imprecision and indefiniteness. Hence they were held to lack the minimum degree of certainty demanded of legislation that creates criminal offences. [184] The court declared the provisions unconstitutional and ordered that they be struck out for being discriminatory, contrary to Articles 27 and 29 of the Constitution, and for infringing the fair hearing provision under Article 50. Some of the aspects that the court considered when examining the lack of clarity in the law were in respect of terms used. They found that neither the terms 'loan' or 'credit facility' had been defined under the Banking Act, or indeed under the Interpretations and General Provisions Act.[185]

The court temporarily suspended the striking out of the provision to avoid the "risk of throwing the entire banking industry in turmoil". The court gave Parliament twelve months (until March 2020) to re-examine the law. Thereafter, efforts were made to address the existing loophole with the

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[181] CBK, *The Impact of Interest Rate Capping on the Kenyan Economy: Draft for Comments* (March 2018) <https://www.centralbank.go.ke/wp-content/uploads/2018/03/Interest-Rate-Caps_-March-2018final.pdf> accessed 5 September 2019.

[182] Mehnaz Safavian abd Bilal Zia, 'The Impact of Interest Rate Caps on the Financial Sector-Evidence from Commercial Banks in Kenya' (April 2018) The World Bank Group, Working Paper 8393. <http://documents.worldbank.org/curated/en/681501522684167817/pdf/WPS8393.pdf> accessed 5 September 2019.

[183] *Boniface Odour vs AG & 2 others*, High Court of Kenya at Nairobi Petition 413 of 2016, eKLR 2019; <http://kenyalaw.org/caselaw/cases/view/169536/> accessed 3 September 2019.

[184] Article 27 on equality and freedom from discrimination; Article 29 freedom and security of the person; The court stated that the penalties for contravention of the provision were fairly severe and banks, financial institutions and their respective CEOs would risk suffering severe penalties for failure to comply with unclear laws (para 180).

[185] *Boniface Odour vs AG & 2 others* (n 183) — on the lack of clarity of terms see para 165 and 166 of the judgement.

introduction of a new Bill. However, this was unsuccessful as the provision on rate caps was eventually repealed in November 2019.[186]

The court further recognised that a circular that the CBK had issued to the industry on 13 September 2016 had enhanced stakeholder certainty on some level, and that this should continue until the enactment of a new provision.[187] The court interpreted the issuance of the circular to clarify several issues as evidence of ambiguity of the relevant sections.[188] The CBK Circular referenced was issued pursuant to section 57 of the CBK Act, which empowers the bank to make regulations, and to issue guidelines, circulars and directives for the purpose of giving effect to the provisions of the Act and for the better carrying out of objects of the Bank under the Act. The circular clarified the provision under 33B of the Banking Act on the base rate. Further, in line with section 31A of the Banking Act, which makes it mandatory for banks or financial institutions to disclose all the charges and terms relating to loans prior to granting them, it also required institutions to submit copies of their policies to the CBK, which, in keeping with the circular, would ensure full disclosure in line with the Act.

On a more general note, the CBK circular also mentioned the need for reforms to improve the operation of the credit market. The reforms proposed include measures to enhance the cost of credit disclosures, to strengthen credit information sharing, and to improve interbank liquidity management.[189] This articulation of reforms suggests that the regulator has identified the credit market as exhibiting weaknesses. We suggest in this work that a robust product regulation governance framework could be helpful for achieving the

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[186] The provision on capping of interest rates (Banking Act s 33B) was removed in with the enactment of the Finance Act 2019 on 7 November 2019; KPMG, The Finance Act 2019 a KPMG Analysis (November 2019) <https://assets.kpmg/content/dam/kpmg/ke/pdf/tax/2019/KPMG_Finance_Act2019_Analysis.pdf> accessed 24 December 2019; James Anyanzwa, 'CBK Regains Control of Monetary Policy After Uhuru Signs Repeal of Interest Rate Law' *The East African* (10 November 2019) < https://www.theeastafrican.co.ke/business/Rate-cap-repeal-frees-CBK-after-three-years/2560-5344032-m09x3o/index.html> accessed 24 December 2019.

[187] *Boniface Odour vs AG & 2 others* (n 183) para 207.

[188] ibid para 175.

[189] CBK, Banking Circular No. 4 of 2016 on The Banking (Amendment) Act 2016. <https://www.centralbank.go.ke/uploads/banking_circulars/1456582762_Banking%20Circular%20No%204%20of%202016%20-%20The%20Banking%20Amendment%20Act%202016.pdf> accessed 3 September 2019.

goals that the CBK set out for the wider credit market and MC. This case is instructive as it illustrates the impact of vague or imprecise rules, and therefore emphasises the need for achieving the right level of precision in the rule-making process.[190]

4.7.2.4 Consumer and industry warnings

These warnings could be used as a means for regulators to nudge firms and consumers away from worrisome products that exhibit problematic features. Alternatively they could disincentivise those that would be considered too complex or otherwise unsuitable for more vulnerable consumers. This approach would be beneficial for managing risks linked to product mis-selling. It would be open to the regulator to issue a warning for one product or several. To be effective, such warnings would need to be properly timed. Specifically, warnings would need to be published as early as possible, that is before the harmful effects of the products spread. The warnings would be published by the regulator or by providers.[191] They would also need to be framed in the right way. Applying behavioural insights to the crafting of such warnings is something that regulators will want to give attention to in order to ensure they are effectively communicated and have the desired effect on the market; i.e. of modifying behaviour by guiding participants away from these products.

The warnings are not bans and should not be construed as such. In the end, the decision whether or not to purchase product(s) that are the subject of warnings sits with consumers. Nonetheless, of import would be the fact that the regulator had been proactive—in this instance by warning consumers of their danger or requiring this from the industry. An example of reference to the use of consumer warnings in Kenya is in the CBK prudential guidelines on consumer protection. These provide that specific disclosure mechanisms, including possible warnings, should be developed by institutions to provide information commensurate with complex and risky products and services.[192]

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[190] See Colin S Diver, 'The optimum Precision of Administrative Rules' (1983) 93 *Yale Law Journal* 65; Julia Black, *Rules and Regulators* (Clarendon Press, 1997) Ch. 1 and 4.
[191] FSA, *Product Intervention* (n 112)57-58.
[192] CBK/PG/Consumer Protection 3.4.1 (iv).

The CBK is also empowered by NPS regulations to publish any information the Bank considers useful to customers. This might include, but is not limited to, tariffs, quality of service and statistical information. Although worded very generally, we would argue that the CBK could rely on this provision to publish customer warnings.[193]

A recent example illustrates the use of warnings by regulators in Kenya. To address challenges relating to the proliferation of unlicensed and unregulated financial services and products, regulatory action has recently been taken in the form of public warnings and notices to consumers. Six regulators in the financial sector issued a joint public notice that highlighted the risks of emerging unregulated mobile lenders, including the fact that some were exposing borrowers to losses.[194] The notice was signed by the Capital Markets Authority, Central Bank of Kenya Insurance Regulatory Authority, Ministry of Trade, Industry and Co-operatives, Retirement Benefits Authority and Sacco Societies Regulatory Authority. The notice provided a list of licensed financial providers that excluded Fintech firms that have become synonymous with mobile credit offerings. Following this notice, the Government warned the public against dealing with digital credit providers, saying many of them were operating illegally, advising borrowers that they should only deal with financial providers that are regulated and licensed.

Warnings can also take the form of letters circulated to the industry in respect of problematic products, as the example drawn from the UK illustrates. For instance, in January 2018 the FCA issued a fierce Dear CEO letter to companies offering risky investment products to retail clients, highlighting poor compliance, management failings and the high risk of mis-selling. The products that were the subject of this letter are called contracts for difference (CFDs), and the regulator said that a market review revealed areas of unease

[193] NPSR reg 36(1) and (2).
[194] Dominic Omondi, 'Regulators Cautions Public against Mobile Loan Providers' *The Standard* (25 July 2018) <https://www.standardmedia.co.ke/business/article/2001289331/government-warns-public-on-mobile-loan-providers, Standard Digital> accessed 5 September 2019.

that they wanted to highlight. They asked firms offering these products to resolve failings which might cause significant harm to consumers.[195]

4.7.2.5 Mandated risk warnings

Mandated risk warnings are a disclosure-based solution. The approach is similar to what is used for health warnings on cigarette packs. Assertions have been made that debt incurrence can become addictive, and in some instances the use of credit products has been likened to addiction or compulsion.[196] For instance, credit cards have been compared to tobacco [197] and crack cocaine.[198] Consequently, it is argued that, in view of the dangers, consumers should be warned of the dangers of credit products in the same way as warnings are issued for other addictive products. Moreover, they should be informed about how to reduce their risk.

In adapting this approach to financial products, a regulator could mandate the warnings to be disclosed on products that are considered suspect. It could be made a mandatory requirement that language used should be clear and unambiguous. Indeed, the mandate could go so far as to specify the format, font, position and size of the warnings on disclosure documents. The types of document in the purview of such a mandate will vary. They may include, for instance, financial promotions and other advertising, or standard form contracts.[199] This level of prescription would apply to a product regulation approach, as discussed earlier. By contrast, under a conduct based principles approach, this might be framed as a broad rule requiring firms to employ language that is “clear and unambiguous”. Under conduct based product governance, firms might be given the responsibility of defining warning parameters, which would be subjectable to regulatory oversight.

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[195] FCA, *Dear CEO Letter* (10 January 2018) <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-cfd-review-findings.pdf> accessed 28 January 2018.
[196] Joan Caplin, *Confessions of a Compulsive Shopper*, MONEY, 4 November 2005, <https://money.cnn.com/2005/07/20/pf/shopper_0508/index.htm> accessed 26 August 2019.
[197] David K Stein, 'Wrong Problem, Wrong Solution: How Congress Failed the American Consumer' (2007) 23 *Emory Bankruptcy Developments Journal* 626.
[198] Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, (2005) 79 *American Bankruptcy Law Journal*, 520.
[199] FSA, *Product Intervention* (n 112)58.

An example of a provision that embodies some of these elements and references their application to the use of warnings is the CBK Prudential Guidelines on Consumer Protection. The provision does not go so far as to mandate the warnings to be disclosed on products, but it does spell out some general restrictions. Specifically, it stipulates that an institution shall not disguise, diminish, obscure or conceal a material fact or warning through, among other means, use of unreadable small print, describing the material fact or warning in complex language, use of voluminous documents, or omitting a material fact or warning.[200]

The challenge with mandated risk warnings is that, for them to work, consumers must first read and thereafter follow them. As was proposed in respect of the designing of consumer and industry warnings, behavioural insights could be applied to framing risk warnings in a way that has the greatest chance of nudging consumers to heed the warning and to elect not to purchase the product if inappropriate for them.

4.7.3 Point of Sale and Post-Sale Interventions

The point of sale and post-sale stages are important parts of the product life cycle and have typically been the areas that have received regulatory attention. These will be considered briefly, as the focus of this chapter is early intervention options. A review of Kenya's legal and regulatory framework reveals provisions governing aspects such as information provision and advice to customers, advertisement and financial promotions,[201] and other disclosures. On information provision, the CBK Prudential Guidelines on Consumer Protection provide for consumers to be given explanations of product features and material aspects of financial products.[202] Further, there is a specific provision that asks providers to prepare a key facts document to inform consumers. This summarises things like key product features, fundamental benefits and risks requirements to be met in order to consume

[200] CBK/ PG Consumer Protection 3.2.1 (c)(vii)
[201] CBK /PG Consumer Protection 3.4.1 (ii) provides that financial promotional material should be accurate, honest, understandable and not misleading.
[202] CBK /PG Consumer Protection 3.2.3 (a) and (b) Provision of Information and Advice to a Consumer and CBK / PG Consumer Protection 3.4.1 (i).

the product or service, charges and fees, transaction process, and complaint procedures.[203] Institutions are also required to ensure that information on their products and services is updated, current and easily available via branches, websites and other communication channels.[204] The NPS Regulations also stipulate that a payment service provider shall provide a clear and understandable description of the services it offers.[205] It further provides that a payment service provider shall notify customers (and CBK) of material changes to rates, terms, conditions and charges at least seven days prior to their taking effect.[206] Notably, this is not worded as to require the regulator to pre-approve these changes.

There are also a number of provisions that specify that consumers should be informed about product charges, fees, rates and penalties, and other terms and conditions, including under the CBK Prudential Guidelines on Consumer Protection[207] the Competition Act[208] and the NPS Regulations.[209] In addition to prescribing the information to be given to customers, the NPS regulations specify that CBK and customers should be notified of any material changes in the rates, terms, conditions and charges. This should take place at least seven days before the changes take effect. The CBK Guidelines on Consumer Protection similarly require that customers are notified of changes "within a reasonable time as the circumstances of the case may require and before implementing any changes to the terms and conditions of a contract, fees or charges". [210]

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[203] CBK /PG Consumer Protection 3.4.3 Key Facts Document.
[204] CBK /PG Consumer Protection 3.4.2 (h)
[205] NPSR reg 35(1) (a).
[206] NPSR reg 35 (c).
[207] CBK/PG Consumer Protection 3.2.3 (a) and (b) Provision of Information and Advice to a Consumer; CBK/PG Consumer Protection 3.4.3 Key Facts Document. See also CBK/PG Consumer Protection 3.4.4 that provides that the terms and conditions provided by an institution shall highlight to a consumer the fees, charges, penalties, relevant interest rates and any other consumer liabilities or obligations in the use of the financial product or service. CBK/PG Consumer Protection 3.4.5 requires disclosure of interest rates for both interest-bearing deposits and loans to consumers prior to contract signing. See also CBK/PG Consumer Protection 3.4.6 and 3.4.7 for additional provisions on fees and charges and their display, including requiring disclosures for third party fees and charges, and specifying that these third parties third party or agent must be approved by the CBK as stipulated under the relevant legislations such as Outsourcing and Agent Banking Guidelines.
[208] Competition Act section 56(4).
[209] NPSR reg. 35(1) (a).
[210] CBK / PG Consumer Protection 3.2.9.

There are also provisions prescribing suitability assessments to be conducted at the point of sale, such as in CBK's Prudential Guidelines on Consumer Protection. Institutions are required to request the consumer to provide, where applicable, all the information needed to verify their eligibility for a product or service that they are interested in.[211]

4.8 Looking Ahead—Proposed Changes to Financial Market Conduct Regulation in Kenya

At the time of writing, a draft Financial Markets Conduct Bill 2018 (FMC Bill) is under consideration in Kenya.[212] The FMC Bill contains a number of provisions relevant to the subject of product regulation and governance. If passed, it will offer some level of improvement to the conduct regulation landscape, and it may address some of the concerns raised in this chapter.

The discussions relating to the FMC Bill in Kenya point to a shift in focus and great interest in adoption of a model similar to the twin peaks model (adopted in the UK, Australia and New Zealand).[213] This model establishes two centres of expertise, one of which focuses on conduct regulation. The proposed Act will establish new authorities, including a proposed Financial Markets Conduct Authority with a sector-wide mandate.

The purpose of the proposed Act is provided as being:

> *To promote a fair, non-discriminatory marketplace for access to credit, to provide for the establishment of uniform practices and standards in relation to the conduct of providers of financial products and financial services, including regulating the cost of credit, establishment of the Financial Markets Conduct Authority, the Financial Sector Ombudsman and the Financial Sector Tribunal, supervision of conduct of providers*

[211] CBK / PG Consumer Protection 3.2.3 (a) (iii).
[212] Dominic Omondi, 'Inside Treasury's New Bold Plan to Rein in Rogue Lenders' *The Standard* (29 May 2018) <https://www.standardmedia.co.ke/business/article/2001282137/inside-treasury-s-new-bold-plan-to-rein-in-rogue-lenders> accessed 12 September 2019.
[213] The UK model is not considered to be strictly twin peaks as the prudential supervision is conducted by both the PRA and FCA. The former supervises firms considered significant to overall financial stability, while the latter oversees smaller firms.

in relation to retail financial customers, promotion and maintenance of a fair and efficient financial sector in Kenya, and for connected purposes

The type of conduct in the scope of supervision is that related to financial persons, and small and medium enterprises.[214]

We would argue that the CBK has (implicitly) been tackling conduct risks, but the new Bill aims to make things more explicit, including setting up a separate authority: a Financial Markets Conduct Authority which is established under section 11 (1), with its objectives and functions set out in section 12 and 13 respectively.[215] This authority is to be tasked with responsibility for retail financial market conduct and specifically for conduct related to financial products.

The authority is to have a specific mandate over credit products. Its responsibility in this regard is stipulated as:

12(b) protect retail financial customers with respect to credit—
(i) by regulating the cost of credit;
(ii) from inappropriate lending practices; and
(iii) by regulating the accuracy, availability and protection of financial information through credit sharing mechanisms;

The scope of the proposed law is intended to be wider than the existing financial sector provisions. This can be seen from the definition of the financial service providers to whom the law will apply. This includes a person that, as a business or as part of a business, provides a financial product, as well as references in various sections to lenders. This definition is, in our view, wide enough to include different provider categories. However, it must be noted that

[214] FCM Bill s 2.
[215] The objectives of the Authority shall be to—
(a) protect retail financial customers—
(i) from misleading, deceptive, unfair and fraudulent conduct;
(ii) by promoting fair, equitable and sustainable access to financial products and financial services;
(iii) by ensuring that retail financial customers can make informed choices through the provision of useful information about financial products and services; and
(iv) by promoting financial literacy and the ability of retail financial customers and potential retail financial customers to make sound financial decisions.

this provision is in conflict with the NPS Regulations, which restrict lending to institutions, as the definition of institutions provided in the regulations does not seem to extend to MNO and Fintech credit.

The Bill proposes to introduce a mandatory requirement that all providers of financial products or services obtain financial conduct licences, which are to be issued by the proposed Financial Markets Conduct Authority. There are some exceptions to ensure proportionality; for instance it is specified that this licensing requirement will not apply to providers who have fifty clients or less.[216] The Bill also has provisions on unlawful credit contracts and stipulates what would fall into that category.[217]

4.8.1 Product Intervention Options in the FMC Bill

4.8.1.1 Price interventions

The Bill specifies prohibited fees and charges. It prescribes that a lender under a regulated credit contract shall not (a) have a provision in a credit contract that provides for an interest to become payable before the end of the period by reference to which the interest is calculated or charged or recovered. Nor should they attempt to charge or recover any amount referred to under paragraph (a) before the time at which the amount becomes due and payable. Moreover, it makes it an offence for a lender to contravene this provision.[218]

4.8.1.2 Disclosures

Disclosures to be made to consumers of relevance to products include, at the pre-contract stage, a pre-contract statement that specifies the proposed interest rates, insurance required by the proposed contract, and, specifically, the identification of any fees and charges imposed under the proposed credit

[216] FMC Bill s 53(3).
[217] FMC Bill Part IX.
[218] FMC Bill s 72(1) and (2).

contract in relation to insurance.[219] Moreover, lenders must specify any fee, charge or cost, repayment intervals and dates, and total amounts payable.[220]

4.8.1.3 Reckless lending

There is also a provision that seeks to deal with reckless lending. It makes it an offence for a person to enter a regulated credit contract as a lender unless they have determined that the likelihood that the borrower will be able to comply with the financial obligations under the contract without substantial hardship, is acceptable. The same rules also stipulate that borrower consent is required to increase credit limits. Variations or agreements to vary are predicated on determining that the borrower will be able to repay. Contravention is an offence.[221]

A number of other restrictions are stipulated, including requiring lenders to obtain borrower consent to increase, or include in the contract a provision that permits the increase of the credit limit. Additionally, variation, or agreements to vary the contract to increase the amount of credit to be advanced to the borrower or the credit limit, is predicated on determining that the borrower will be able to repay without substantial hardship.[222]

4.8.1.4 A brief critique of the Bill

Although discussions around the Bill point to progress, this development amounts to more CAC type regulation. Additionally, it is the operationalisation of envisaged rules which will be the true test of their effectiveness in addressing conduct in the finance sector.

One of the areas that remains unclear is how the roles of the CBK and the new conduct authority will be delineated. There have been murmurs of possible tensions and worries from the CBK that, with the establishment of the conduct authority, its powers will be curtailed. In view of this, it will be important to minimise tensions by putting in place measures to address any perceived

[219] FMC Bill s 59(2) (a) and (b).
[220] FMC Bill s 59(2) (c).
[221] FMC Bill s 61.
[222] FMC Bill s 63.

regulatory creep, and to create clarity regarding the roles of the CBK and the proposed authority.

The Bill places a lot of emphasis on credit. Part VI of the Bill contains the relevant provisions on credit. Credit may have been singled out for attention in view of the current challenges presented by the rise of unregulated providers of financial products and services offering this product, particularly with the rise of MC. However, a glaring weakness of the Bill is its seeming lack of foresight. Credit products may be the big concern now, but it does not sufficiently address scenarios in which other product types emerge further down the line. In our view, the Bill should be drafted to accommodate a wider array of products. Even more of a concern is the fact that it seems to suggest that, in the universe of conduct regulation, credit regulation is the chief risk area, which in our opinion would be an incorrect framing of the scope of conduct regulation.

Overall, the FMC Bill is more rules than principles based. There seems to be no clear principles driven approach. As argued before, Kenya could benefit from the adoption of a principles-based approach to conduct regulation. Such an approach would give more enforcement latitude to regulators and address future/longer term developments. Debates in this area suggest that rules may quickly become outdated, but principles are often better able to deal with advancements in financial innovation as the pace of innovation in this sector is often rapid. An approach that offers a better balance between principles and rules would thus be preferable.[223]

The Bill is yet to be passed into law, and there is still a lot of debate around it, so it remains to be seen whether further iterations will be released that address the weaknesses we have briefly pointed out here. Of relevance to the thesis is the fact that there is an attempt to regulate conduct, and specifically that of products—which is a laudable development.[224]

[223] See discussion on rules and principles in chapter on risk regulation (ch2).
[224] At the time of submitting this thesis, discussions on the Bill have gone quiet and there are murmurs indicating that it may have been shelved.

4.9 Conclusions

We have discussed several themes relevant to the structuring of a product regulation and governance regime for Kenya and will outline some key points in closing. The principles based approach to conduct regulation discussed above has been argued to be more effective than product regulation, given its ability to control both the provision of information and product design.[225] In addition, the product governance approach to conduct regulation is also recommended for its ceding of control over design choices to product manufacturers, thereby harnessing their vast expertise concerning consumer behaviour in order to contribute to the indirect promotion of better consumer choice. While we recognise the benefits of a conduct-based strategy, we posit that, although product regulation has shortcomings, it has far-reaching benefits for addressing the specific product challenges presented by MC. The regulatory prescriptions that form the basis of product regulation are sometimes necessary. This may be the case, for example, where a regulator has observed problematic products in the market. As was mentioned above, this is the approach that has been employed to regulate pay day lending in the UK—a product that shares many of the characteristics of MC. Later in the chapter, we examined several product intervention options, some of which could fall into the category of product regulation.

We have also made an additional and broader recommendation in this work—that Kenya needs to develop and implement an overarching conduct regime that addresses *inter alia* conduct regulation in relation to consumer products. The inattention to conduct aspects of regulation in Kenya is revealed by CBK's *prudential guidelines.*[226] These are equivalent to the rule books issued by the UK's FCA, but as their title suggests, they are focused on the *prudential* and there are no rules to address the conduct side. While it is recognised that prudential and conduct matters tend to overlap,[227] we submit that, as the lead

[225] Armour and others, *Principles of Financial Regulation* (n 1) 265.
[226]CBK Prudential Guidelines for Institutions Licensed under the Banking Act <https://www.centralbank.go.ke/wp-content/uploads/2016/08/PRUDENTIAL-GUIDELINES.pdf> accessed 23 September 2019.
[227] Clive Briault, 'The Rationale for a Single National Financial Services Regulator' (1999) FSA Occasional Paper No 2, 14.

finance sector regulator, CBK needs to create understanding around these two broad categories to help improve regulatory effectiveness in the MFS/MC context and beyond. An explicit conduct regime would embody high-level principles as proposed, as well as the product governance approach, and thereby serve to address the weaknesses intrinsic in product regulation. In so doing CBK can draw inspiration from the product intervention and product governance source book that was issued by the FCA in January 2018,[228] as well as the EU, where the product governance strategy has similarly been adopted.[229]

The EU's embrace suggests a recognition of the value of this strategy for other sector regulators besides the UK, and therefore the strategy is worth considering for finance sector regulators in Kenya as well. By arguing for consideration of these approaches, this work is not advocating blanket borrowing from other jurisdictions. The danger of transplantation has been previously noted, and therefore the approaches must first be analysed and tweaked as appropriate to address the peculiarities of the Kenyan regime. The analysis may well lead to a decision that eschews wholesale transplantation and instead borrows key elements of the strategies, structuring them in a way that is suitable for the country specific context.

Further, in contemplating the adoption of a conduct regulation regime Kenyan regulators should give careful thought to the scope of the rules to be crafted. This will avoid the challenge that has been noted in some jurisdictions, whereby conduct regulation ends up doing too much of the work of general

[228] FCA, PROD <https://www.handbook.fca.org.uk/handbook/PROD.pdf> accessed 9 September 2019.

[229] See examples of consultations by EU sector authorities on product governance frameworks to be embedded in corporate governance rules for firms; ESMA, 'Structured Retail Products—Good Practices for Product Governance Arrangements' (March 2014); EIOPA, 'Consultation Paper on the Proposal for Guidelines on Product Oversight and Governance Arrangements by Insurance Undertakings' (October 2014); EBA, 'Draft Guidelines on Product Oversight and Governance Arrangements for Retail Banking Products' (November 2014). Notably this approach has been adopted by authorities at EU level as reflected under The Markets in Financial Instruments Directive (MiFID II). It is the framework of European Union (EU) legislation for investment intermediaries that provide services to clients around shares, bonds, units in collective investment schemes and derivatives (collectively known as 'financial instruments') and organised trading of financial instruments. Product governance was rolled out through MiFID II to all investment firms across Europe in 2018: see MiFID II, Arts 16(3) and 24(2).

law.[230] The questions of how to minimise duplication and how to create clarity around the way in which conduct regulation interacts with general law are therefore important ones.[231] They address the challenge that parallel regimes of public and private law often present—that they can create confusion where the statutory framework neglects to clarify how the two interact.[232]

On the subject of product intervention most of the intervention options we have examined can be applied either on *ex-ante* (before harm materialises) or *ex-post* (after harm) bases. Others, such as product pre-approval, are only capable of being applied *ex ante*. Besides the examples discussed, there are a number of measures that could be used *ex-post* that form part of the product regulatory frameworks in some jurisdictions. These include consumer post-event complaint processes; for example, complaints via an Ombudsman service. Another is post-event compensation through consumer compensation schemes. A look at additional post-sale regulatory approaches in other jurisdictions is also instructive, especially with regards to how regulators can take pre-emptive action even at the post-sale stage. In the UK, the regulator can take pre-emptive action in respect of problematic contract terms.[233] As a first step, they may write to the firm indicating their concerns and give them an opportunity to review and revise them.[234] Further, for purposes of guidance, the regulator has provided an indicative list of terms considered problematic (grey list) but may inquire into other terms.[235] Although these are beneficial and should form part of a robust regulatory framework, their use signals that the consumer will have already suffered some harm. Moreover these options are not costless; consider, for instance, the vast amounts of compensation that have been paid out to customers who have been mis-sold financial products.[236] While these serve an important role as recourse methods in the event of market or regulatory failure, we would argue that the best strategy

[230] MacNeil, 'Rethinking Conduct Regulation' (n 125) 414.
[231] See Julia Black, 'Law and Regulation: The Case of Finance', in Christine Parker and others (eds) R*egulating Law* (Hart Publishing 2004) for discussion on how regulatory rules and (common) law negotiate their relationship around each other.
[232] MacNeil, 'Rethinking Conduct Regulation' (n 125) 418.
[233] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5) 260-1.
[234] FCA Handbook (Unfair Contract Terms Regulatory Guide) UNFCOG 1.3.4.
[235] UNFCOG ibid Annex 1.
[236] For example in respect of mis-selling of PPI in the UK.

from a consumer protection perspective, would be for regulators to do their utmost to minimise the need for customers to use them. Customers could then seek them out as options of last resort. It is in this spirit that this thesis strongly urges a shift towards early intervention and regulator proactivity for the Kenyan financial services landscape.

In re-evaluating their supervisory approach, sector regulators will want to embed appropriate product intervention options. In order to do this effectively, they need to undertake a prior assessment aimed at isolating weaknesses in existing approaches, and then to determine what intervention would be suitable to address them. One of the principles we can draw from the discussion to guide this process is that, in order to ensure good outcomes for financial services consumers, regulators and firms should be attentive to the entire product life cycle-development and distribution, as well as point of sale and post-sale stages.

Several examples of early product intervention mechanisms have been considered above. As the discussion has demonstrated, the existing regulatory framework in Kenya does not give enough weight to these product intervention options. Additionally, there is the challenge of the limited applicability of some of these provisions. Although general law has a wide reach where there are relevant provisions, the scope of the CBK's Prudential Guidelines only extends to banks and regulated institutions as defined under the Banking Act. The Guidelines would therefore exclude providers such as Fintechs and MNOs (such as Safaricom). The NPS provisions mentioned would likewise only apply to authorized payments service providers, including mobile payments service providers. Kenyan financial regulators should contemplate the adoption of early intervention options as additional tools in the regulatory toolkit, in order to form a holistic regulatory framework. In addition to such rules, there is need for the development of a more comprehensive product regulation and governance regime that is more prescriptive and addresses the risks presented by the offering of financial products by different categories of providers, including banks, MNOs and Fintechs. Such a regime would spell out *inter alia* the specific product

intervention options that will be applied by the regulator. Overall, regulators should be ready to subject products to scrutiny and to challenge, and, where the suitability of products is in question, firms should be required to furnish regulators with proof of this.

The exercise of regulatory judgement is also important in order to determine when to intervene and which option to choose. For instance, some regulators have been said to adopt a 'light-touch' or less interventionist stance during good times so that they are not seen as overreaching.[237] However, this exercise of discretion presents the risk of creating decision-making that is opaque and erratic.[238] They should therefore incorporate accountability mechanisms to ensure their intervention powers are properly exercised.[239]

An additional point of reflection is the impact that the adoption of a pre-emptive and protective approach could have. In line with Beck's assertion that we have become a risk society, concerns have been raised that the aforesaid approach could lead to consumers becoming unduly intolerant of financial risk.[240] Moreover, there are concerns that a paternalistic approach could promote conduct that absolves personal responsibility in favour of assigning third party responsibility for risk.[241] On the flip side, Luhmann cautions that pre-emptive strategies can alter risk perception, which could result in individuals becoming more risk-seeking.[242] Another question raised is whether the approach may generate moral hazard because it may result in consumers assuming that responsibility for financial risk rests with firms.[243] Ongoing sector monitoring may help to clarify these concerns.[244] Other areas to be monitored, as proposed by Ferran, are the impact of product intervention on product choice,

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[237] Ferran, 'Regulatory Lessons from the Payment Protection Insurance Mis-Selling Scandal in the UK' (n 137) 248.
[238] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5) 239.
[239] The UK regulator for example has detailed measures to ensure that their product intervention powers are used in an accountable way. See FSA, 'The FCA's Use of Temporary Product Intervention Rules' (March 2013) <https://www.fca.org.uk/publication/policy/fsa-ps13-03.pdf> accessed 16 September 2019.
[240] Sidney A Shapiro and Robert L Glicksman, *Risk Regulation at Risk* (Stanford University Press, 2003) referenced in Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5) 257.
[241] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5).
[242] Niklas Luhmann, *Risk: A Sociological Theory* (Walter de Gruyter 1993) 29.
[243] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5) 257.
[244] ibid.

including effects on product innovation.[245] It is also suggested that, in order to address moral hazard risks, the pre-emptive paternalistic approach ought to be balanced by the implementation of contemporaneous initiatives, such as consumer financial literacy and education.[246]

Regulator capacity, in terms of skill level, is another important aspect to consider. To carry out their supervision role effectively requires expertise in product design, and, in the absence of this, they should endeavour to build it.[247]

In summary, in this chapter we have emphasised the need for the establishment of a robust product regulation and governance approach for Kenya. Subject to effective implementation and checks on regulatory forbearance, this would help to reduce the innovation and product specific risks generated in the wider products context and for MFS/MC. Such an approach would incorporate aspects of product regulation and a conduct regime for products. It would also require the use of *ex-ante* and *ex-post* interventions as part of a comprehensive strategy. The development and implementation of this approach may necessitate regulatory and legislative amendments in some instances.

[245] Ferran, 'Regulatory Lessons from the Payment Protection Insurance Mis-Selling Scandal in the UK' (n 137) 248.
[246] Andenas and Chiu, *The Foundations and Future of Financial Regulation* (n 5) 267-273. Authors suggest that these initiatives could even be aimed at overcoming behavioural biases.
[247] FSA, *Product Intervention* (n 112) 35.

5. Regulatory Nudging

5.1. Introduction

The concept of "regulatory nudging" (RN) explored in this chapter refers specifically to the use of 'nudge' and nudge-like tools by regulators as a regulatory strategy. We use this concept to interrogate how to structure decision making contexts or present choices to the regulated with a view to modifying their behaviour. As will be explained below, we consider RN to be preferable to more traditional approaches, namely Command and Control regulation (CAC), and economic or incentive-based approaches. In other circumstances we consider RN to augment them.

In this chapter we will principally consider how the RN approach can be used to address the boundary between risk and uncertainty, and thus, more broadly, how its application can support the achievement of regulatory objectives, including consumer protection. With regard to the latter, we further suggest that the increasing use of BE and nudging for the purposes of improving regulatory outcomes—particularly in respect of consumers—indicates that consumer protection is evolving. Notably, in the post-GFC years there have been efforts at rebalancing the *caveat emptor* principle that has for years underpinned consumer participation in financial markets. The UK is a case in point. Prior to the crisis, the FSA's consumer protection objective was promoted alongside an emphasis on consumer empowerment to assist consumers make informed choices.[1] It is suggested that the weakness of this model was that it posed the risk of too much financial savvy being expected of retail consumers. Under the approach, consumers were considered shrewd

[1] See Niamh Moloney, 'Regulating the Retail Markets: Law Policy and the Financial Crisis' (2010) 63 (1) *Current Legal Problems* 375—on 'caveat emptor' and post-crisis reform in retail markets in general; See also Joanna Gray Jenny Hamilton, 'Regulation and the Emergence of the Financial Citizen' in *Implementing Financial Regulation: Theory and Practice* (John Wiley and Sons Ltd 2006) ch. 6—authors point out, for instance, that information disclosure was expressed in terms of directly benefiting consumers by enabling them to make more informed choices about the goods or services they buy, without restricting their choices.

consumers of products, for whom financial purchases comprised merely one of their numerous consumption choices.[2] Significantly, during its transition to the FCA, the FSA explicitly acknowledged that the new supervisory approach it would adopt was a philosophical deviation from the former *caveat emptor* principle and also its heavy reliance on transparency at the point of sale.[3] The approach signaled a move from the consumer choice and responsibility model, which had emphasised consumer competence. The revised approach has sought to minimise risk-shifting[4] by firms, and instead emphasises firm obligations and risks, as opposed to focusing on disclosure and informed choice by consumers. It is evidenced for example in the exercise of the FCA's powers to ban products that are considered unsuitable for retail customers.[5]

We recognise that different approaches can be employed to achieve regulatory objectives, but this chapter advocates for RN. We categorise RN as a soft, more informal compliance-oriented approach. We suggest that such approaches might be particularly beneficial for countries searching for cost effective regulatory approaches, especially given the limited regulatory resources that many regimes have to contend with. Additionally, RN allows us to examine the extent to which regimes can use non-coercive techniques to modify the behaviour of regulatees. This chapter considers various suggested applications and, in so doing, will interrogate the benefits of "regulatory nudging" as a regulatory strategy. The discussion builds on the introduction to the concept of nudge that we introduced in Chapter 1.

The discussion of applications of RN, which will be examined in the latter part of this chapter, categorises them into two broad classes, which we refer to as 'classical' and 'nuanced'. The former refers to those applications that fall

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[2] Niamh Moloney, *How to Protect Investors: Lessons from the EC and UK* (Cambridge University Press 2010) 40-41.
[3] Clive Adamson 'FCA Supervision' (Speech at the British Bankers Association Conference London, 25 January 2012) <https://webarchive.nationalarchives.gov.uk/20120302151151/http://www.fsa.gov.uk/library/communication/speeches/2012/0125-ca.shtml> accessed 19 February 2020.
[4] Diane B MacDonald, 'Managing Risk by Shifting it to Consumers: Responsible Business Behaviour' 2013 (13) 1 *Journal of Accounting and Finance* 45—Risk-shifting is a concept that denotes the shifting of risk from one party to another. Author discusses ways in which firms shift risks (including legal and business risks to consumers).
[5] See chapter 4 for discussion on use of product bans.

squarely within the definition of nudge tools as expressed in the nudge theory literature.[6] The latter is a more nuanced categorisation that emerges from our interpretation of nudging as applicable to interventions that draw on the elements of non-coercion. Even though these interventions might not strictly embody all the elements encapsulated in the definition of nudge,[7] they nevertheless can be construed as serving to modify regulatee behaviour by steering or 'nudging' the regulated towards desired conduct. In other words, the second category can be read as embodying the spirit of nudge, even if not the letter.

5.2. Regulatory Nudging and Regulators

The behaviour of regulators is also a cause for concern for financial regulation and for efforts aimed at minimising crises. This is supported by analyses suggesting that regulators often play a part in the development and unfolding of financial crises. This can be seen, for instance, in regulatory forbearance, which is enabled by the wide discretion granted to regulators under risk-based supervision. In the immediate aftermath of the GFC, such forbearance was arguably observed in the "lenient approach adopted by banking regulators towards European banks' sovereign risk-weightings, asset quality, liquidity, and stress testing".[8] As the behaviour of regulators can also contribute to crises, this begs the question whether regulators too can be nudged. In other words, can RN be employed in respect of regulators? We wish to put forward two contrasting positions.

We will first proceed from the perspective that regulators too are 'nudgeable' or susceptible to steering towards desired behaviour. We will explain why this might be so. In order to carry out their roles, regulators enjoy a level of autonomy. This enables them to exercise the discretion that is delegated to

[6] Robert Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (2014) 77 (6) *Modern Law Review* 833; Richard H Thaler and Cass R Sunstein *Nudge: Improving Decisions about Health, Wealth and Happiness* (Yale University Press 2008)—Nudge tools enumerated in the literature are: defaults, persuasive, campaigning and counselling strategies, design approaches, commitments, transactional shortcuts, information mechanisms and warnings and reminders; See also chapter 1 discussion on tools.
[7] The elements are drawn from the definition of nudge highlighted below.
[8] John Armour and others, *Principles of Financial Regulation* (Oxford University Press 2016) 564.

them without undue political interference. However, accountability mechanisms are typically put in place in some regimes to check on regulator autonomy, and to minimise the rise of regulatory failure. It is recognised that there is inherent friction between these two areas—that unfettered autonomy can be abused, and unchecked accountability measures can undercut regulatory political independence and expertise. Consequently, balance is required to counteract this tension.[9] Proposals have been made regarding how to achieve this while enhancing regulatory accountability, the overall objective being to minimise regulatory forbearance. Suggestions include, on the one hand, those that pertain to institutional arrangements—transparency requirements, independent oversight, pre-commitment mechanisms (e.g., prompt corrective action), compensation, and institutional and personal liability. On the other hand are strategies that leverage regulator concern for their reputation, or those that ensure they are protected from politicians and safeguards their independence. Examples of the reputation harnessing requirements are certification requirements for members of the Financial Stability Oversight council prescribed under the US Dodd-Frank Act of 2010.[10] With regard to the application of nudge in regulatory settings, we suggest that it may be possible to situate the use of strategies that leverage reputation within nudge discourse, and therefore that regulators can also be nudged. This proposal is discussed further below under the subject of shaming.

The contrasting position is that efforts to nudge regulators are likely to be frustrated for the following reasons. The difficulty of nudging regulators is created by various tensions that exist in a regulatory context. Regulators carry out functions that are often incompatible and they frequently have to make trade-offs. Additionally, a consideration of the political economy of financial regulation brings other tensions into focus. Regulators have to deal with a mix of persons who seek to influence them—and not always for good. These include: self-interested policymakers, special interest group pressures, and re-election-seeking politicians pursuing pro-growth policies. These interactions

[9] ibid 567.
[10] ibid 567-575; See also Dalvinder Singh, 'Legal Accountability of Financial Regulators' in Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate Publishing 2007) 181-218.

generate tensions that lead to failures in design, implementation, monitoring, and enforcement of financial regulation. These tensions are also said to generate conflicts between decisions of financial policymakers and the pursuit of regulatory objectives or broader social welfare. In connection with the current discussion, we can appreciate that these tensions will naturally limit the success of attempts to nudge regulators. While we take on board the arguments that elected politicians have ultimate control over financial regulation and regulators' actions, we point out that regulator-independence need not be completely undermined. There are mechanisms that can be relied on to support the achievement of at least considerable, even if not complete political independence. These include measures such as budgetary independence and the appointment of independent minded officials.[11]

A general caveat prior to proceeding with the discussion—we wish to emphasise that with regard to the subject of nudge applications for regulators, an extensive examination of this aspect is beyond the scope of this thesis. Having said that, we have in the course of the discussion briefly highlighted some examples of nudging that could also be applicable for regulators, in addition to the regulated. These examples are illustrative of the fact that regulatory nudging may have a much wider scope beyond applications to the regulated—that is, to industry and consumers.

5.3. "Regulatory Nudging" vs. Other Strategies

In further considering this concept of RN and making a case for its use in a regulatory context, we will consider it against other strategies.

As was explained in the discussions in chapter 1 and 2, command regulation is perceived as highly restrictive and is also associated with greater enforcement costs.[12] Nudges, are perceived as an alternative to CAC

[11] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation*: *Theory, Strategy and Practice* (2nd edn, Oxford University Press 2012) 505; On the political economy related tensions, see Armour and others, *Principles of Financial Regulation* (n 8) 560, 575.
[12] Baldwin, Cave and Lodge, ibid 134; Stewart B Richard, 'Regulation, Innovation and Administrative Law: a Conceptual Framework' 1981, California Law Review, 1256. See for general discussion on weaknesses of CAC.

regulation because they do not carry these disadvantages.[13] Incentives based approaches are perceived in a more favourable light and, in our view, share a number of similarities, in terms of perceived advantages, with nudging. As such, we will compare them with each other, highlighting where they share points of convergence, and circumstances in which nudging may be preferable to incentives.

Incentives are considered less restrictive than command regulation, and therefore more attractive. Baldwin contends that under the incentives approach, the potential mischief maker can be induced to behave in accordance with the public interest. This is achieved by the state or a regulator imposing negative or positive taxes or deploying public grants and subsidies.[14] Incentives typically provide positive inducements to cooperate with the regulator, rather than negative penalties, such as disqualification or market disclosure. Incentives range from grants and subsidies, for example, to favourable administrative considerations.[15] Regulatory holidays are another incentive, whereby an organisation is relieved from inspections because of its 'good track record' in compliance with regulatory requirements. Incentives-based approaches are viewed as advantageous on account of the relatively low levels of regulatory discretion required. This is possible because financial punishments or rewards operate automatically once they have been established.[16] This strategy is also seen to be cheaper to administrate, and to involve lighter burdens of information collection. Grabosky also asserts that incentives may reduce the burden of regulation, and he encourages their use.[17] Incentive-based strategies are also seen as beneficial for enhancing communication, while providing the regulated an environment in which they can influence the way regulation is designed to operate in the market place.[18]

A point of convergence is found in the fact that both incentives and nudges can be considered soft/implicit and less interventionist approaches, which

[13] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (n 6) 834.
[14] Baldwin, Cave and Lodge, *Understanding Regulation* (n 11) 111.
[15] Peter N Grabosky, 'Regulation by Reward: On the Use of Incentives as Regulatory Instruments' (1995) 17 *Law and Policy* 257.
[16] ibid.
[17] ibid.
[18] Keith Hawkins and John M Thomas (eds), *Enforcing Regulation* (1st edn, Springer 1983) 32.

operate more in the background. Morgan and Yeung in their work describe instances where the law's threat recedes from view—

> At its most hidden, the law's threat recedes from view—particularly where consent based regimes rest on social norms and consensus, rather than legal coercion, as the means through which behaviour is influenced. In these instances, the law provides a background threat, reflected in the regulated community's fear that interventionist mechanisms may be introduced if regulation through social consensus is considered inadequate.[19]

As some nudge tools leverage social norms and consensus, they fall within this category of background threat. By contrast, command-based instruments exhibit a threatening face, operating largely in the foreground on the basis of "threat of sanctions with the aim of deterring undesirable behaviour through fear of sanctions that might be imposed if the law's command is violated".[20]

In general soft/implicit approaches carry merits that should encourage their use as much as possible. For example, in the context of international law, soft law is cited as being easier to achieve, as providing strategies for dealing with uncertainty, and as being capable of facilitating compromise among differentiated actors.[21] These benefits may be translatable to financial services regulation, where use of such soft/implicit approaches, will likely be more effective in modifying the behaviour of firms as they are likely to be more receptive to their use. Such approaches also resonate with academic arguments advocating for keeping sanctions in the background and the use of softer approaches to make regulation more effective. Falling in this category are proposals such as the use of moral suasion—a soft compliance-driven, as opposed to deterrence-driven, approach—to make regulation effective.[22] Hard

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[19] Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation, Text and Materials* (Cambridge University Press 2007) 147.
[20] ibid.
[21] Kenneth W Abbot and Duncan Snidal, 'Hard and Soft Law in International Governance' (2000) 54 (3) *International Organization* 421. Another advantage discussed in the paper is that it is less of an infringement on sovereignty.
[22] See, for example, Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press 1992) 19.

law is generally more difficult to achieve because of the steps needed to enact and enforce legislation.[23] Moreover, when we consider the dynamic environment that characterizes financial services, where law often trails innovation, it is suggested that this space is better served by an approach that can quickly be applied in an uncertain environment, as regulators attempt to catch up with advancements and develop additional rules.

We will now discuss some of the advantages of nudge that distinguish it from the traditional approaches, particularly incentive-based approaches. First, a look at the definition of nudge points to some of its advantages. A nudge is defined as—

> …any aspect of choice architecture that alters people's behaviour in a predictable way without forbidding any options or significantly changing their economic incentives. To count as a nudge, the intervention must be easy and cheap to avoid.[24]

A number of things can be highlighted from this definition. Nudges are capable of altering behaviour without: a) forbidding options, or b) significantly changing economic incentives, and c) interventions are cheap and easy to avoid. The lack of reliance on economic incentives and the aspect of cost effectiveness are the main distinguishing points between nudge and incentives.

Second, traditional tools are typically inattentive to cognitive and behavioural limitations.[25] This can affect the effectiveness of command regulation and of incentives as they are largely premised on rational actor models. Per nudge theory, behavioural analyses can be used in devising regulatory strategies which correct for the effects of irrational behaviour.[26]

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[23] The process of tabling bills in parliament is an example.
[24] Thaler and Sunstein *Nudge* (n 6) 6-8.
[25] Fabiana Di Porto and Nicolette Rangone, 'Behavioural Sciences in Practice: Lessons for EU Rulemakers' in Alberto Alemano and Anne-Lise Sibony (eds) *Nudge and the Law: A European Perspective* (Hart Publishing Ltd 2015) 54.
[26] Simon Deakin, 'The Evolution of Theory and Method in Law and Finance' in Niamh Moloney, Eilís Ferran and J Payne (eds) The *Oxford Handbook of Financial Regulation* (Oxford University Press 2015) 23.

Third, nudges, as conceptualised, are anticipated to be cheaper to implement, as they aim to change behaviour without significantly altering economic incentives.[27] Conversely, the reliance on fiscal measures to modify behaviour can make incentive-based approaches expensive to implement.

Fourth, although incentives are seen as reducing the burden of regulation, because they are set to operate automatically once they have been set up, we propose that nudges might serve to reduce this burden even further. This is because their implementation only involves the structuring of decision-making contexts and does not require further fiscal spending once an effective nudge has been designed and operationalised.

The above discussion has reflected on the circumstances under which nudging may be preferable to other strategies. Based on this, we posit that "regulatory nudging" can be beneficial in circumstances where more traditional strategies are limited in some way or have proved ineffective. In other words, the approach can be applied by regulators to modify behaviour that is not caught by conventional approaches, such as command regulation or incentives.

Developing countries may find "regulatory nudging" especially valuable. Because of budget constraints and less wealth overall (in comparison to higher income countries), they need approaches that are cost effective and less burdensome to enforce. Further, if implemented as less rigid impositions (soft/implicit approach), this may permit firms to continue operating in an environment that supports innovation without unnecessarily imposing strict rules. This may be accomplished while at the same time ensuring that some form of market discipline is maintained, because appropriate nudges will have been put in place by regulators to guide behaviour. Nonetheless, the recommendations made in this chapter are worthy of consideration for all regulatory regimes interested in nudge applications.

In as much as the approach of regulatory nudging may be beneficial, we do not suggest that regulators ditch the other approaches. Scholars of regulation

[27] Thaler and Sunstein *Nudge* (n 6) 6-8.

have engaged in debates regarding the right mix of strategies, and have considered questions about when to punish/persuade, which is also framed as when to use deterrence versus compliance based strategies. It is accepted that the choice of strategy will often vary, and regulators, as part of their role, will exercise discretion in making choices about what strategy to apply in a given situation. In deciding between nudge and other regulatory strategies, regulators are advised to compare it to conventional tools to decide which would be most effective.[28] With this in mind, we therefore propose that "regulatory nudging" should be seen as augmenting the holistic approach to financial regulation, in order to enhance the regulatory environment within the financial services sector.

5.3.1 Regulatory Nudging and the New Governance

We propose the concept of regulatory nudging (RN) for inclusion under the new governance umbrella. We will turn to a discussion of this concept of RN and consider some of the features of new governance that are particularly evident in the application of nudges. Later in the chapter, we will discuss some ways that regulatory nudging could be applied in a new governance context, and consider more broadly how RN can help to address the boundary between risk and uncertainty. The discussion will proceed in two parts. The first will be an examination of how RN can be applied to enhance regulatory compliance and enforcement, and the second will examine applications to product regulation and governance.

Nudge and the arguments that support its use have been considered above. One of the main arguments relates to the libertarian paternalism approach—upon which nudge is buttressed—which has gained a lot of currency, having shown great potential for modifying behaviour in instances where other tools have failed.

The concept of nudges and choices has been situated within the 'new governance' fold by Amir and Orly. They argue that "these concepts are

[28] Di Porto and Rangone, 'Behavioural Sciences in Practice (n 25) 59.

closely related to a growing body of regulatory studies that can be grouped under the label “new governance” and fall between command and control regulation and deregulated markets”.[29] Further emphasising this connection, they state that—

> Nudge's proposals of choice architecture are related to a broader school of thought termed "new governance," which calls for an expansion of the policymaking toolbox. New governance offers a comprehensive vision for policy reform; one that integrates design with incentives, collaboration with control, process with coordination, in formation with data mining and data minding, and reflexive regulation with monitoring and enforcement.[30]

Distinctions between the new governance and BE (from which the nudge theory emerges) have also been made. For instance, these two areas have very different starting points. Whereas New Governance begins from the limits of classical regulation, BE begins from the limits of individual choice. Despite this, the end point locates both approaches in similar territories of problem solving, which are discernible in both law *(and regulation*)[31] and individual decision-making. Moreover, it is also noted that the goal of improving decision-making is both present in the context of regulation and affects private individuals as well as regulators who, being human, are also affected by biases and heuristics.[32]

5.3.1.1 New Governance and Nudging: some commonalities

New Governance and nudges exhibit similar characteristics particularly in respect of features like experimentalism, localism and non-coerciveness.

[29] On Amir and Orly Lobel, ‘Stumble, Predict, Nudge: How Behavioral Economics Informs Law and Policy’ (2008) 108 *Columbia Law Review* 2100.
[30] ibid 2127.
[31] Italics authors.
[32] Amir and Lobel, ‘Stumble, Predict, Nudge’ (n 29) 2127.

5.3.1.1.1 Experimentalism

With regard to experimentalism, new governance techniques strive for pragmatism and recognise that, in searching for policy solutions to public problems, solutions that may work in a given context may only do so for a limited period of time.[33] They are also said to highlight experimentalism, going beyond trialling.[34]

Nudge as a new governance tool is heavily reliant on this aspect of experimentalism. In general, many of the pioneering Behavioural Economics studies have been lab experiments. The limitations of these have been stressed by those who hold that they lack "the rich "social and organisational" context" of real market interactions and therefore have limited direct application to concrete social policy".[35] Nevertheless, there are ongoing changes, and increasingly there are instances of movement from the lab to field-based testing, including through the use of randomised control trials (RCTs). The RCT approach is considered a gold standard methodology, and is borrowed from the medical research field.[36] The idea behind these trials is that an important step in nudge policy design and implementation requires pilot testing of targeted interventions to gather evidence of effectiveness (for proof of concept, so to speak) followed by wider scale roll out thereafter.

5.3.1.1.2 Localism

Context is a key factor for consideration under new governance, and the transplantation of a new governance regime from one context to another

[33] This gives a nod to responsiveness, which is the focus of approaches like really responsive regulation.
[34] Jeroen van der Heijden, 'Looking Forward and Sideways: Trajectories of New Governance' Amsterdam Law School Legal Studies Research Paper 04/2013; On experimentalist governance see Charles F Sabel, C and Jonathan Zeitlin 'Experimentalist Governance' in David Levi-Faur (ed), *The Oxford Handbook of Governance* (Oxford University Press 2012) 169.
[35] Amir and Lobel, 'Stumble, Predict, Nudge' (n 29) 2135—discussing the limits of behavioural studies in capturing the complexities of real institutions.
[36] Richard Thaler, *Misbehaving: The Making of Behavioural Economics* (Penguin Random House 2016) 338; Regulators such as the FCA have designed and conducted both lab and field experiments and in the spirit of transparency and learning, published along with positive results, also negative or insignificant findings. Other regulators and BE practitioners may find these useful for shaping their own research—See Laura Smart, 'Full Disclosure: A Round up of FCA Experimental Research into Giving Information' FCA Occasional Paper 23 (November 2016).

without adaptation is discouraged. In this regard, attention is to be paid to the social, legal and political history and the environment in which decisions are to be made.[37] Nudge enthusiasts and users alike agree that interventions need to be adapted to fit culture and context in order to work.[38]

5.3.1.1.3 Non-coerciveness

Under the New Governance paradigm, non-coerciveness is considered to involve the objective of New Governance, which is to 'create a fluid and flexible policy environment that fosters "softer" processes which will create an environment more conducive to participation and dialogue'. [39]

One of the key elements that defines a nudge is its non-coerciveness.[40] Per nudge theory, as previously discussed, nudges are to be designed in such a way as to permit nudgees to opt-out. Non-coerciveness is also a characteristic that is associated with NG.[41]

5.4. The Problem of Firm Behaviour and Culture

An important weakness that typically affects all regulatory techniques, including new governance, is the behaviour of both regulator and regulatees.[42] Indeed, proponents of responsive regulation and of really responsive regulation recognise that managing the behaviour of firms is important for effective financial regulation.[43] Notably, one of the key elements articulated in

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[37] Jannis Sarra, 'New Governance, Old Norms, and the Potential for Corporate Governance Reform' (2011) 33(4), *Law and Policy* 576-602.
[38] Sherzod Abdukadirov, 'Introduction: Regulation versus Technology as Tools of Behavior Change in Sherzod Abdukadirov (ed), *Nudge Theory in Action: Behavioural Design in Policy and Markets* (Palgrave Advances in Behavioral Science, 2016) 5.
[39] Orly Lobel, 'New Governance as Regulatory Governance' in David Levi-Faur (ed), *The Oxford Handbook of Governance* (Oxford University Press 2012) 67.
[40] The various elements of nudge are found in the definition which is provided in discussion above.
[41] Rob Baggott 'By Voluntary Agreement: the Politics of Instrument Selection', (1983) 64(1) *Public Administration* 51; See Orly Lobel, 'The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Leal Thought' (2004) 89 *Minnesota Law Review* 342; William H Simon, 'New Governance Anxieties: A Deweyan Response' (2010) 2010 Wisconsin Law Review 727.
[42] Cristie Ford, 'New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation' (2010) *Wisconsin Law Review* 441.
[43] While responsive regulation emphasises focusing on behaviour, really responsive regulation calls for regulators to adapt to strategies besides the behaviour of regulatees, including: behaviour, attitudes and culture; institutional setting of regulatory regime; interactions between the different logics of regulatory tools and strategies; regime's performance over time; changes in each of these elements.

the really responsive regulatory approach calls for regulators to take into account behaviour, attitudes and culture within firms.

A historical analysis of the conduct of firms reveals many incidences of compliance lapses in finance that have resulted in ruinous consequences for the financial services industry. Examples of lapses that have impinged on customers include: unethical sales practices, including deception, manipulation and concealment. Such practices can be detrimental to consumers as well as threatening financial stability, as was the case during the GFC, where subprime loans not only damaged the lives of many unwary borrowers, but played a major role in the development of the crisis.[44] The GFC also showed that these failures can cause a decline in trust in institutions like banks, and that this abatement also has a bearing on financial intermediation.[45] Product mis-selling is another example of such lapses. The effects of financial mis-selling have been observed in various markets, including the UK, where several scandals have been reported, such as the mis-selling of collateralised debt obligations, the mis-selling of Payment Protection Insurance, the sale of Unregulated Collective Investment Schemes (UCITS) and mis-selling in respect of the sale of contingent convertible securities.

To address issues linked to firm behaviour and culture requires an understanding of human decision-making. Economists like Adam Smith argued that the pursuit of personal gain through activities like barter and exchange is natural to humans,[46] and some of the misconduct observable in the financial sector may be explained by an intensified search for yield. In general, reflecting on how to modify behaviour using a behavioural lens can help regulators appreciate human complexity. Such a lens reveals that, on the one hand we can manifest characteristics like greed and self-interest, which are said to drive employees of financial sector firms. Conversely, it shows that

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[44] John R Boatright, *Ethics in Finance* (3rd edn, John Wiley & Sons Inc 2014) 64.
[45] Marcus Knell and Helmut Stix, 'Trust in Banks? Evidence from Normal Times and from Times of Crises' (2015) 82, Economica 995—Authors discuss findings from an empirical study undertaken in Austria, where it was found that there was a slight decline in trust in the aftermath of the crisis, but overall trust level remained high (60%) because no major retail bank broke down.
[46] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (5th edn, Methuen & Co Ltd 1904) book 1 ch 2.

humans can also be altruistic, and are often motivated by goals besides personal gain.[47] Such an understanding of the human make-up is an essential first step in formulating nudges that can modify behaviour—that is, regulatory nudging.

BIs may offer explanations that can help to identify and explain why compliance dilemmas arise in organisational contexts. An example that may explain the insidiousness of compliance failures is research that reveals problems related to blind obedience and how humans react to 'authority' figures. Robert Cialdini discusses this subject in his examination of a famous psychological experiment called the Milgram study, which offered some disturbing insights into obedience. Study participants were told that the experiment was about how punishment affects learning and memory, and participants were divided into the roles of Teacher and Learner. The study's true objective was to determine the level of suffering that ordinary people would be willing to subject an innocent person to when it is their job. The Learner was tasked with learning and recalling a list of words. The Teacher's role was to test the Learner's memory and to deliver progressively unsafe levels of electric shocks for every error. The experiment revealed that the typical Teacher was willing to deliver as much pain as was available to give. Milgram attributed the Teachers' actions to a "deep-seated sense of duty to authority".[48] Cialdini argues that findings from studies like Milgram's reveal "a great deal about obedience's power and value in our culture" and that we ordinarily respond to authority in an automatic way due to "systematic socialization practices designed to instil in members of society the perception that such obedience constitutes correct conduct".[49] Moreover, when faced with genuine authority figures, we rely on heuristics as these persons are typically more knowledgeable, powerful or wise than ourselves.[50] Similar findings have been shown in the medical field, where issues of unthinking

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[47] Ernest Fehr and Klaus M Schmidt, 'The Economics of Fairness, Reciprocity and Altruism–Experimental Evidence and New Theories in Serge-Christophe Kolm and Jean M Ythier (eds) *Handbook of the Economics of Giving, Altruism and Reciprocity* 1 (Elsevier BV 2006) 615-691.
[48] See generally, Robert Cialdini, *Influence: Science and Practice* (5th edn Pearson Education Inc, 2009) ch 6 discussing details of the study. Notably, in the study, no shock was actually administered and the Learner was actually an actor, but the Teacher wasn't aware.
[49] ibid 181, 195.
[50] ibid 195.

deference to the 'boss' have also been identified. Numerous cases have been reported of attending physicians issuing incorrect prescriptions, but patients, pharmacists, nurses and other doctors not challenging the prescription.[51] Other studies that illustrate deference to authority show that even clothes and titles can be symbols of authority, so that people respond to such symbols by following orders unquestioningly from those dressed in guard uniforms or even well-tailored business suits, even if they may harbour doubts about directions given.[52]

These BI findings may explain some responses to instructions from senior management, whereby employees comply with directions even when they know that what has been asked of them is improper. Related to this aspect of deference to authority and its effects on organisational behaviour, personality, and those especially of senior management who shape the culture and tone of the organisation, has been identified as a behavioural risk in corporate governance and argued to have contributed to myriad corporate failures.[53]

One of the aspects of conduct regulation that regulators have increasingly been focused on in the post-GFC years is firm culture. A challenge that arises in the implementation of regulatory approaches such as RBA, which was considered in chapter 2, is how to deal with behaviour attitudes and the culture of various regulatees, as they are not homogenous.[54] Additionally, there is an acknowledgement that there is need for a shift in culture within financial firms, and that this is a crucial step in curbing the problems related to financial product mis-selling and other compliance concerns.

In respect of culture specifically, Lobel points to empirical evidence demonstrating that in most contexts institutional culture and design have a

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[51] ibid 181-187.
[52] ibid 188-190.
[53] Ngozi V Okoye, *Behavioural Risks in Corporate Governance: Regulatory Intervention as a Risk Management Mechanism* (Routledge 2017); For more general discussion on behavioural biases in organisations see Zanna Iscenko and others, 'Behaviour and Compliance in Organisations' FCA Occasional Paper 24 (December 2016) 16-20.
[54] Dalvinder Singh, 'The Centralisation of European Financial Regulation and Supervision: Is There a Need for a Single Enforcement Handbook?' 2015 (16) *European Business Org Law* 450; on how culture in financial services can be changed see generally FCA, 'Transforming Culture in Financial Services' Discussion Paper DP18/2 (March 2018).

profound impact on the likelihood of individuals being involved in unlawful action.[55] To address concerns, and particularly the incentives for risk-taking behaviour especially within banks, the UK's Parliamentary Commission on Banking Standards suggested that there was need to expose individuals to regulatory regimes in terms of professional competence, and also in terms of ethical behaviour.[56] They therefore recommended that the regulator devise a comprehensive Banking Standards Code applicable to all financial sector personnel, dealing largely with ethics and standards of conduct.[57] While we accept that such interventions can be beneficial, we further argue that the recommended approach leverages traditional approaches that are reliant on giving more information to regulatees in the hope that this will foster reform. This, in our view, would be inadequate to obtaining modification and sustained improvement in firm culture and behaviour. A more robust approach would need to draw from BIs and from other fields such as organizational behaviour and the sociology of institutions. The latter fields are beneficial for providing lessons on how internal processes shape compliance.[58] This is why we see RN as having greater potential for helping to modify firm behaviour, attitudes and culture. We will discuss below how RN can help to address some of the challenges relating to firm behaviour and culture.

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[55] Lobel, 'New Governance as Regulatory Governance' (n 39) 67-68; Jennifer Arlen and Reiner Kraakman, Controlling Corporate Misconduct: an Analysis of Corporate Liability Regimes' (1997) 72 *New York University Law Review* 692–693—Authors demonstrate how imposing different levels of liability upon firms can influence company culture and employee behaviour; Yuval Feldman and Orly Lobel, 'Behavioral versus Institutional Antecedents of Decentralized Enforcement in Organizations: An Experimental Approach' (2008) 2 *Regulation & Governance* 171–181—Feldman and Lobel demonstrate the impact of institutional processes on individual decisions about whether to blow the whistle on illegality.

[56] The Commission on Banking Standards Report, *Changing Banking for Good* (Vol II, 2013) ch 6. <http://www.parliament.uk/documents/banking-commission/banking-final-report-volume-i.pdf> accessed 16 April 2017.

[57] ibid para 612 ff.

[58] Amir and Lobel, 'Stumble, Predict, Nudge' (n 29) 2131: see also FCA, 'Transforming Culture in Financial Services' Discussion Paper DP18/2 (March 2018) 37-59.

5.5. Incorporating Regulatory Nudging in New Governance and Enforcement—preliminary considerations

In our view there is great potential for RN to be used to reframe regulatory and supervisory efforts. We propose that RN can be invaluable to regulators if applied in an enforcement context. The definition of regulation goes beyond legal action to include other forms of informal enforcement techniques such as education, advice, persuasion and negotiation.[59] So, regulation can include informal techniques, and the use of RN may be construed as part of these informal approaches. Another important point to highlight is that these informal techniques would fall under the category of compliance based techniques. It is acknowledged among scholars and regulators that finding the right balance between compliance and deterrence based approaches is key for effective enforcement.[60] This is because firms may be motivated by different things, which in turn determines their level of compliance.

It is suggested that firms exploit a strategy of persuasion and self-regulation when they are motivated by economic rationality. On the other hand, it is argued that a strategy based largely on punishment will undermine the good will of actors when they are motivated by a sense of responsibility. Braithwaite therefore concludes that the basis for sound regulatory enforcement is an appreciation of the fact that business actors are often strongly motivated by opposed objectives; for instance, sometimes it is making money and other times it is social responsibility.[61]

While this chapter largely explores the compliance-based approaches to enforcement, and considers the extent to which they can be employed to address contemporary regulatory challenges, it must be stressed that

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[59] See Morgan and Yeung *An Introduction to Law and Regulation: Text and Materials* (n 19) 151.
[60] See for example Ayres and Braithwaite, *Responsive Regulation* (n 22)—on deterrence versus compliance models of regulation. They call for balancing, i.e., when to punish and when to persuade.
[61] John Braithwaite, *To Punish or Persuade: Enforcement of Coal Mine Safety* (SUNY Press 1985). Braithwaite's conclusion is that "business actors exploit a strategy of persuasion and self-regulation when they are motivated by economic rationality. But a strategy based mostly on punishment will undermine the good will of actors when they are motivated by a sense of responsibility".

deterrence based approaches also have their place and are equally important.[62]

5.5.1 Regulatory nudging in the regulatory pyramid

In considering the development of an appropriate enforcement strategy (one that will improve compliance) the 'enforcement pyramid' model proposed by Ayres and Braithwaite is a natural starting point (See Figure 5.1). It has been extremely influential in many jurisdictions for developing an enforcement strategy. In this pyramid they propose an appropriate balance between persuasive and punitive techniques. Ayres and Braithwaite for instance advocate for the use of moral suasion (as opposed to sanctions) to make regulation more effective.[63] They further suggest that heavy reliance must be placed on persuasion rather than on punishment in industries where technological and environmental realities change so quickly that regulations that give detailed content to the law cannot keep up.[64] The finance sector is one such industry.

[62] Punishment is to be adopted when firms exploit the privilege of persuasion. Morgan and Yeung, *An Introduction to Law and Regulation* (n 19) 195.
[63] Ayres and Braithwaite, *Responsive Regulation* (n 22) 19.
[64] ibid 26.

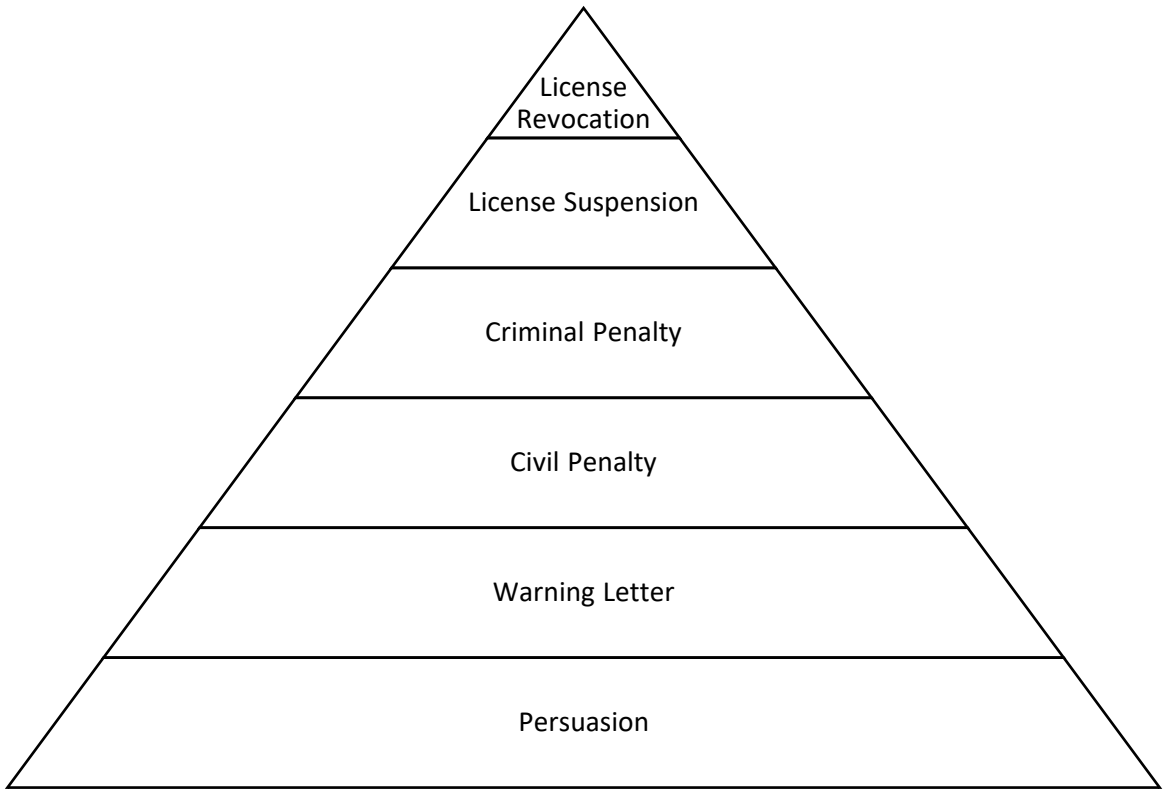

Figure 5.1 Enforcement Pyramid

Source: Ayres Ian and John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (Oxford University Press 1992) 35.

For the purposes of addressing the issue under consideration in this section, we propose a new approach to enforcement that builds on the insights of Ayres and Braithwaite—one that integrates regulatory nudging into the enforcement pyramid. The enforcement pyramid recognises that firms will respond differently, hence the need to increase the severity of sanctions as regulators move up the pyramid. Most regulatory action is said to occur at the base of the pyramid where attempts are made in the first instance to obtain compliance through persuasion. A step up the pyramid is a warning letter; where this does not work civil monetary penalties are imposed; at the next level is criminal prosecution; and at the very top is license revocation.

In our view, we see the most relevant area for the use of RN as being at the lower end of the pyramid. We would suggest that it could help regulators to think about more persuasive, and hence more effective, techniques for securing compliance conduct among firms. When developing nudges, regulators will also need to bear in mind that nudges do not work in the same

way for all people, so they will have to tailor nudges accordingly. In this regard, Baldwin asserts—

> Nudges, and different degrees of nudge, accordingly, can be expected to echo the tendency of traditional regulatory styles to vary in their effectiveness when targeted at different types of regulated concern and at people with different characteristics.[65]

Baldwin further considers the impact of nudge on different levels of individual, and this can be a useful guide for designing regulatory nudge tools (see figure 5.2 below). Baldwin seeks to illuminate the kinds of variation in effectiveness that can be expected across (a) the degrees of nudge, and (b) the different nudge tools.

Borrowing from regulation literature,[66] he categorises individuals as: well-intentioned and high capacity; well-intentioned and low capacity; ill-intentioned and high capacity; ill-intentioned and low capacity. He explains that intention means "the extent to which the target espouses the same objective as the nudger". Capacity, he explains means "the ability of that person to gain, receive absorb and act on information". Having considered the impact of nudge on different targets, he draws the following conclusions—[67]

a. Varied nudge tools and different ways of implementing these tools can be anticipated to bring different effectiveness profiles;
b. Nudges may have limited effectiveness, so that even a First Degree Nudge like providing information may only succeed with a small group of targets;
c. For targets who are ill-intentioned and high capacity, no matter the degree or tool of nudge is used, they can be expected to be harder to nudge with a high degree of effectiveness.

	Information Mechanism:	**Default:**	**Design:**	**Warning:**

[65] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (n 6) 840.
[66] For example Julia Black and Robert Baldwin, 'When Risk-Based Regulation Aims Low: A Strategic Framework' (2012) 6 *Regulation and Governance,* 131; Baldwin, Cave and Lodge, *Understanding Regulation* (n 11) 230-231.
[67] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (n 6) 842.

	Simple nutritional information is provided on food packaging (A first Degree Nudge)	An opt-out regime is adopted for organ donation. (A Second Degree Nudge)	The smoking zone is placed at a distance from the office work area. (A Second Degree Nudge)	Shocking photographs of lung cancer victims are used to control smoking. (A Third Degree Nudge)
Well-Intentioned and High Capacity	High	High	High	High
Well-Intentioned and Low Capacity	Low	High	High	High
Ill Intentioned and Low capacity	Low	High	Medium	High
Ill Intentioned and High Capacity	Low	Low	Low	Medium

Figure 5.2: The Anticipated Impact of Nudges on Different Targets [68]

5.5.2 At what level of the regulatory pyramid will regulatory nudging be most effective?

Implicit within nudge theory is an important philosophical theory concerning the relationship between leader and group. This might impact how regulatory nudging is used, and therefore is worth discussing. According to this theory, in many relationships between leader/manager/authority (regulator) and the

[68] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (n 6) 841.

people/groups/followers, whose change is sought, people are influenced (consciously or unconsciously) by their feelings towards the leader/authority ('choice architect') or the perceived 'nudger'. Essentially, people are more accommodating (open and cooperative) of being nudged if they have positive feelings towards the nudger, and less where their feelings are negative, such as feelings of fear and distrust.[69] With regard specifically to this aspect of trust, Sunstein argues that it is key and that where people do not trust government officials they will be sceptical of nudges.[70] This point—that nudges may well work best in environments typified by positive feelings—is an important one for regulators to consider. It has important implications for the application of nudge to enforcement, as it may inform the kind of enforcement action that lends itself to nudging. For instance, at the bottom of the enforcement pyramid where regulators employ persuasion, we can expect to find more positive feelings. When we move up the pyramid to the 'warning letter' stage, these positive feelings may begin to cool, and feelings can be expected to become increasingly negative as we approach the apex of the pyramid. Based on this, it is possible to draw the conclusion that nudging will likely be most effective at the level of persuasion.

5.6 Regulatory Nudging—suggested applications

In considering an appropriate approach to address financial sector risks, regulators are encouraged in regulation discourse to think about how to enhance the responsiveness of regulation. We suggest in this work that, as part of achieving this end, regulators can employ RN in the enforcement context. Moreover, RN may be used in processes like product regulation and governance to improve regulatory compliance within firms. This may in turn help to reduce risks like financial product mis-selling. To accomplish this they will need to think of themselves as choice architects and, on this basis, structure the 'choice architectures'—the contexts in which firms make

[69] Philosophical underpinnings of nudge.
[70] Cass R Sunstein, *The Ethics of Influence: Government in the Age of Behavioural Science* (Cambridge University Press 2016) 13.

decisions. This procedure is central to the nudge approach.[71] It entails crafting nudges that guide the regulated, for instance employees in financial sector firms, towards more compliant behaviour.[72]

This reflection and design process will entail an examination of nudge discourse, some of which has been explored in this work. Additionally, they may need to gather insights from other fields. For example, studies on the effects of distance on morality are considered relevant for the purpose of designing nudges that could be utilized at the organisational level to address compliance problems. Dan Ariely has found, for instance, that the use of mediums such as poker chips and accounting standards allows actors to distance themselves from misconduct. Previous work in this area examined firms involved in production chains. Nudges that could be set up to address this challenge would entail interventions that increase the visibility and salience of an actor's non-compliance. Such nudges could work as a mechanism for internal self-enforcement within the organisation.[73]

BIs relating to motivation and social norms have also been used by regulators to encourage a culture of compliance among regulatees. These insights demonstrate that adversarialism makes firms and individuals less disposed to information sharing and participating in mutually beneficial problem solving.[74] Application of BIs has seen regulators emphasising cooperation and self-regulation with regulatees, instead of adversarialism, of which it is said that it "serves as a "collaborative placebo," triggering an ethos of voluntariness while maintaining background rules of command".[75] Regulatees are effectively enrolled into the regulatory process with this emphasis on self-regulation (or indeed meta-regulation), which requires them to identify problems and risks and formalize solutions. On the other hand, regulators support this process by

[71] Daniel Hausmann and Brynn Welch, 'Debate: To Nudge or Not to Nudge, (2010) 18(1) *Journal of Political Philosophy* 123.
[72] See generally Dan Ariely, *The (Honest) Truth About Dishonesty: How We Lie to Everyone-Especially Ourselves* (1st edn, Harper Collins 2012).
[73] Amir and Lobel, 'Stumble, Predict, Nudge' (n 29) 2134-2135—Author draws from Dan Ariely, *Predictably Irrational* (Harper 2008) 220-221: See also Zanna Iscenko and others, 'Behaviour and Compliance in Organisations' FCA Occasional Paper 24 (December 2016) —section 4 discussing morality and rule breaking and section 6 on changing the way firms make compliance decisions.
[74] Amir and Lobel, ibid 2130.
[75] ibid 2129.

"offering consultation and assistance, practical and reputational rewards through safe havens, flexibility and variance accommodation, and the public certification of responsible practices".[76] The nudges which the regulators are utilizing in this collaborative process comprise carrots in the form of information and design processes, instead of inflexible CAC type approaches and sticks.[77]

As was mentioned at the outset, the applications of RN that are discussed in this thesis are categorised broadly into two—classical and nuanced. The examples of applications of RN that we will examine below will help to clarify the distinction further. In developing the discussion regarding how RN can be applied as a regulatory strategy, we will consider other suggested applications in the section that follows. The table below provides a snapshot of these.

[76] ibid.

[77] ibid 2129-30—Authors also refer to Orly Lobel, 'Interlocking Regulatory and Industrial Relations: The Governance of Workplace Safety' (2005) 57 *Administrative Law Review* 1071, 1089-91—arguing that adversarial regulatory frameworks cannot fully utilize these long-term incentives as a means of increasing compliance; and also to Jody Freeman and Daniel A Farber, 'Modular Environmental Regulation' (2005) 54 *Duke Law Journal* 795, 815—describing how market-based incentives may lead some industries to provide agencies with information that they normally would not reveal.

Regulatory Nudging in New Governance and Enforcement			
Regulatory Nudge	**Category of RN (Classical vs. nuanced)**	**Nudge tools leveraged**	**Some Key biases/heuristics at play**
Conversational model of regulation	Nuanced	Persuasive, Campaigning and counselling strategies	Social norms
Interpretative communities	Nuanced	Persuasive, Campaigning and counselling strategies	Social norms
Nudging and risk regulation	Nuanced	Persuasive, Campaigning and counselling strategies	Social norms
Shaming	Nuanced	Persuasive, Campaigning and counselling strategies	Social norms
Attention cascades	Classical/Nuanced	Persuasive, Campaigning and counselling strategies	Optimism bias Limited attention
Pre-mortems	Nuanced	Commitments 'Design' approaches	Prospective hindsight
Benchmarking prompts	Nuanced	Information mechanisms	Social norms Salience

		Persuasive, Campaigning and counselling strategies	
Regulatory Nudging in Product Regulation and Governance			
Model contracts	Classical	Defaults	Status Quo Anchoring Limited attention Self-serving bias Optimism bias
'Sticky' opt-outs	Classical	Defaults	Status Quo Framing Loss aversion Anchoring
Regulatory Sandboxes and innovation hubs	Nuanced	Persuasive, Campaigning and counselling strategies	Salience Self Serving Bias
Framing in disclosure regulation Framing also crosscutting approach	Classical	Information mechanisms Persuasive, Campaigning and counselling strategies	Salience Social norms Anchoring
Traffic Light Labelling	Classical	Information mechanisms Warnings/reminders	Salience

Figure 5.3—Regulatory Nudging Applications

5.6.1 Applying regulatory nudging to Rule Design and Enforcement

Several strategies can be used to address the innate limitations of rules: the adoption of different types of rules, structuring the context in which rules operate, building and using interpretative communities and adopting a conversational model of regulation.[78] In this section we will consider two types of interventions, namely use of a conversational model of regulation and the development of interpretative communities. We assert that these embody the spirit of nudge and should be considered as falling into the category of RN.

5.6.1.1 Conversational model of regulation

Black, in her examination of the meaning and operation of rules, proposes the conversational model of regulation as a solution for addressing the limitations of rules, especially those of inclusiveness and the inability to sufficiently anticipate future events. Under-inclusive rules are problematic for their inefficacy in promoting or proscribing conduct that aligns with the rule's purpose. On the other hand, over-inclusive rules are problematic, as they result in penalizing conduct that was not within the ambit of the rule.[79]

It is therefore suggested that the conversational model can be helpful for addressing these problems. This would require the adoption of regulatory strategies and techniques that facilitate the use of formal or informal waivers, or the modification of rules by making this a straightforward process that results in understanding and consensus on any modifications emerging from conversations between regulator and regulated. This approach is drawn from how normal conversations occur, say with friends. For example, if in the course of a discussion they make use of a term that does not fit within a particular accepted understanding or is more general, then the other friend can highlight and correct that misperception or make qualifications to their statement.[80]

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[78] Julia Black, *Rules and Regulators* (Clarendon Press 1997) 19-45.
[79] See generally Black, ibid; specifically on the problems of over and under inclusive rules see pg. 37; Julia Black 'Talking about Regulation' [1998] *Public Law* 77.
[80] Black, *Rules and Regulators* (n 78) 38.

The conversational model is proposed as embodying four key characteristics which, although capable of existing at the same time, cannot all be present in a system at any one time. One is the formal approach to modifying rules through an amendment process entailing clarification, deletion or embellishment. This approach would not suit a rule making process that is costly from a time and resource perspective.[81] A second, a formal policy of rule adaptation via the use of exceptions and waivers conferred by the regulator on a case by case basis, still falls within the conversational model, with the advantage that the challenges of amending rules are minimised. This would see rules continuing to apply to other regulatees. However, this approach may be challenged due to disparate treatment, and it may also be time consuming for regulators to implement on account of the one to one engagement it calls for.[82] A third characteristics would involve the development of a system of individualized application of general rules. This could take the form of an approach like enforced self-regulation,[83] whereby a firm would formulate rules under regulatory supervision. Or, the regulator could negotiate with the regulatee to agree on how a vague rule should be applied to them. This would create an environment where there are ongoing conversations between the regulator and regulated regarding the application of rules. This approach is considered to work best where regulatees are well-intentioned, well-informed and well-resourced. Further, it may require an environment with few regulatees, on account of the expense in regulatory time and resources that could be brought on by having to review and negotiate the rules developed by regulatees.[84]

Fourth, it demands that enforcement officials on the ground adopt an informal or formal enforcement strategy of 'compliance' as opposed to 'deterrence'. This would result in the non-application of the rule. Instead of the enforcement officials sanctioning past contraventions, they would focus on enhancing compliance with rules by explaining to regulatees how to comply in the future. A compliance strategy addresses over-inclusion or under-inclusion as the

[81] ibid 39.
[82] ibid.
[83] Proposed in Ayres and Braithwaite, *Responsive Regulation* (n 22).
[84] Black, *Rules and Regulators* (n 78) 40.

case may be, through, for instance, waiving of the rule or negotiation as to its application, to novel or unanticipated circumstances, for example. This approach can help to simplify the rule formulation process such that the adoption of over-inclusive rules becomes less of a constraint, because there is always the possibility of their waiver.[85] A compliance strategy can also be advantageous, as compared to deterrence, as it may impose less of a regulatory burden from a time and staff perspective.[86]

5.6.1.2 Limitations of the conversational model

The conversational model offers advantages, but it is important to bear in mind its limitations. Institutional constraints may mean it is better suited to an environment with few regulatees. This makes it easier to arrange conversations with individual regulatees. Fewer regulatees may also make the option of adopting vague rules, with a view to negotiating exceptions and waivers as necessary, more feasible.[87] The concern about number is an important one to bear in mind, as the financial services sector continues to evolve, with provider categories moving beyond banks to MNOs and Fintech. Some suggestions for dealing with these constraints which could be applied to a larger population of regulatees may involve implementing a system of adequate record keeping that captures all the different formats—from waivers, no action letters, on-line conversations and advice—which can be referred to for future conversations in order to ensure similarity of treatment for similar cases.[88]

The model also raises concerns about the relative standing of the persons engaging in the conversation. Assuming that the regulator is in a stronger position is not always accurate. The success of a model that would lead to a regulator reaching the decision on whether to, for example, grant a waiver or no action letter, or indeed negotiating the applicability of a rule or its modification in respect of a particular regulatee, or to the process of monitoring

[85] ibid 40-41.
[86] ibid 42.
[87] ibid.
[88] ibid.

rules developed under a regime of self-regulation, is contingent on the regulator having significant resources in the form of time, expertise and information.[89] Another misconception regarding the standing of regulators *vis a vis* regulatees is that they retain authority regarding whether or not to enforce rules, and that this conveys a position of strength. However, regulator decisions not to impose sanctions may be informed by an interest in maintaining future relationships with regulatees as well as time and budget constraints.[90]

The adoption of a conversational model also presents accountability challenges and causes tensions for regulatory systems that stress participation and transparency. Although it may be possible to achieve participation and transparency at the stage of rule development, adopting a compliance strategy of enforcement that also combines a conversational model may make it even more difficult for other regulatees and persons outside of the conversation to observe and monitor the implementation and enforcement process, because it effectively excludes these third parties.[91]

5.6.1.3 Regulatory conversations—looking beyond rules

In addition to the application of regulatory conversations to the challenges relating to the assignment of meaning and the operation of rules, Black, in her follow up work, ascribes an expanded meaning to the term 'regulatory conversations'. The expanded definition describes regulatory conversations as "the communications that occur between regulators, regulated and others involved in the regulatory process concerning the operation of that regulatory system".[92]

Regulatory processes are considered to be imbued with a discursive element. According to Black, regulatory conversations are likely to be an important characteristic of regulatory processes that are characterised by a number of features. First is a regulatory system that is dependent on written norms

[89] Notably, this challenge is present in any aspect of rule development and application.
[90] Black, *Rules and Regulators* (n 78) 43-44.
[91] ibid 44.
[92] Julia Black, 'Regulatory Conversations' (2002) 29 (1) *Journal of Law and Society* 170-171.

(including rules, standards and principles) and in which discretion is prevalent. She describes discretion as "the space both within and between rules in which decision makers exercise choice".[93] It is in this space of discretion, in which choice is exercised, that we suggest there is room for RN. Herein, regulators can shape the choice architecture, and thereby nudge towards desired behaviour.

Black proposes that regulatory conversations may take centre stage in the regulatory process in situations of uncertainty.[94] Uncertainty can arise in the context of operation of rules, as the work of both Diver and Black demonstrate.[95] The wider context of regulation often gives rise to additional situations of uncertainty. Often things are ambiguous, and the process of reaching consensus regarding the definition of problems and solutions assumes an in-depth exchange of ideas across various subjects and negotiations of meaning. The process of risk regulation is an example of such a scenario. Other examples are situations where regulators are charged with meeting clashing principles or objectives, or where the environment in which they are operating is fast paced and characterised by intricate and changing definitions of problems and uncertainty regarding outcomes of regulatory action.[96]

5.6.1.4 Regulatory interpretative communities

The meaning, and in turn the application of a rule, is not an objective fact, and whether or not a rule is certain goes beyond the rule itself. It hinges on consensus within the interpretative community that reads it, and whether they will adopt a similar interpretation in their application of the rule.[97] (A community of this kind comprises authors of rules—mainly regulators, although legislators can arguably be included—regulatees, enforcers and adjudicators.) In sum, interpretative communities bring together various actors within the regulatory

[93] ibid 172.
[94] ibid 172. Also refer to the discussion on how risk and uncertainty influences rule design in chapter 2 of this thesis.
[95] Black, *Rules and Regulators* (n 78) 1-19; Colin S Diver, 'The Optimal Precision of Administrative Rules' (1983) 93 (1) *Yale Law Journal* 65.
[96] Black, 'Regulatory Conversations' (n 92) 172.
[97] Black, *Rules and Regulators* (n 78) 12.

system to share interpretative strategies.[98] The establishment and use of regulatory interpretative communities, it is suggested, can help to facilitate and therefore guarantee a shared and informed understandings of rules.

Interpretative communities can be instrumental in addressing questions of precision, uncertainty and genuine perplexity. It is further recommended that this approach may be helpful for dealing with creative compliance in two ways. This could be through the building of implicit knowledge and understanding that can shape how rules are applied. Another way is by curbing the underlying factor that enables creative compliance—the exploitative approach to rules.[99]

The possibility of a clash of interpretations of rules can arise even in the case of regulators and courts. To attain similarity in the interpretation and application of rules, several approaches could be used that result in 'closing off' the regulatory system from external court control. One proposal involves parliament granting regulators power to formulate rules with evidential status to serve as guides for the interpretation of vague rules in legislation. These could be used by courts to guide interpretation. This has the effect of reducing the number of actors involved in the development of rules. Another approach would entail minimising the role of courts in interpretation; for example, by making breaches actionable only by the regulator taking disciplinary action against the regulatee, instead of via court action.[100] Closing off the regulatory system from external controls raises concerns about the accountability of regulators. Options for addressing this may include measures like requiring public participation in the rule development process,[101] and by the use of mechanisms such as judicial review.

Interpretative communities can also be useful for dealing with the challenge of explicitness, and to some extent they may encourage 'instinctive compliance' with rules by regulatees. Rules that are less explicit are better able to adapt to future developments. However, such vague rules work best in an environment of norms, definitions and standards, buttressed by shared goals and

[98] ibid 31-32.
[99] ibid 32.
[100] ibid 34.
[101] ibid 37. The regulated and others affected are to be included as participants.

understanding by regulatees (comprising the community). This requires overall that the shared goals and understanding matches those of the authors of the rules. This is not an automatic process. Rather, it requires deliberate building up through the implementation of measures such as training and education. The ideal outcome is for the correct interpretation as expressed by the adjudicator and other members of the interpretative community to mirror the regulator's. Another point that must be emphasised is that we should appreciate that these communities are not purely lexicographical. They are also instrumental for building a shared understanding about the goals and values of the regulatory system.[102]

5.6.2 Nudging to meet enforcement challenges in risk-based regulation

As asserted in regulation discourse, an enforcement strategy ought to recognise that firms and individuals comprise heterogeneous groups and that their incentives to comply with rules also differ.[103] This reality is captured in the grouping by Kagan and Scholz, who cluster regulatees broadly into three: political citizens, organisational incompetents and amoral calculators.[104] This categorisation is useful as it can inform aspects such as approaches to regulatory supervision and enforcement. In the context of enforcement, regulators generally have the discretion to employ various types of sanctions for the different categories to address compliance shortcomings by firms and individuals. These range from punitive to non-punitive measures. This is also described in the literature as deterrence versus compliance based approaches.[105]

In respect of risk regulation, the categorisation of regulatees is also of relevance as the different group of regulatees will present varying levels of risk

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[102] Ibid; See Julia Black, 'Managing Discretion', ARLC Conference Papers (June 2001)—stating that interpretative communities are not limited to defining technical meanings of terms
[103] Ayres and Braithwaite, *Responsive Regulation* (n 22); John Braithwaite, *To Punish or Persuade* (n 61); Singh, 'The Centralisation of European Financial Regulation and Supervision' (n 54) 450.
[104] Robert A Kagan and John T Scholz, 'The Criminology of the Corporation and Regulatory Strategies in E. Blankenburg et al (eds), *Organisation und Recht* (Westdeutscher Verlag GmbH, Opladen 1980) 354-355.
[105] Ayres and Braithwaite, *Responsive Regulation* (n 22).

to regulatory objectives. In risk based regimes, regulators have been noted to rely on risk based frameworks to inform decisions about the intervention method to adopt, whether punitive or non-punitive, to modify firm behaviour.[106] For the amoral calculator, who is most likely to respond to action in the last resort, enforcement action may take the form of administrative, civil or criminal action directed at offending firms or individuals found to be personally responsible for non-compliance.[107] Sanctions meted out to the organisational incompetent will be less severe in comparison to those targeted at the amoral calculator,[108] and for the political citizen, action will be the least severe.

A key challenge for the risk based regulator emerges from the process of identifying risks that might impede the achievement of its objectives.[109] Once identified, these are the risks that will be subjected to regulatory assessment and control. However, the process of identification generates concerns. It is suggested, for instance, that it can result in focus being placed on 'silos' of risk.[110] The nature of the operation of a silo is that supervisors who are responsible for one site will typically be closed off from what is happening in another. We argue in this work that these 'silos' of risk could also operate in respect of the categorisation mentioned above, so that, once regulatees have been evaluated and assigned to a particular category based on their risk score, supervision and enforcement is undertaken on this basis. This takes place with the different categories being isolated from one another and, generally, with the prioritization of regulatory attention being informed by the scores assigned. In furthering this argument, we suggest that it may be possible to see the categories of political citizen, organisational incompetent and amoral calculator as analogous to the low, medium and high risk categorisation that is employed in some risk based regimes.[111] However, this is again a crude generalisation. This is not to say, for instance, that a firm categorised as a political citizen is automatically low risk. It can be considered high risk, for example, when viewed from the perspective of the impact or failure of such a

[106] Baldwin, Cave and Lodge, *Understanding Regulation* (n 11) 282.
[107] Singh, 'The Centralisation of European Financial Regulation and Supervision' (n 54) 451.
[108] ibid 452.
[109] Baldwin, Cave and Lodge, *Understanding Regulation* (n 11) 283.
[110] ibid
[111] ibid 282—Authors refer to this as 'traffic light' regimes.

firm, and so may be prioritised for regulatory attention because it is systemically important. But, for the purposes of the current discussion, we emphasise that the basis of categorisation into low, medium or high risk, is regulatee incentives to comply or their attitude towards compliance.

Of concern for the risk based regulator is how to surmount the tendency to maintain silos. In other words, how are they to move the regulated from one risk category to another, and thereby shift firms and individuals ideally towards conduct that conforms to the political citizen category. While the groupings are not fixed, and therefore movement across the various categories is possible, it has also been argued that firms and individuals can sometimes occupy different categories simultaneously.[112] As such, achieving movement can prove difficult. To determine whether there has been a shift might entail waiting for a new evaluation cycle to assess whether a regulatee's risk level has altered. This is a more rigid approach in our view, and might in the intervening period require the performance of inspections followed by the imposition of sanctions for non-compliance to achieve shifts towards desirable behaviour. While this approach is not without merit, we instead propose the use of non-punitive enforcement measures, which we argue would offer greater flexibility for regulators. In this regard, the conversational model of regulation proposed by Black to address problems presented by rules is instructive.[113] In line with this, Black proposes in subsequent work that the conversational model can be employed beyond the perimeter of rules, to cover the operation of other areas of the regulatory system.[114] Whereas the author does not specify risk-based regulation among these, we would argue that this is one area that could benefit from the application of this model. We will now suggest one way in which the model can be used to address the concern raised by risk based regulation regarding movement between risk categories. For the political citizen, in contrast to the organisational incompetent and amoral calculator, the regulator does not prioritize the imposition of sanctions, and instead will adopt a compliance-oriented strategy based on negotiation and persuasion and, in

[112] Singh, 'The Centralisation of European Financial Regulation and Supervision' (n 54) 452.
[113] Black, *Rules and Regulators* (n 78) 12 and 19-45.
[114] Black, 'Regulatory Conversations' (n 92) 170-171.

other instances, on consultation and education. This approach is said to encourage communication and the creation of an environment in which regulatees can shape the manner in which regulation is designed to operate in the market place.[115] This is where conversations will kick in, as this process requires dialogue about how compliance and other regulatory concerns will be dealt with. This might include, for example, conversations about the implementation of strategies such as the risk-based approach, or the best practices for addressing risks presented by product innovation. It is suggested that these discussions about best practice (or other matters) can also be used as platforms for highlighting to *other* regulated persons what practices they should emulate, and thereby to encourage behaviour modification.[116] Consequently, negotiation and persuasive strategies can be used by the risk-based regulator, not only in private interactions with regulatees, but also in public or joint fora to 'nudge' others in the firm or industry towards desired conduct, hence regulatory nudging. In this way, the regulator may be able to achieve movement across the other categories of amoral calculators, or organisational incompetents as the case may be, towards the political citizen.

Whereas, the use of approaches that are based on negotiation and persuasion raise concerns about regulatory capture, on account of the bargaining power that regulatees may hold in this relationship, on the upside, it is suggested that the process creates an 'environment of mutual responsibility which can, on the majority of occasions outweigh such concerns'.[117]

A related measure that is similarly compliance driven and may also be useful for dealing with firms who fall within the regulator's low risk category, whether in terms of impact to regulatory objectives or incentives to comply, is that of information campaigns.[118] This can be seen as an education based strategy. These have been used by some risk based regulators, and we assert that they

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[115] Singh, 'The Centralisation of European Financial Regulation and Supervision' (n 54) 450-51.
[116] ibid 452; Dalvinder Singh, 'Enforcement Powers and Banking Supervision' in Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate Publishing 2007) 133-134—Author says that publicity can be used by regulators to show good practices uncovered in the supervisory process.
[117] Singh, 'Enforcement Powers and Banking Supervision' ibid 115-16.
[118] Julia Black, 'Risk and Regulatory Policy: Improving the Governance of Risk' (OECD 2010) 201-202.

can also serve as regulatory nudges to be used to highlight messages targeted at both high and low-risk firms. They may be particularly beneficial for those who are not in more regular contact with the regulator. This may help to ensure that low risk firms are not entirely forgotten, and that they are made aware of best practices in respect of regulatory compliance or other important information relevant to the operation of the regulatory system. Further, it may help to ensure that compliance issues are not developing in high or low risk firms without receiving some level of regulatory attention in the first instance, even where more intensive supervisory action, such as inspections, have not been undertaken or issues have not been uncovered in a particular firm, but are nevertheless of regulatory concern.

The FSA's supervision of the Dunfermline Building Society[119] further illustrates that informal approaches that harness the conversational model of regulation in the form of communications from regulators to industry can be leveraged to modify behaviour. We also argue in this work that these can nudge regulatees if couched appropriately. The FSA was criticised over its supervision and communication with Dunfermline. The Scottish Affairs Committee that investigated this case concluded in their report that in the years prior to the Society's eventual post-GFC transfer, the regulator failed to provide the required level of supervision and to issue clear and specific warnings. However, per the FSA, Dunfermline—along with other industry participants—had been made aware through a supervisory talk about regulatory requirements, and thus could not feign ignorance or claim that they had not been directed to modify their behaviour. The weakness in this approach was a lack of appreciation of the weight of the communications that had been shared. It is suggested that, prior to the Dunfermline transfer, whereas banks and building societies underestimated the weight to be attached to regulatory communications to industry, the FSA on their part overestimated how seriously the communication would be taken. The takeaway here is that, although conversational approaches such as speeches to industry and CEOs letters

[119] See case study in Dalvinder Singh, 'The UK Banking Act 2009, Pre-Insolvency and Early Intervention-Policy and Practice' University of Warwick Legal Studies Research Paper No. 2010-27, 21-23.

can carry weight, a regulator who intends to use them should make the seriousness of the communications they disseminate explicit. Financial firms, for their part, should be aware that they need to take the communications seriously and take action as they would if it were disseminated in a regulator visit or meeting. This reinforces the need for regulators and regulated, as part of an interpretative community, to develop a shared understanding regarding the weight of these communications.

An additional point of reflection in respect of the application of RN in risk-based regulation is our proposal that this approach has the potential to operate outside of rules. In line with this, we assert that nudges do not have to be entirely supervisor led. Drawing from the discourse on de-centred regulation, we would suggest that other industry bodies, such as Banking Associations (e.g., Kenya Bankers' Association or British Bankers' Association), who regularly communicate with industry can use fora such as talks, to disseminate communication about best practice, or other regulator concerns. We would therefore challenge regulators to consider how to use other actors to nudge in order to modify behaviour through conversations. In this way regulatory nudging can be de-centred. Moreover, this proposal also illustrates that regulators can harness existing mechanisms or institutional arrangements to achieve behaviour modification, albeit indirectly.

5.6.3 Pre-mortems

The implementation of new governance approaches, such as RBA, requires a great deal of reliance on firms to establish robust internal control systems. This, however, can present challenges for regulatees and regulators. We suggest that RN may be able to help improve this process through the use of pre-mortems. This is drawn from lessons on project failure. According to Gary Klein, the majority of projects fail, and one of the reasons is that too many people are hesitant to raise their misgivings during the crucial planning phase. Further BIs suggest that, if it was made safe for knowledgeable dissenters with concerns to voice them, then the project's success rate could be improved.

Klein draws on research conducted in 1989, which found that prospective hindsight, which involves imagining that an event has already happened, increases ability to identify reasons for future outcomes by 30%.[120] It is on this basis that he recommends that project teams conduct pre-mortems (seen as a hypothetical opposite of a post-mortem) to support the challenging of ideas, which entails thinking ahead and identifying fault lines and weak spots—with a view to using these to help the formulation of measures to improve prior to project inception, that is, before things go wrong. Klein suggests that this can be set up as a competition or a storytelling exercise. [121] He explained this concept in the McKinsey Quarterly-

> The logic is that instead of showing people that you are smart because you can come up with a good plan, you show you're smart by thinking of insightful reasons why this project might go south. If you make it part of your corporate culture, then you create an interesting competition: 'I want to come up with some possible problem that other people haven't even thought of'. The whole dynamic changes from trying to avoid anything that might disrupt harmony to trying to surface potential problems.[122]

We argue that the use of pre-mortems can be seen as in keeping with a forward looking approach that is recommended, for example, in the application of judgement-based regulation that seeks to take into account future risks. Regulatees would be encouraged to embed pre-mortems into their internal processes, and to build in findings from the discussions to bolster internal control systems. We also suggest that regulators may equally benefit from

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[120] Klein draws on research conducted by Deborah J Mitchell, Jay Russo and Nancy Pennington.
[121] Gary A Klein, 'Performing a Project Premortem (2007) 85(9) *Harvard Business Review* 18–19; See also Julie Verity, 'Behavioural Strategy' in *The New Strategic Landscape, Innovative Perspective on Strategy* (Palgrave Macmillan 2012) 81-82 discussing this aspect.
[122] See Verity, 'Behavioural Strategy' ibid 81-82; McKinsey Quarterly, 'Strategic Decisions: When Can You Trust Your Gut', (March 2010) <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/strategic-decisions-when-can-you-trust-your-gut> accessed 25 March 2019; The Case for Behavioural Strategy (March 2010) <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-case-for-behavioral-strategy> accessed 25 March 2019.

embedding pre-mortems as part of their processes. This includes in shaping areas such as firm recovery and resolution planning. We further suggest that the use of such pre-mortems aligns with the pre-emptive approach to regulation, as forming part of a comprehensive regulatory strategy.

5.6.4 Nudging by Shaming

Approaches that entail naming and shaming might be another area in which RN could be employed. This approach would leverage social norms, as people would not want to be seen by persons in their social group/peers (in the case of finance sector this will be other financial services providers) as having breached accepted norms. The place of shame in regulatory settings has been explored by Nathan Harris, for instance,[123] who argues that "shaming can have a deterrent effect, as an informal sanction that threatens the loss of respect by valued others".[124] Braithwaite proffers a theory of reintegrative shaming, which is considered to be distinctly advantageous in comparison to shaming that is stigmatising because it allows concerns about behaviour to be communicated effectively to offenders. Further, according to this theory, affirmation and the inclusion of the individual permit for moralising and for denunciation of the act to occur in a way that invites the offender to acknowledge guilt and express remorse, knowing that he or she will not be outcast and that forgiveness, or decertification of their deviant status, will occur. Stigmatisation emphasises the individual's status instead of the harm he or she has caused, and is more likely to damage the offender's bonds with those who are law-abiding.[125] The importance of shaming to regulatory

[123] Nathan Harris, 'Shame in Regulatory Settings', in Peter Drahos (ed), *Regulatory Theory: Foundations and Applications* (Australia National University Press 2017) chapter 4; See also John Braithwaite *Crime, Shame and Reintegration (*Cambridge University Press 1989). Braithwaite argues that the criminal justice system has underestimated the significance of social disapproval in preventing offending.

[124] Harris, 'Shame in Regulatory Settings' ibid; Nathan Harris, 'Reintegrative Shaming, Shame and Criminal Justice' (2006) 62(2) *Journal of Social Issues* 327; Braithwaite, *Crime, Shame and Reintegration* ibid.

[125] Harris, 'Shame in Regulatory Settings' ibid; Reintegrative shaming theory places considerable store in the ability of moral persuasion to reform individual offenders.

intervention has been explored in various domains, including business regulation.[126]

It is suggested that shaming can affect our choices remarkably, while objectively limiting our freedom of choice only a little.[127] An example of nudging considered as harnessing shaming that may be instructive for financial regulators is smoke free regulation.[128] Such regulation is said to have contributed to a high reduction of smoking rates. BIs may partially explain this outcome. Firstly, smoking was made inconvenient as smokers had to go to designated geographical areas, such as outside buildings, to smoke. BIs suggest that we gravitate away from difficult things and that we are often lazy, hence the recommendation that, if you want to persuade people to do something, you should make it easy.[129] Secondly, the rule was underpinned by subtle stigma. Requiring people to step away to smoke is read as 'banishment', and social animals are cued to respond strongly to signals of banishment. Consequently, the intimation of even minor or 'lite' stigma is considered to have triggered many smokers to reduce their smoking levels or quit.

As was highlighted in chapter 2, one of the challenges of risk regulation concerns whether it should be geared towards blame. It is suggested that an institutional set-up in which blame is absent might foster transparency and learning about the challenges of dealing with risky activities. Further, it is suggested that an approach focused on placing blame on individuals or organizations could have negative effects, such as encouraging risk averse behaviour and gaming or system manipulation.[130] Additionally, this aspect of blame also drives political and bureaucratic considerations regarding the best

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[126] John Braithwaite and Peter Drahos, 'Zero Tolerance, Naming and Shaming: Is There a Case for it with Crimes of the Powerful?' 2002 35(3) *Australian & New Zealand Journal of Criminology* 269; See also Morgan and Yeung, *An Introduction to Law and Regulation* (n 19) 100-102.
[127] Eyal Nir, 'Nudging by Shaming, Shaming by Nudging' (2014) 3 (2) *International Journal of Health Policy and Management*, 53.
[128] ibid.
[129] Tim Harford, 'Richard Thaler: 'If You Want People to do Something, Make it Easy' *Financial Times* (2 August 2019) <https://www.ft.com/content/a317c302-aa2b-11e9-984c-fac8325aaa04> accessed 02 August 2019; Richard H Thaler' Nudge, not Sludge' (2018) *Science* 431. A nudge is contrasted with a "sludge" that makes wise decision-making more difficult.
[130] Baldwin, Cave and Lodge, *Understanding Regulation* (n 11) 97; Richard A Posner, *Economic Analysis of Law* (6th edn, Aspen Law and Business 2002).

approach to adopt. Risk aversion may result in favouring resilience based strategies over anticipatory ones out of a fear of regret.[131]

The potential for a blame focused approach to result in adverse effects is an important factor for regulators to reflect on; for instance, with regard to the applications of mechanisms like naming and shaming. They may, for example, decide to minimise the use of a blame-emphasising approach, except in extreme cases or for repeat offences. This may be particularly beneficial in situations such as following the launch of new market innovations whose risks are not yet fully understood. It is quite possible that things go wrong, even where risk management plans have been put in place. Where firms understand that the regulatory stance emphasises a blame free position, and provided the firm's actions were in good faith, then they are more likely to be open and even to approach the regulators with a view to finding solutions to address the problems that have arisen. This is not to say that regulators should not hold culpable individuals /firms accountable. They need to know when to select blame as an option—it should not be the default.

In general, in applying this theory to the context of financial regulation, when using the shaming approach, regulators might want to exercise caution, bearing in mind that shaming regulatees might generate negative feelings which might in turn inhibit cooperation and compliance. This could lead to the concealment of problems by regulatees. Regulators may, for instance, consider private shaming in their one on one interactions with regulatees, and save public naming and shaming (public censure) for more egregious conduct. It is suggested that the latter use of public naming and shaming will be considered an escalation further up the pyramid of enforcement.

This discussion on shaming may also be relevant to the nudging of regulators themselves. Picking up on the discussion in the introductory section, in which we considered whether regulators are 'nudgeable'. We assert that reputational concerns could potentially nudge regulators. Nudge discourse emphasises the

[131] Bridget M Hutter 'Anticipating Risk and Organising Risk Regulation: Current Dilemmas' in Bridget M Hutter (ed), *Anticipating Risk and Organising Risk Regulation* (Cambridge University Press 2010) 14.

power of social/institutional norms and explains how they come into play in nudging towards desired behaviour. These can be formalised norms embedded in rules but they need not be formalised, provided there is some kind of expectation regarding proper conduct within a specific context. If a certain type of behaviour would be frowned upon in the financial regulation interpretative community (e.g., regulatory forbearance in the identification and review of systemic risk), and regulator lapses in this regard could potentially earn them a lambasting from quarters such as the media, or consumer bodies—and thereby result in a loss of reputation—then then they are likely to take greater care in handling their responsibilities in order to safeguard their reputation.[132]

5.6.5 Benchmarking prompts

BIs reveal that people are influenced by what members of their social group—their peers and neighbours—do. Shiller's work on herd behaviour and how people make decisions within markets under situations of uncertainty also shows that individuals make decisions not on the basis of product or security information, but on the basis of information relating to the trading behaviour of others in the market.[133] It has also been suggested that social influences played a significant role in driving the bubble that culminated in the GFC.[134] This herd behaviour was manifested in, for example, the popularity of the opaque Collateralised Debt Obligations and Mortgage Backed Securities, or the fad that led to the dotcom bubble. Perceived as fashionable investments, they were purchased by scores of investors with limited knowledge of what their choice entailed.[135]

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[132] Armour and others, *Principles of Financial Regulation* (n 8) 574-575.
[133] Robert Shiller, 'Market Volatility and Investor Behavior' (1990) 80(2) *The American Economic Review* 58; Robert Shiller, *Irrational Exuberance* (Princeton University Press 2015); Robert Shiller 'From Efficient Market Theory to Behavioural Finance' (2003) 17(1) *Journal of Economic Perspectives* 83; John Kay, 'The Kay Review of Equity Markets and Long Term Decision Making' (BIS London, 2012) paras 5.10-5.30.
[134] Thaler and Sunstein, *Nudge* (n 6) 70; Alastair Hudson, *The Law of Finance* (1st edn, Sweet and Maxwell 2009) 841-842.
[135] Michael Lewis, *The Big Short: Inside the Doomsday Machine* (WW Norton 2011). Social networks also influence herding behaviour. It is argued that being part of a social network influenced whether a market actor fuelled the 'irrational exuberance' that led to the financial crisis or betted

The knowledge that the behaviour and choices of people often mirror those of close associates has been used to address global concerns regarding antibiotic resistance. It was found that simple benchmarking prompts for GPs—telling them whether they prescribe more or less than their peers—led to a substantial reduction in the levels of unnecessary antibiotic prescriptions.[136] In the context of financial regulation, we propose that similar benchmarking prompts could be employed at firm level to provide comparisons between different regulatees. In this regard, regulators can formulate different factors for measurement to guide such comparisons. Measures that could be used could relate to aspects like the number of fines a firm receives, or even the average time-frame for addressing consumer complaints. These are only examples; they should tap into their creativity and possibly draw from their monitoring and inspection activity to develop some important benchmarks similar to the concept of key performance indicators, which are sometimes used to assess employee performance within organisations.

5.6.6 Nudging via Attention Cascades

Organisational decision-making and individual decision-making have been argued to be closely connected. Further, it has been argued that it is not possible to really understand how organizations operate without a strong sense of information processing and decision-making at the individual level.[137] An examination of decision making by organisations and individuals reveals that they can only process a restricted quantity of information at any given point, and are thus incapable of participating in unending inquiry. In other

against it. Notably, those who bet against the MBS market were considered outsiders and mavericks, and were not part of the existing social and professional networks.

[136] David Halpern 'Behavioural Economics' May Sound Dry but it May Change Your Life, *The Guardian (*10 October 2017) <https://www.theguardian.com/commentisfree/2017/oct/10/behavioural-economics-richard-thaler-nudge-nobel-prize-winner> accessed 20 November 2018.

[137] Bryan D Jones, 'Bounded Rationality and Political Science: Lessons from Public Administration and Public Policy' (2003) 13(4) *Journal of Public Administration Research and Theory* 401.

words, they are plagued by limited attention. Consequently, they rely on heuristics in their decision making.[138]

Attention cascades are often exploited to highlight long term problems. They are typically facilitated by the media, campaign groups and civil servants,[139] and we assert that they could also be applied in a regulatory context. To address the challenge of limited attention, it is suggested that individuals and organisations are provided with simple ways to filter, prioritise and create agendas by exploiting attention cascades to raise the profile of long term problems.[140] Attention cascades can be created if an issue is presented in a powerful and salient way. Because of limited attention, policymakers have been found to deal with attention cascades by relying on mental shortcuts or heuristics. For instance, they may wait and watch, observe what others are doing, or gauge how much media attention an issue is receiving prior to taking any action.[141] The BIT reported the impact of a TV series called 'Blue Planet II', which highlighted the problem of plastic in oceans. This elicited prompt government action within a few months of the programme airing. Although used to grab the attention of policymakers, it can also be applied in reverse, by policymakers or regulators harnessing attention cascades to highlight significant issues to the public or relevant industry.[142]

In applying methods that exploit attention cascades to the regulatory context, regulators need to identify the long term problems that demand vivid highlighting, and importantly it requires reflecting on how they can communicate information about these issues to regulatees in the most powerful way, so as to ensure that they attract maximum attention and catalyse action.[143] The specific issues that need to be highlighted will differ by regime, and will also be based on the point in time. They may also be triggered

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[138] Michael Hallsworth and others, '*Behavioural Government: Using Behavioural Science to Improve How Government Make Decisions'* (2018) The Behavioural Insights Team <https://www.bi.team/publications/behavioural-government/> accessed 10 October 2018. 25.
[139] Darren Halpin 'Explaining Policy Bandwagons: Organized Interest Mobilization and Cascades of Attention' (2011) 24(2) *Governance* 205.
[140] Hallsworth and others, *Behavioural Government* (n 138) 25.
[141] ibid 25.
[142] ibid 28.
[143] ibid 28.

by a crisis or other event. In the financial sector, regulators may be concerned about specific products. At the time of writing, concerns about short term high cost consumer credit is an example of one of the issues that is in the spotlight in regulatory circles.

5.7 Regulatory Nudging and Product Regulation and Governance

Financial product mis-selling is a recurrent issue in many jurisdictions. RN could be applied to tackle the gaps that contribute to the development of this and other types of misconduct that could cause harm to consumers and financial markets in general. In this section, we will discuss RN applications applicable to the area of product regulation and governance.

5.7.1 Use of model contracts as default options to address unfair contract terms

One of the areas that BE insights have been applied to is analysing the challenges presented by unfair contract terms, and how to develop appropriate remedies to address these concerns. This is an important area because, if it is not dealt with then, it could give rise to market failures, such as information asymmetries or situations in which consumers sign contracts without reading them. These are a concern because they could lead to adverse selection, manifested in a market in which only poor quality contracts (and providers) are left. This poses the risk of harm to consumers, including from less favourable terms, and possible exploitation and mis-selling.

A number of possible interventions have been proposed, such as reliance on market mechanisms like reputation and consumer learning, introduction of a duty to read, or the use of interventions like the “blacklisting” of stipulated unfavourable terms with the assumption that a court will strike these out in the event of a dispute. These are to a large extent based on insights from information economics and consumer policy that have championed remedies such as disclosures. These remedies, although valuable, have limits. BE

insights may be helpful for developing more effective remedies. BE has demonstrated that, because of behavioural biases and heuristics, conventional remedies that are informed by information economics and consumer policy, such as disclosures, will not remedy market failures such as information asymmetries, or instances where consumers sign contracts without reading.[144] Results from empirical studies illustrate the limited effectiveness of disclosure mechanisms in increasing the likelihood of consumer reading or indeed understanding contract terms. For instance, in the case of online standard form contracts, it has been found that it matters little how accessible they are, consumers rarely read them.[145] This finding is of direct relevance to the thesis, as the contracting process for mobile financial products such as mobile loans discussed in this thesis is undertaken remotely, meaning that it is dependent on online forms.

Additionally consumers might feel that reading to gain information is pointless because they have no choice except to agree to the terms if they want the product or service as there are no alternatives.[146] This might be the case for products such as loans, where poor customers might have limited access, for reasons such as lack of collateral or absence of a credit history, to support their applications. The concern in this regard relates to findings from studies that show that contract terms generally favour the provider and tend to be of poor quality.[147] However, the problem of signing without reading has been shown to persist even where consumers are provided with appropriate information.[148]

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[144] Michael G Faure and Hanneke A Luth, 'Behavioural Economics in Unfair Contract Terms' (2011) 34 *Journal of Consumer Policy* 340-343.
[145] Yannis Bakos, Florence Marotta-Wurgler and David R Trossen 'Does Anyone Read the Fine Print? Testing a Law and Economics Approach to Standard Form Contracts' Working Paper 09/04 NET Institute (August 2009) <https://archivefda.dlib.nyu.edu/bitstream/2451/29503/2/Bakos_Marotta-Wurgler_Trossen_09-04.pdf> accessed 20 May 2019; Florencia Marotta-Wurgler , 'Does Disclosure Matter?' New York University Law and Economics Working Papers, Scholarship Repository 242/2010 <https://pdfs.semanticscholar.org/5b24/42832d305159f5c2f734212fbe7b8ca8af98.pdf> accessed 24 May 2019.
[146] Geraint Howells 'The Potential and Limits of Consumer Empowerment by Information' (2005) 32(3) *Journal of Law and Society* 358.
[147] Florencia Marotta-Wurgler, 'What's in a Standard Form Contract? An empirical Analysis of Software License Agreements' (2007) 4(4) *Journal of Empirical Legal Studies* 677.
[148] Faure and Luth, 'Behavioural Economics in Unfair Contract Terms' (n 144) 338.

Additionally, obtaining and analysing information may be challenging for consumers due to problems such as information overload. This difficulty, coupled with the complexity and ambiguity of information, may lead to a decline in the quality of their decision-making.[149] This can apply to contract terms as well, such that, when presented with standard terms, consumers opt to satisfice rather than make optimal decisions.[150] Empirical studies have also revealed that lay individuals interpret standard contract terms more favourably than they actually are because of false consensus bias. That is, they believe that their interpretation is the normal one.[151] This is attributed to unrealistic optimism and self-serving bias. In short, over-optimism might cause one to underestimate the possibility of an unfavourable event happening.[152]

BE theory also proposes that humans have an unwarrantedly high belief in their good fortune, believing overoptimistically in their capacity to effect or attract good outcomes whilst evading bad ones.[153] Most consumers deem themselves to have sound judgment and to be capable of devising profitable and safe purchasing and investment strategies. An example of over-optimism is to be found in a study in which employees who had signed contracts of employment thought that they could only be fired on the basis of cause, even though the contract stipulated that they could be fired at will.[154] This might also affect consumer assessment regarding their likelihood of defaulting on a loan. Card customers have been found to systematically miscalculate their future levels of credit borrowing on account of optimism bias, imperfect self-control, hyperbolic discounting and the possibility of borrowing small amounts at a time.[155] Also, it has been suggested that over-optimism may cause a credit

[149] Russel B Korobkin and Thomas S Ulen, 'Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics' (2000) 88 *California Law Review*, 1077-1084. On information overload see Jacob Jacoby, 'Perspectives on Information Overload' (1984) 10(4) *Journal of Consumer Research*, 432.
[150] Faure and Luth, 'Behavioural Economics in Unfair Contract Terms' (n 144) 348.
[151] Lawrence Solan, Terri Rosenblatt and Daniel Osherson, 'False Consensus Bias in Contract Interpretation' (2008) 108 *Columba Law Review* 1268.
[152] Faure and Luth, 'Behavioural Economics in Unfair Contract Terms' (n 144) 348; For a discussion of self-serving bias, unrealistic optimism and over-confidence see Cass R Sunstein, 'Behavioural Analysis of Law' (1997) 64 *The University of Chicago Law Review* 1182-1184.
[153] Christine Jolls, Cass R Sunstein and Richard Thaler,'A Behavioural Approach to Law and Economics' (1998) *50 Stanford Law Review* 1541—explaining that overconfidence leads most people to believe that their own risk of negative outcomes is lower than the average person's.
[154] Cass R Sunstein, 'Human Behaviour and the Law of Work (2001) 87(2) *Virginia Law Review* 205.
[155] Oren Bar-Gill, 'Seduction by Plastic' (2004) 98 *Northwestern University Law Review* 1373.

card customers to sign up for cards that incorporate repayment terms that are more challenging for them to meet. [156] Another bias that could be at play is the status quo bias,[157] which may increase the likelihood of consumers accepting standard terms without reading.

In general, although scholars accept the findings from behavioural studies, there are conflicting views about what action should follow-the normative implications—and specifically the extent to which behavioural-based interventions should inform regulation. Concerns have been raised about the use of more interventionist's solutions. This is why approaches on the spectrum of soft/asymmetric paternalism, such as nudge interventions, are seen as more palatable, as they are non-coercive.[158]

Behavioural literature proposes some solutions to address the challenges presented by heuristics and biases that could lead consumers to accept contracts that are unfavourable. The framing of choice has been shown to matter, and thus, where disclosures are made, in line with behavioural insights, attention must be paid to format, quantity and effectiveness for this to support consumer decision-making and help avert negative consequences.[159] But, given the recognised limitations of disclosures as highlighted, other policy interventions that draw on behavioural insights should also be implemented alongside them, as discussed below.

Faure and Luth urge governments seeking to improve the quality of standard contract terms to implement policy suggestions that go beyond giving information or depending on consumer vigilance, as, based on empirical findings, these have proven to be insufficient. They propose more substantive

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[156] Oren Bar-Gill, 'The Behavioral Economics of Consumer Contracts' (2008) 92 (3) Minnesota Law Review 763. Author discusses why consumers end up paying more interest than they must suggesting one possible explanation "that consumers underestimate the amount that they will borrow—or at least borrow on the specific card—in the post-introductory period. In other words, at the time they take out their cards, consumers are optimistic about their future credit needs; about their future will power; about the likelihood that they will switch to a new card with a new, low introductory rate; or all of the above".

[157] William Samuelson and Richard Zeckhauser, 'Status Quo Bias in Decision Making' (1988) 1 *Journal of Risk and Uncertainty* 17. The paper analyses responses to surveys, demonstrating that when individuals have to select among different options, they display a bias towards sticking with the status quo.

[158] Faure and Luth, 'Behavioural Economics in Unfair Contract Terms' (n 144) 345-346.

[159] Jolls, Sunstein and Thaler, 'A Behavioural Approach to Law and Economics' (n 153) 1533-1535.

control over standard terms that go beyond the fairness test.[160] By substantive control, they mean that a body would test the quality of standard terms either on an ex-ante or ex-post basis, through the application of the efficiency criteria, in order to make a determination as to whether the terms lead to a maximisation of aggregate social welfare. One of the proposals they make is for an ex ante or ex-post administrative control of consumer standard terms.[161] Another suggestion would entail collective bargaining to arrive at agreed standard terms.[162] The negotiation process would draw representations from various parties, including, for instance, consumer organisations and industry firms, with the process supervised by an independent authority like an ombudsman.[163]

These options each have advantages and limitations.[164] In terms of advantages, employing default terms will minimise transaction costs as parties no longer have to draft contract terms themselves and consumer search costs can be minimised by making the default terms easily accessible. Further, even if they do not read the contract, they can still enjoy a measure of protection, particularly from terms that are problematic for being onerous, such as those that would be captured through a "blacklisting" process. Awareness of the limitations is also important as it helps us to understand the limits of these options. Concerns have been raised about whether a negotiated process will lead to the adoption of efficient standards. In this regard, the inclusion of various parties as opposed to having a single party (such as a firm) is thought to be likely to lead to the achievement of more efficient standard terms. Other concerns have been raised about regulatory capture and the likelihood that

[160] They argue that the effectiveness of the fairness test is reliant on enforcement, and that in practice, the enforcement of standard terms poses many difficulties; For discussion see generally Faure and Luth, 'Behavioural Economics in Unfair Contract Terms' (n 144) 337. For discussion of the two models see 352-354.
[161] Clayton P Gillette, 'Pre-Approved Contracts for Internet Commerce' (2005) 42 *Houston Law Review* 975; this model entailing the pre-approvals of standard terms has been used in Israel. <https://heinonline.org/HOL/Page?handle=hein.journals/hulr42&id=987&div=34&collection=journals> accessed 20 May 2019.
[162] This model has been employed in the Netherlands, where draft model standards terms are negotiated within the bounds of the social economic council.
[163] Hugh Collins, 'The Freedom to Circulate Documents: Regulating Contracts in Europe' (2004) 10(6) *European Law Journal* 798-802.
[164] Hanneke A Luth, 'Behavioural Economics in Consumer Policy: The Economic Analysis of Standard Terms in Consumer Contracts Revisited' (DPhil thesis, Erasmus University Rotterdam 2010)—See for discussion on advantages and limitations.

consumer representatives will be weak, with the result that their input may be inadequate. Another concern is that a model contract may be too general, and thus it may not cater to consumers who want more stringent terms incorporated into their contracts. Furthermore, there is a concern that mandatory model contracts would be more paternalistic and impinge on the parties' freedom to contract, as they leave no option for opt-outs. Faure and Luth argue that the presentation to firms and consumers of model contract terms as the default option can be characterised as a nudge. To address concerns about overly paternalistic interventions, and for this to qualify as a nudge, it is therefore important to present model contract terms as the default, but to leave the door open for opt-outs.[165]

To address this latter concern, there are proposals for the inclusion of rules governing the design of contracts that would entail the presentation of contractual choices in the form of 'menus'. The envisaged rules would emphasise the manner in which information is presented to consumers, as opposed to forbidding consumers from entering into contracts that could be disadvantageous to them because they present inordinate risk. The rules would comprise the design of default rules, including opt-in and opt-out rules (to be used alongside other rules) to leverage or offset biases. The improvement to menu design would discourage consumers from accepting unfavourable contract terms.[166]

However, it is notable that this does not completely resolve the concerns about defaults. Another argument pointing to the drawback of defaults is made by Madrian and Shea[167] in their work on the power of suggestion. They observe that defaults, although powerful, can result in nudgees treating them as suggestions or advice, where they are not. So that absent the default, they

[165] Faure and Luth, 'Behavioural Economics in Unfair Contract Terms' (n 144) 353-354.
[166] Erik F Gerding, 'The Subprime Crisis and the Link between Consumer Financial Protection and Systemic Risk' (2009) 4 *Florida International University Law Review* 458-459; Ian Ayres, 'Menus Matter' (2006) 73 *University of Chicago Law Review* 3.
[167] Brigitte C Madrian and Dennis Shea, 'The Power of Suggestion: Inertia in 401(k) Participation and Savings Behaviour (2001) 116(4) *Quarterly Journal of Economics* 1149.

might have opted for a higher pension contribution or loan repayment, as the case may be.

In sum, the use of model contracts as a nudge, through the reliance on these as a default option, can be helpful for regulators and policymakers seeking to improve the quality of standard terms. A further argument in support is that it can also have the added benefit of helping to reduce the risk and uncertainty attached to the contracting process, including from information asymmetry, and particularly for retail consumers, who are often weaker parties in this process.

An additional intervention that may be embedded under this approach is the incorporation of financial literacy training and education as an avenue for creating awareness about general financial management and product risks. This may help to increase the comprehension of model contract provisions among consumers. In this way, they can be nudged to make better financial decisions. Care is advised in using this intervention, however. In designing financial literacy programmes, there is need to take into account findings that suggest that generic financial training and education is less effective in surmounting biases, such as procrastination, status quo and loss aversion. Alternatives that have proved most effective are individually tailored programmes in which participants are given the chance to put decisions into practice and to learn from experience.[168] We further suggest that these programmes should be employed from a young age, for instance by being incorporated into school curriculums. This way, the knowledge can be internalised from early on and drawn on in future financial decision-making. Financial regulators will need to engage other stakeholders such as education policy makers to implement such programmes.

[168] Deakin, 'The Evolution of Theory and Method in Law and Finance (n 26) 25; David De Meza, Bernd Irlenbusch, and Diane Reyniers, 'Financial Capability: A Behavioural Economics Perspective' (2008) 69 *Consumer Research*.

5.7.2 'Sticky' opt-outs for mobile credit

The idea for this nudge is based on a proposal by Michal Barr and others.[169] They suggest the implementation of what they term "sticky" opt-out mortgage regulation to address the causes of the sub-prime mortgage crisis, which saw consumers taking out loans that they had limited understanding of and could not afford. Although they recommend this as a system for mortgage regulation,[170] this work proposes that it is an approach that could also be adopted and adapted to the regulation of other products, like mobile credit.

Some of the harms that the GFC mortgages posed for consumers are also present in mobile lending, including opaque fees and charges, the use of complex terminology, and the inability to properly estimate one's likelihood of default. Although disclosure mechanisms can help, their effectiveness is limited, as already expressed in the discussion on default contracts.

What is the nature of these sticky default options? Michal Barr and others suggest setting up a default whereby firm liability or severity of the penalty to be imposed rises with the increase of variations that generate consumer harm. Under this system, it would be stipulated that lenders offer borrowers loans with standard terms. Borrowers would have the choice to opt-out and select other loans, but this would be subject to the lenders meeting enhanced disclosure requirements. Further, it would be stipulated that the level of liability or more severe penalties would attach to these other loans.[171]

This effectively results in the creation of a two tier system comprising standard and non-standard loans. The basis for this tiering, and hence this nudge, is that borrowers have been shown to have difficulty differentiating between complex and non-complex products, and selecting optimal choices based on that understanding. By giving borrowers a standard loan by default, this will

[169] Michael S Barr, Sendhil Mullainathan and Eldar Shafir, 'An Opt-Out Home Mortgage System' (2008), The Brookings Institution Hamilton Project Discussion Paper 2008/ 14.
[170] Michael S Barr, Sendhil Mullainathan, and Eldar Shafir 'Behaviorally Informed Financial Services Regulation' (2008) Asset Building Program Policy Paper, *New America Foundation* 8-11.
[171] ibid.

enhance the likelihood that they get loans that they will find more easily understandable.[172]

Implementing this system would require that regulators set out *ex-ante* the parameters by which a mobile loan is to be considered standard or non-standard, and thus subject to more stringent requirements, and what would comprise enhanced disclosure. Regulators will therefore need to issue lenders with rules, principles or guidelines around this, but in general firms would need to provide transparent and comprehensive information regarding the loan terms and risks. Regarding the criteria for delineating the loan types, we would suggest, for example, that mobile loans which have problematic features associated with high cost consumer credit and could expose particularly vulnerable retail consumers to the risk of unmanaged debt, could fall into this category of non-standard loans. Additionally, it would also require prior determination regarding the sanctions to be imposed for contraventions; for example, whether fines or consumer compensation or, for more egregious deviations, product temporary withdrawal or complete bans should be imposed.

This approach is buttressed by two insights. First, there are behavioural insights about the power of defaults, and also leverages the anchoring and framing effects, and loss aversion. When borrowers are offered the alternative loans, they will be informed that these are deviations from the default, and this will have the effect of anchoring them to the default. The framing of the loan choice as a choice between a standard vs. a non-standard product would nudge and hence enhance borrower decision-making. For borrowers, the enhanced disclosure requirements should hopefully trigger them to reflect a bit more before taking up a non-standard loan. Lenders, on the other hand, although having the freedom to offer non-standard loan types, would also be nudged away from loan options with terms that are unreasonable, unfair, or generally riskier. However, where they offer non-standard loans, they will have to reflect on how to provide appropriate disclosures to ensure regulatory

[172] Lawrence M Ausubel, 'The Failure of Competition in the Credit Card Market' (1991) 81(1) *The American Economic Review* 50.

compliance and to minimise costs that could accrue from liability for any contraventions. From a behavioural perspective, the risk of increased costs plays on the loss aversion bias. It is expected that firms will take greater care, when offering non-standard loans, to minimise their exposure to liability or other sanctions.[173]

A second insight is drawn from industrial organisations, in which some market incentives can subvert a pure opt-out system. A simple opt-out would be inferior, because market pressures may drive lenders to offer non-standard loans and to keep the true risks of borrowing hidden from borrowers, as they stand to generate greater profits from riskier alternatives.[174]

This system can present several challenges. One is whether the default will be 'sticky' enough to counteract market pressures, such as pressure to offer 'bad' loans. Another is that incentive structures for loan officers within the firm could undermine the default if the rewards for non-standard loans are more attractive. A key challenge is how to correctly set up the default product to minimise deviations towards a non-standard loan that might be more appropriate for borrowers. Regarding how to set up the default, it is suggested that smart defaults can be generated that take into account pivotal borrower attributes, such as demographic factors. With this, a suitable default can be tailored that might more appropriately address a wide range of borrowers.[175] We would further assert that application of algorithms to support the decision-making process might enhance the process of setting up defaults.

To verify adherence to the opt-out system, and to ensure that the defaults and accompanying disclosures continue to be suitable, regulators should subject them to scrutiny as part of the continuous supervision process. Firms will also need to have their internal processes of review that may, for example, be

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[173] Barr, Mullainathan, and Shafir, 'Behaviorally Informed Financial Services Regulation' (n 170) 9.
[174] ibid.
[175] ibid 10; N Craig Smith, Daniel G Goldstein and Eric J Johnson 'Choice Without Awareness: Ethical and Policy Implications of Defaults' 2013 32(2) *Journal of Public Policy & Marketing* 166-168; Daniel G Goldstein and others, 'Nudge Your Customers Toward Better Choices' (2008) *Harvard Business Review* 99 <https://www.researchgate.net/profile/Daniel_Goldstein3/publication/236302899_Nudge_Your_Customers_Toward_Better_Choices/links/0deec5179295364232000000.pdf> accessed 20 May 2019.

supported by findings from surveys or other forms of consumer experimental design. The firm's processes should also be subjectable to regulatory review and challenge as part of the supervision process.[176]

In summary, the 'sticky' opt-out nudges both lenders and borrowers. This option is different from a pure opt-out system. The use of the term 'sticky' may refer to the measures implemented to make the default more difficult to opt-out of. The stickiness is enabled by the more stringent disclosures and increased exposure to liability.

5.7.3 Framing

Studies have shown that people are affected by the presentation of choices to them, how objects or ideas are displayed or placed. For instance, the decision on whether to choose fruit or pastry in a cafeteria has been shown to be dependent on the prominence or position in a queue given to these choices.[177] Human minds may be similarly directed in decision-making regarding financial products and general investment strategies.[178] Behavioural insights also indicate the importance of framing, explaining that people make different decisions depending on whether things are framed as losses or gains. Even small changes along these lines can tap into deep feelings of 'loss aversion', the tendency to more strongly prefer to avoid losses than to acquire gains.[179] Kahneman and Tversky also observe that people have a greater desire to avoid losses than to acquire gains of the same value.[180] They also do not evaluate actual losses and opportunity costs in the same way.[181]

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[176] Barr, Mullainathan, and Shafir 'Behaviorally Informed Financial Services Regulation' (n 170) 11.
[177] Thaler and Sunstein, *Nudge* (n 6) 1-6; Amos Tversky and Daniel Kahneman, 'Choices Values and Frames' (1984) 39 (4) *American Psychologist* 341.
[178] Paul Slovic, Baruch Fischhoff, and Sarah Lichtenstein, 'Facts and Fears: Understanding Perceived Risk' in Paul Slovic (eds) *The Perception of Risk* (Earthscan Publications 2000) chapter 8; Also see Paul Slovic, Baruch Fischhoff, and Sarah Lichtenstein,'Response Mode, Framing, and Information-processing Effects in Risk Assessment' in Paul Slovic *The Perception of Risk* (Earthscan Publications 2000) discussing how framing affects risk assessment.
[179] Hallsworth and others, *Behavioural Government* (n 138) 21.
[180] Daniel Kahneman and Amos Tversky, 'Prospect Theory: An Analysis of Decision under Risk' (1979) 47 *ECONOMETRICA*, 279; Daniel Kahneman, Jack L Knetsch and Richard H Thaler, 'Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias' (1991) 5 *Journal of Economic Perspectives* 193.
[181] Daniel Kahneman and Amos Tversky, 'Subjective Probability: A Judgement of Representativeness' (1972) 3 *Cognitive Psychology* 430.

Framing and its effects are commonly harnessed in advertising. Numerous tactics observable in contemporary advertising target system 1 such as the use of bold colours, music, attractive people and unique aesthetics in order to create specific moods and associations and ultimately to sell products. The affect heuristic is typically the target. When engaged, it leads to people attributing their emotional responses to goods or services as a type of mental shortcut to replace a detailed reflection about the variables at issue.[182]

Due to the power of framing effects, it is important that, in their interactions with regulatees, regulators consider framing effects. This knowledge should shape regulatory communications; for instance, communication to regulatees could be framed in such a way that choices are positioned and explained positively and in a way that is relevant and clear to the intended regulatee. Regulators should generally use words carefully and focus on how the communication will be understood by the receiving party, and not merely how they understand it.

Framing effects are also important in considering in the context of disclosure regulation, which can present challenges. A review of legal frameworks in jurisdictions like the UK, and even the Kenyan one analysed in this work, reveals a focus on disclosure regulation. This has its benefits, and there is no regime that can effectively operate in the absence of such disclosure requirements, and there are ways to enhance disclosure to improve its effectiveness. However, we argue that this is a major weakness of this regime. Where firms make disclosures they may exploit biases, or alternatively when consumers are presented with disclosures, they may make poor decisions because they are lumbered by biases or heuristics. For example, findings from empirical literature show that consumers are less likely to purchase a product where the bulk of the cost is included in the base price, as opposed to being hidden as part of the shipping and handling charges.[183]

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[182] Cass R Sunstein, *The Ethics of Influence: Government in the Age of Behavioural Science* (n 70) 94-97.

[183] Hunt Allcott and Cass R Sunstein, *Regulating Internalities* (2015) 34 *Journal of Policy Analysis and Management* 698.

The achievement of optimal disclosure requires sophistication, and the application of psychological insights can be helpful for improving its effectiveness. In this regard, per Bertrand and Morse, the effectiveness of disclosure regimes on payday lending varied across borrowers, and they suggest that the regimes that are likely to be more effective are those that take into account borrowers' cognitive biases.[184] To be effective, disclosure regulation needs to go beyond just providing information to consider how to improve the way the information is presented, so that it is disseminated in an easily comprehensible and salient way. An example of this is in relation to product regulation is giving information about how commonplace product failures are, so that, for instance, the warning that "2 out of 10 borrowers who take this kind of loan default" can help consumers to stop and think about whether to take a loan or not.

Another example is drawn from Barr, Mullainathan and Shafir, who propose the use of framing and salience to encourage good credit card behaviour.[185] Their proposal may be equally applicable to mobile lending. On the subject of credit card usage, BE findings suggest that consumers underestimate how much they will borrow and overestimate their capacity to repay their bills on time.[186] Enhanced disclosure that leverages framing and salience has been proposed as a way of addressing consumer biases in a lending context. One option entails the provision of minimum payment terms to borrowers, including clear statements about the length of time it will take to repay, and the total amount of interest consumers will repay if they make only minimum repayments. This may need further strengthening in view of BE findings that

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[184] Marianne Bertrand and Adair Morse, 'American Finance Association Information Disclosure, Cognitive Biases, and Payday Borrowing' (2011) 66 *The Journal of Finance*, 1865; The FCA has designed and conducted experiments investigating how disclosure can be improved through harnessing BE insights. See for example Paul Adams and others, 'Helping Credit Card Users Repay their Debt: a Summary of Experimental Research' FCA Research Note (July 2018) <https://www.fca.org.uk/publication/research/research-note-helping-credit-card-users-repay-their-debt-summary-experimental-research.pdf>accessed 18 February 2020; See also Lucy Hayes, William Lee and Anish Thakrar, 'Now You See It: Drawing Attention to Charges in the Asset Management Industry' FCA Occasional Paper 32 (April 2018). <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-32.pdf> accessed 18 February 2020— FCA findings suggest that clearly presenting understandable and engaging information in a prominent way can increase the effectiveness of disclosures.

[185] Barr, Mullainathan, and Shafir, 'Behaviorally Informed Financial Services Regulation' (n 170).

[186] Bar-Gill, 'Seduction by Plastic' (n 155) 1395-1396.

suggest that intention does not always lead to action. Additional enhancement may further help to plug any other gaps that may be leveraged by providers seeking to exploit consumer biases.[187] The enhanced option entails an opt-out payment plan. Under this option consumers would be required to automatically repay balances within a short period—the default period—unless they affirmatively opt-out and elect an alternative payment plan-longer or shorter than the default repayment plan.[188] Behavioural insights regarding the effects of defaults and framing suggest that many consumers would follow this option. The adoption of an opt-out repayment plan may present benefits and challenges. This option would be beneficial to consumers who would pay lower interest and other related fees, and it would also minimise problems such as over-indebtedness. With regard to challenges, it could give rise to costs to some consumers who would have paid faster, but for the default option—this means they will pay higher interest and fees, or run the risk of over-indebtedness. This may be too expensive for some, so that money that could have been used for other necessities is instead used for meeting repayment obligations.[189]

Companies such as Apple are already implementing solutions that harness framing and salience, and have embedded these within their Apple Card, which is essentially a personal finance app called the Wallet App. They state their objective to be the improvement of transparency and the encouraging of paying less interest. To this end, they have come up with innovative features to display credit balances. For example, when a customer plans to make a repayment, the Wallet immediately calculates and displays different levels of interest rate if the balance is paid over a few months versus years. The display interface is also interactive, and consumers can adjust a virtual dial with their fingers with the dial transforming from grey to red with a rise in interest rate

[187] Barr, Mullainathan, and Shafir, 'Behaviorally Informed Financial Services Regulation' (n 170) 13-14.

[188] Michael S Barr, 'An Inclusive, Progressive National Savings and Financial Services Policy' (2007) 1(1), *Harvard Law and Policy Review* 161; Robert Gordon and Douglas Derek, 'Taking Charge: Attention Credit Card Companies: When We Want You to Charge us Hidden Fees We'll Let You Know' (2005) 37(12) *The Washington Monthly*—authors suggest related proposals in the form of an opt-out direct debit arrangement for credit cards.

[189] Barr, Mullainathan, and Shafir, 'Behaviorally Informed Financial Services Regulation' (n 170) 13-14.

charges.[190] Other mobile phone app providers could add similar features, and this could in turn improve consumer protection by addressing some of the concerns linked to transparency and over-indebtedness. However, a limitation with this specific initiative is that it would only benefit smartphone users, and thus may not be accessible to many in developing countries still transacting via feature phones.

A challenge with regard to framing is how to set the right tone and to ensure consistency in diverse circumstances. Other difficulties that arise relate to challenges related to consumer awareness or education efforts, which are intended to influence intentions and the eventual action. This is on account of gaps "between understanding and intention, and particularly between intention and action".[191] In summary, disclosure regulation has its limits, and these should be to be taken into account when using this approach. Applying behavioural insights can be beneficial for improving this approach. In our view regulators should consider applying enhanced disclosure in conjunction with relevant RN examples that have been discussed in this section.

Paying attention to framing effects should also be a consideration for regulators as they review firm conduct. For instance, product providers may exploit framing and loss aversion to try to get consumers to purchase products like credit. Regulators should pay attention to this in reviewing disclosures, for example in promotional materials or other forms of advertisement.

It must also be noted that framing is a cross-cutting approach which can also be applied to enhance several RN applications that have been considered in this section.

5.7.4 Nudging via Traffic Light Labelling for financial products

Traffic control symbols are a ubiquitous fixture in urban infrastructure. These symbols comprise traffic lights, and other signs and symbols. Traffic lights

[190] Patrick McGee'What the Apple Card Gets Right, and Wrong' *Financial Times* (San Francisco, 13 August 2019) <https://www.ft.com/content/aad5be8a-bce8-11e9-b350-db00d509634e> accessed 8 October 2019; other features include colour coding purchases to make it easy to compute what money is spent on.
[191] Barr, Mullainathan, and Shafir, 'Behaviorally Informed Financial Services Regulation' (n 170) 6.

typically employ a universal colour code—comprising red, amber, and green.[192] The traffic light colour coding system has also been applied in other contexts. It has been used as a rating mechanism for products and processes. For example, it is prominent in food labelling, and has also been used in energy rating. [193] In this work, we would like to propose the use of traffic light labelling systems as a regulatory nudge, in financial product regulation and governance. To our knowledge, there is no research that discusses its usage as a nudge in this context. We consider this proposal in more detail below.

In the consumer consumption context, traffic light labels (TLL) are typically used to communicate product risks and benefits.[194] The use of TLL and their effects on consumer choices for food and financial products has been examined by Drescher, Roosen and Marette.[195] The authors' state that, although there is an abundance of literature on the effects of TLL on consumer choice for food products, equivalent literature is absent for financial products. They assert that their work seeks to address this gap, and to establish whether TLL have comparable effects for financial products. Their study uses data from an online survey, that features a choice experiment focused on food and financial products that are labelled with and without traffic lights.[196] The theoretical foundation for their research is Behavioural Economics (BE), which recognises that consumers have limited cognitive capacities. Despite this, they have to make consumption choices regularly, daily for food though more infrequently for financial products. Due to the inherent cognitive challenges, humans often rely on heuristics. It is suggested that use of TLL as a heuristic helps consumers to make better, healthier, or safer consumption choices because information—such as on nutrition, in the case of food labels—is

[192] Clay McShane, 'The Origins and Globalization of Traffic Control Signals' (1999) 25 (3) *Journal of Urban History* 379-404.
[193] Ann N Thorndike and others, 'Traffic Light Labels and Choice Architecture: Promoting Healthy Food Choices' (2014) 46(2) *American Journal of Preventive Medicine* 143; See EU Council Directive 92/75/EEC on the indication by labelling and standard product information of the consumption of energy and other resources by household appliances.
[194] Larissa S Drescher, Jutta Roosen and Stéphan Marette, 'The Effects of Traffic Light Labels and Involvement on Consumer Choices for Food and Financial Products' (2014) 38 *International Journal of Consumer Studies* 219.
[195] ibid 217–227.
[196] ibid 218.

summarized. Labelling has also been used to signal product quality.[197] The authors hypothesized that consumer choices would differ when TLL are employed, compared to when they are not—even in the financial products domain, where there is limited research on the effects of such labelling.[198] With regard to financial products, the research highlights some interesting findings that have relevance for the present discussion. Based on the participants sampled, it was found that 'willingness to pay' is always higher if the financial product carries a TLL. It is suggested that this means that consumers strongly follow the guidance provided by the TLL, and therefore that they pay attention and value these labels.[199] This finding supports our proposal in this work that TLL could be beneficial if used for financial products.

TLL systems largely seek to help consumers 'recognize, evaluate and compare the risks of the different attributes of financial investment'.[200] For financial products, the colours green amber and red would correspond to low, medium, and high risk, or unregulated product, respectively. We appreciate that product risk and complexity is dependent on the specific consumer who is purchasing it; for instance, retail versus sophisticated consumers. We would argue that TLL could be harnessed especially to steer retail customers away from products that have the potential to cause them harm. Regulators may have some problematic products in mind. One of the examples we highlighted in chapter 4, where we discussed various product intervention options, is the case of the sale of mini-bonds in the UK. In late 2019, the FCA issued a temporary ban on the marketing of these products to retail consumers. Regulators often have to balance between consumer choice and consumer protection, and there are instances where interventions that are seemingly intrusive (such as bans) are justified to ensure consumers are protected from possible detriment. As enforcing such bans in a command style may prove challenging, a more tailored approach that we would propose is that the FCA consider directing firms to use TLL as a nudge to accompany promotional

[197] For example, organic food. Or eco labels to signal environmental impact.
[198] Drescher, Roosen and Marette, 'The Effects of Traffic Light Labels and Involvement on Consumer Choices for Food and Financial Products' (n 194) 218.
[199] ibid 226.
[200] ibid 218.

material for these products. Additionally, they may stipulate that any firms not complying will have their products pulled from the market. We further suggest that, although TLL would be targeted at retail consumers, they may also nudge the more sophisticated to seek advice prior to product purchase or investment, particularly those products bearing a red label, in order to better understand risks before committing their money (loss aversion at play). Additionally, once TLL is implemented, it may even be used to determine what remedies a consumer is entitled to; for instance, in the event of a financial firm's failure. For example, retail consumers seeking compensation in respect of products that had carried a red label as a signal of unsuitability due to high risk level, but who ignored the TLL, may have limited recourse.

Regulators in Kenya and elsewhere need to consider how to effectively incorporate TLL in financial product regulation. Additionally, they may need to test the effectiveness of this nudge via experimental research. Certainly, TLL would be a novel product intervention option for Kenya. For other jurisdictions, TLL systems in finance have either been adopted or have at least been discussed as an area of policy reform, although not in a nudge context. In the EU, the European Parliament's vote on usage of TLL, in March 2010, was followed by a shift towards TLL for non-food products.[201] Further, it is noted that following the GFC, labelling of financial products has become prominent in a number of EU states. For example, in Germany a TLL system was introduced in 2010 by 'Targobank' to help customers more easily determine whether a product aligned with their investment goals.[202] Similarly, TLL risk labelling for different investment products was mandated by Executive Order in Denmark. It was described as serving the purpose of safeguarding especially less experienced investors.[203] In the UK, the use of a TLL for financial products was proposed in a Treasury white paper published in 2009 as a way of delivering simplicity and clarity to consumers. It was suggested in

[201] ibid 217.
[202] ibid 217.
[203] The Danish Ministry of Economic and Business Affairs, 'Risk-labelling of Investment Products' (Oct 2010); Executive Order on Risk Labelling of Financial Products< https://www.danskebank.dk/PDF/PRISER-VILKAAR-FAKTAARK/Homepage-UK/Privat/Investment/ExecutiveOrderRiskLabelling-InvestmentProducts.pdf> accessed 7 February 2020.

the paper that despite food and financial services falling into different categories of consumer products, food labelling may hold important lessons that could help to improve the transparency of financial products.[204] Accordingly, we will consider a few insights from food labelling that financial regulators may find beneficial in considering the use of TLL.

5.7.4.1 Lessons from food labelling, and application to financial products

A key lesson is the need for simplicity. An analysis of consumer perception, understanding, and acceptance and use of nutritional food labelling indicates consumer preference for the idea of simplified front-of-packet-information.[205] Plainness is considered an important aspect in achieving this simplicity.[206] Findings from a UK study suggest that consumers have a higher understanding of TLL on food items in comparison to other types of labels.[207] This underscores the point that not all labels are equal—some communicate better than others. To enhance communication, it is suggested that semiotic traditions in colour schemes are used.[208] The power of colour for both attracting and retaining attention, and thus for enabling further information processing, is acknowledged.[209] The potential of semiotic conventions for increasing consumer understanding has been revealed by observational

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[204] HM Treasury, Reforming Financial Markets (London 2009) Treasury White Paper 107 and 154-156 < https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/238578/7667.pdf> accessed 02 February 2020.

[205] Klaus G Grunert and Josephine M Wills, 'A Review of European Research on Consumer Response to Nutrition Information on Food Labels' (2007) 15 *Journal of Public Health* 385–399.

[206] Drescher, Roosen and Marette, 'The Effects of Traffic Light Labels and Involvement on Consumer Choices for Food and Financial Products' (n 194) 219.

[207] Sally Malam, and others, 'Comprehension and Use of UK Nutrition Signpost Labelling Schemes' (May 2009) BMRB Social Research Report for the UK Food Standards Agency.

[208] Drescher, Roosen and Marette, 'The Effects of Traffic Light Labels and Involvement on Consumer Choices for Food and Financial Products' (n 194) 219. On semiotics see John Fiske, *Introduction to Communication Studies* (2nd edn, Routledge 2002) 38. He describes semiotics or semiology as the study of signs and how they work.

[209] Hannele Kauppinen-Räisänen, Marie-Nathalie Jauffret, 'Using Colour Semiotics to Explore Colour Meanings' (2018) 21 (1) *Qualitative Market Research* 101-117; See also Hayes, Lee and Thakrar, 'Drawing Attention to Charges in the Asset Management Industry' (n 184). <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-32.pdf> accessed 18 February 2020— FCA experimental research suggests that using colour (as well as graphics and plain language) can make information more noticeable and more likely to be acted upon.

studies showing that in the UK there is a very high understanding of TLL, with 80% of consumers able to identify the healthiest product.[210]

According to colour semiotics research a red label is considered a negative label. Also noteworthy are the effects of green TLL. Research in food studies suggest that they can create a halo effect.[211] This is a concern for financial products, as a green TLL might similarly create a 'safe halo'. This may lead to the underestimation of risks, and, in turn, to consumers choosing unsuitable financial products, as they perceive the product to be safer. In general, we would urge caution in the use of green labels. Financial regulators may want to minimise suggestions that a product has received regulator endorsement. They should emphasise that a green label does not guarantee that a product is risk free, merely that it is suitable for retail consumers.

In general, we propose that TLL would be beneficial for retail consumers who—because less savvy, and affected by biases such as information overload, or limited attention—may not read or understand the abundance of promotional material, or complex and voluminous small print that often accompanies financial product marketing and distribution. We propose that a TLL will act a heuristic to signal product riskiness to them and assist them in their decision making.

We further suggest that TLL could even be used alongside product intervention rules—for example, bans whether temporary or permanent—to make enforcement more effective. So, a red label on promotional material for a banned/risky product would more effectively communicate unsuitability.

Besides communicating financial product risk level, we would also suggest that TLL can also be employed by regulators to help consumers distinguish between regulated and unregulated products. The UK mini-bonds scandal illustrates the importance of making this distinction clear to consumers. In this case, consumers did not know that the products marketed by LCF were

[210] Klaus G Grunert and others, 'Use and Understanding of Nutrition Information on Food Labels in Six European countries' (2010) 18 *Journal Public Health* 261–277.
[211] Drescher, Roosen and Marette, 'The Effects of Traffic Light Labels and Involvement on Consumer Choices for Food and Financial Products' (n 194) 225.

unregulated, and therefore their investments were unprotected, even though the firm's promotional material had implied that this was the case. The FCA, having identified that there was confusion in the industry about the status of these bonds, had clarified the correct position to the industry via a supervisory notice explaining that they were unregulated and unprotected. However, following the failure of LCF, investors who had assumed that the bonds were regulated and therefore protected, sought to claim compensation from the Financial Services Compensation Scheme. The regulator advised that, although the firm was authorised (regulated), the bonds were unregulated, and not covered by the scheme. To address such situations, a regulator may stipulate that any unregulated product must carry a red TLL.

In chapter three's examination of the Kenyan regime, we isolated MC as a financial product that is posing challenges for regulation. Intervention in the form of TLL would also be ideal for this product, not because it is necessarily complex, but because it is risky; for instance, there are risks to consumers from high interest rates and rollovers. In this regard, the suggestion that financial products can sometimes be construed as complex due to vagueness of disclosure or technical jargon is relevant.[212] Thus, a MC product that is accompanied by problem features could be deemed complex. Another MC challenge discussed is that some of its providers are unregulated, such as FinTech firms. TLL use could be used to signal their status. Employing TLL would be generally beneficial for Kenyan consumers who experience challenges reading or understanding financial information due to low literacy levels.

The TLL approach may additionally be used to signal the difference in risk level between financial investments on the FTSE 100 index and other emerging market investment products. The former is typically perceived as lower risk due to their high market capitalisation and would carry a green label. On the other hand, emerging market investment products would be labelled amber or red, as these are often higher risk.

[212] See Benedict SK Koh and others, 'A Risk and Complexity Rating Framework for Investment Products' (2015) 71 (6) *Financial Analysts Research Journal* 17.

5.7.4.2 Traffic Lights vs. Product Risk warnings

Product or risk warnings are a commonplace feature that accompany many products. Governments and regulators often mandate their use, and their objective is usually to inform consumers about risks and to help them determine whether a product is appropriate for them.[213] Such warnings are considered as having the potential to improve consumer outcomes. Examples of proposals on the use of warnings include suggestions that disclosure regulation should shift its focus to communicate that the use of products like credit cards can be dangerous. Additionally, that the communication should be accompanied by advice to consumers on ways to reduce their risk. It is thought that such an approach may be helpful for counteracting consumer biases, and specifically that warnings will help them reflect more on their purchases and foster more controlled spending. Additionally, it will increase the salience of risks that might affect their ability to repay debts and the consequences of debt. [214]

We would argue that TLL are essentially product risk warnings. The purpose of red labels on products would be to inform and warn consumers about negative product attributes. Given the close connection between these interventions, we will consider some insights about risk warnings. The findings about risk warnings may also be valuable for the design and implementation of TLL. In line with our proposal above that TLL be used as a nudge, risk warnings are recognised as having a nudge element and are considered to be less intrusive than CAC regulation.[215]

Experiments conducted to determine the effectiveness of risk warnings in financial services reveal insights that could be beneficial for regulators in adopting such interventions. [216] For example, in a research study on

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[213] Lisa A Robinson, Viscusi W Kip, and Richard Zeckhauser, 'Efficient Warnings, not "Wolf or Puppy" Warnings' HKS Faculty Research Working Paper Series RWP16-033 September 2016.
[214] Richard Tooth, 'Behavioural Economics and the Regulation of Consumer Credit' (2012) New Zealand Law Foundation 22-23; David Stein, 'Wrong Problem, Wrong Solution: How Congress Failed the American Consumer' (2007) 23(2) *Emory Bankruptcy Developments Journal*. 620-622.
[215] Robinson, Viscusi and Zeckhauser, 'Efficient Warnings' (n 213) 4.
[216] ibid; see also Laura Smart, 'Don't Look Here: Do risk Warnings Really Work?' FCA Insight (December 2018) <https://www.fca.org.uk/insight/dont-look-here-do-risk-warnings-really-work>

investment prospectuses, it was found that risk warnings are effective in increasing research participants risk perception and minimised incentives to look for additional products.[217] However, caution is advised in the use of risk warnings and findings from experimental research provide guidance on effective use. Regulators are advised to be selective in their usage to increase their effectiveness. This is in view of findings suggesting that a proliferation of warnings may cause 'warning fatigue' among consumers, which reduces their effectiveness.[218] This was revealed in an FCA study conducted to explore the effectiveness of risk warnings on social media posts for ten frequently advertised financial products, including pay day loans.[219]

With regard to how warnings should be framed to ensure effectiveness, as with TLL, plainness and simplicity are important for product risk warnings in general. Plain packaging laws for tobacco products have been implemented, for instance, in Australia. The goal is to diminish the attractiveness and appeal of tobacco products to consumers and to make the mandated health warnings more salient, thereby improving their effectiveness.[220] The same approach could be utilised for particularly risky financial products.

In all, risk warnings are effective, but it is suggested that they work best where products have the potential to cause a high impact and bear a high probability of harm.[221]

We also assert that TLLs are superior to other types of risk warnings—such as a list of ingredients on a food label—as they are more salient, more attention grabbing, and easy to understand because consumers are generally

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accessed 4 Feb 2020—discussing findings from experiments conducted to assess the effectiveness of risk warnings.

[217] Ruben Cox, and Peter de Goeij, 'The Effects of Risk Framing, Balanced Information and a Regulatory Seal of approval on Investor Perception and Behavior' Working Paper 2016.

[218] Timothy L Mullet, Laura Smart, and Neil Stewart, 'Blackbird's Alarm Call or Nightingale's Lullaby? The Effect of Tweet Risk Warnings on Attractiveness, Search and Understanding' FCA Occasional Papers in Financial Regulation (December 2018) <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-47.pdf> accessed 4 Feb 2020; Smart, 'Do risk Warnings Really Work?' (n 216).

[219] Mullet, Smart, and Stewart, 'Blackbird's Alarm Call or Nightingale's Lullaby? ibid— the research was in collaboration with Warwick Business School and the University of Bath.

[220] Leigh Hill, 'The Political Philosophy of 'Nudge' and the Paradigms of Paternalism' (BA Arts thesis, Flinders University 2015) 51.

[221] Mullet, Smart, and Stewart, 'Blackbird's Alarm Call or Nightingale's Lullaby? (n 218).

familiar with the TLL system. This is based on previous encounters, including usage in road traffic symbols or food labelling. In sum, although TLL has been adopted in the consumer consumption context, to our knowledge, there is no research that has been reported of usage as a nudge to help enhance regulatory outcomes. While appreciating the need for caution to avoid a proliferation of risk warnings, as well as the danger of creating a 'halo' effect (with green labels), we think this is an intervention that would be greatly beneficial for nudging consumers away from purchasing unsuitable products. It would also be relatively simple, cheap, and easy to implement—qualities which make it especially attractive in an emerging markets context.

5.7.5 Regulatory Sandboxes and Innovation Hubs as forms of Regulatory Nudging

We suggest that interventions that can encourage firms to be cooperative or more forthcoming about innovations they are developing would also fall within the category of RN. Interventions like regulatory sandboxes,[222] or the establishment of innovation hubs,[223] seek to provide the environment for the testing of financial innovations prior to their launch in an environment of regulatory support, advice and challenge.[224]

Indeed, in recent years, a majority of regulatory sandboxes in developed countries have been designed to accommodate or even stimulate FinTech innovations.[225] In a number of developing countries in which regulatory sandboxes have been, or are being, established, they have overtly listed financial inclusion among their key objectives in establishing the same.[226]

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[222] Ivo Jenik and Kate Lauer, 'Regulatory Sandboxes and Financial Inclusion' (October 2017) *CGAP Working Paper* <https://www.cgap.org/sites/default/files/Working-Paper-Regulatory-Sandboxes-Oct-2017.pdf> accessed 24 November 2018; discussing the potential for sandboxes to enhance financial inclusion.
[223] Such as the one established by the UK's FCA.
[224] National Audit Office Report, *Financial Services Mis-selling: Regulation and Redress* (24 February 2016) 12.
[225] Jenik and Lauer, 'Regulatory Sandboxes and Financial Inclusion' (n 222)—FinTech innovations have the capacity to contribute to more affordable products and services, new distribution channels that reach excluded groups, operational efficiencies that allow for serving low-margin customers profitably and support compliance and risk-management approaches (e.g., simplified customer due diligence and alternative credit scoring).
[226] Jenik and Lauer, ibid. Examples include Bahrain, India, Malaysia and Sierra Leone.

There are different approaches to the design of regulatory sandboxes and other innovation supporting approaches that have been employed successfully. Some examples are the 'test-and-learn' approach, which facilitates the formulation by a regulator of an ad hoc framework within which firms test new innovations in a live environment, with safety measures and key performance indicators in place. This approach has been employed, for example, in Kenya, with the launch of the mobile money service M-Pesa.[227] Another is a 'wait-and-see' approach that enables a regulator to observe the development of a new innovation prior to intervening. This has, for instance, been applied to person-to-person lending in China. [228] Even while recommending the use of interventions like regulatory sandboxes, it must be noted that the newness of their application in many jurisdictions precludes any conclusions as to their long term effectiveness.[229] However, their potential can be appreciated. Such mechanisms can facilitate enhanced understanding of new innovations and products by both innovators and regulators, and also help to foreground the risks they pose and allow for the development of collaborative risk management processes between innovating firms and regulators.

5.8 Conclusion

We have explored the concept of regulatory nudging, characterising it as a non-coercive, compliance-oriented strategy. The discussion of this approach contributes to the discourse on the use of compliance based approaches to regulation and enforcement.

We have explained in this thesis that nudges were originally conceptualised as alternatives to conventional regulation,[230] but, beyond that, they are also understood as representing a move towards less restrictive and lower cost controls of behaviour.[231] Additionally, we consider the increasing use of BE and nudging for the purposes of improving regulatory outcomes—particularly

[227] ibid
[228] ibid.
[229] ibid. Authors list countries with existing or proposed regulatory sandboxes.
[230] Command and Control and incentives-based approaches.
[231] Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree' (n 6) 831.

in respect of consumers—as an indicator of the evolution of consumer protection, and as signaling efforts at rebalancing the *caveat emptor* principle that has underpinned consumer participation in financial markets for many years.

In general, we would recommend that regulators use the knowledge of what nudge reveals about decision-making behaviour among market participants (firms and consumers). Moreover, they should consider what it reveals about their own susceptibility to biases and heuristics, and use this to reframe their approach to the regulation of financial services.

The applications of RN that have been considered in this chapter can help to minimise the risk and uncertainty that arises in the course of regulatory supervision and enforcement, as well as within product regulation and governance processes. Successful implementation in the enforcement context can help to foster compliant behaviour among firms, and this will in turn have spill-over effects for consumers, as it will help to mitigate risks, including harms from financial products.

This does not mean that nudges are to be used in isolation. It is suggested, for example, that policy nudges should be seen as "a first stage of sequenced regulation where, inevitably, more coercive measures are required in later stages".[232] In this way, and to ensure a robust enforcement framework, application of non-coercive nudging could give way to more coercive measures being employed where judged appropriate.

We have proposed both classical and nuanced applications of regulatory nudging that we think would be useful for the regulatory context. These are not exhaustive, but they are illustrative of the potential of the RN approach. The exploration undertaken in this chapter points to a lot of room for the application of RN by regulators. However, in a number of jurisdictions it may be necessary to build capacity in this area when it comes to the development of more classical nudges that may require the implementation of experimental research. They should be encouraged to work closely with academics and

[232] Amir and Lobel, 'Stumble, Predict, Nudge' (n 29) 2100.

researchers, and even private sector organisations that have the necessary expertise to develop and test suitable nudges before they are deployed.

6. Conclusion

Regulation of financial services is a subject of global significance and has sustained continued debate in many jurisdictions, particularly in the wake of the GFC. Regulation is a broad area. It covers a specific set of commands, deliberate state influence, and all forms of social or economic influence. It has been described as a 'red-light' concept—that is, an activity that restricts behaviour and prevents the occurrence of certain undesirable activities.[1]

Central to regulation are concerns about how risk is controlled, and different theories have been advanced to explain approaches to risk control. In line with orthodox regulatory theory, market failure is considered the dominant economic rationale for government regulation of the market place.[2] However, market failure is not the only justification for regulation. Market and non-market goals have been identified as justifications for regulation. Whereas market failure is a market goal, paternalism, distributive justice and community values are identified as non-market goals.[3] The role of regulation is seen as helping "to constitute market relations, to provide the framework of rights and processes that allow markets to work, and to protect markets from fragmentation."[4] This can be said to support the existence of financial regulation, which is seen as serving an important role, namely that of enabling regulators to control which players enter a market to engage in regulated activities, including mechanisms for how they can exit the market place without adversely affecting its operation. Regulation governing licensing of financial firms exemplifies this aspect, as does consumer protection regulation, which

[1] Robert Baldwin, Martin Cave, and Martin Lodge, *Understanding Regulation* (2nd edn, Oxford University Press 2012) 3.
[2] AC Pigou, *The Economics of Welfare* (4th edn, Macmillan 1932).
[3] Peter Cartwright, 'Consumer Protection in Financial Services: Putting the Law in Context' in Peter Cartwright (ed), *Consumer Protection in Financial Services* (Kluwer International, International Banking, Finance and Economic Law Series 1999) 12.
[4] Baldwin, Cave and Lodge (n 1) 22.

is often introduced to ensure that suppliers of goods and services do not harm consumer interests.[5]

The value of regulation is a subject that generates varied sentiments. Critics argue that regulation interferes with the efficiency of the market—but, at the other end of the spectrum, proponents argue that well-designed regulation not only makes markets more efficient, but also ensures that markets are more equitable.[6] As a result of these opposing beliefs, we have witnessed periods of deregulation, often followed closely by heightened regulation, the latter usually in response to some regulatory disaster. Suffice it to say, there is general consensus that regulation is important, but what remains contentious is how much of it is required.

Financial crises such as the GFC often make the necessity of financial regulation more prominent, and are usually followed by calls for regulatory reform.[7] According to post-crisis reports, even a cheerleader of deregulation such as Alan Greenspan (described as the 'high priest of *laissez faire* economics') later acknowledged that he had been wrong about the extent to which markets can self-regulate and self-correct.[8]

The starting point for this study was post-GFC analyses pointing to causes of the crisis. The issues we have considered in this thesis have been situated within two categories of causes. First are those related to problems in regulatory design, and second are those connected to a behavioural element. The latter emerges from complexities of human decision making. The analysis undertaken in the various chapters has revealed a number of lessons, mainly from the UK, about areas in which regulation went wrong. We have also

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[5]See Charles Goodhart and others, *Financial Regulation: Why, How and Where Now?* (Routledge 1998) 4—for discussion on rationales for financial regulation, including consumer protection from monopolistic exploitation and the protection of retail or less informed consumers.

[6] Joseph E Stiglitz, 'Government failure vs market failure: Principles of regulation' (2010) Policy Dialogue Paper, 13 <http://policydialogue.org/files/events/Stiglitz_Principles_of_Regulation.pdf > accessed 19 December 2019.

[7] John Armour and others, *Principles of Financial Regulation* (Oxford University Press 2016) 562.

[8] Edmund L Andrews, 'Greenspan Concedes Error on Regulation' *New York Times* (New York, 23 October 2008) <http://www.nytimes.com/2008/10/24/business/economy/24panel.html> accessed 16 December 2019; See also, Andrew Clarke and Jill Treanor,' GreenSpan—I was wrong about the economy—Sort of' The *Guardian* (New York, 24 October 2008) <https://www.theguardian.com/business/2008/oct/24/economics-creditcrunch-federal-reserve-greenspan> accessed 16 December 2019.

considered how post-crisis regulatory approaches have shifted. This study sought to distil lessons with a view to making recommendations that we consider may be beneficial for enhancing regulatory outcomes in the Kenyan market.

Chapter 2 explored how the GFC has informed our understanding of risk and its regulation, and the lessons of pertinence that can be gleaned for financial markets such as Kenya. We saw that it is important to understand the difference between risk and uncertainty. Clarifying this distinction supports an understanding of the difference between known and unknown risks, and thus an appreciation of the limits on regulatory control. Overall, the distinction shapes regulatory action—for instance regulatory design and supervisory activity. We also saw that the legal and regulatory approaches to addressing risk vary, and we emphasised that risk management is a nuanced process. The discussion, moreover, conveyed the limits of conventional approaches for dealing with risk and uncertainty. We noted that different regimes might adopt different approaches to dealing with the same type of risk. RBA is a popular approach that has been adopted in many jurisdictions. Considered a New Governance approach, it emerged in response to the challenges of implementing CAC. The difficulty of regulating in a command style is attributable to limited resources and shortages in expertise. The discussion revealed that, although RBA offers various advantages to regulators in their quest to manage risk and uncertainty, the shift to RBA is not challenge-free. In other words, the limits of RBA in turn impose limits on regulatory control. Risk based regimes are buttressed by a politics of uncertainty—a recognition that failure is possible and that no one is to blame for failures in respect of unknowable futures or true uncertainty.[9] We concluded the chapter with a recommendation that, in order for New Governance approaches like RBA to address the problems of CAC, there is need to combine them with two additional elements. One is responsiveness and the other is judgement, and especially at the more enhanced level contemplated under the JBR approach. The latter is characterised as a forward looking approach. Enhanced

[9] Michael Power, *The Risk Management of Everything: Rethinking the Politics of Uncertainty* (Demos London, 2004).

judgement requires the implementation of a proactive approach to risk management whereby regulators are encouraged to adopt a more pre-emptive stance that is more interventionist.

With respect to Kenya's approach to risk regulation, we have proposed a revision of the traditional regulatory approach by refashioning the current RBA to make it really responsive.[10] We further suggest that aspects of JBR should be incorporated into the new model to bolster the RBA approach and, overall, to create a more coherent regulatory strategy. Generally, the revised model would call for the exercise of enhanced discretion in the management of risk.

Chapter 3 scrutinised the Kenyan financial market and analysed the legal and regulatory framework to isolate regulatory concerns, including weaknesses, risks and challenges present in the current regime. We established that there are areas of risk and uncertainty that are inadequately captured by the existing framework. Several limitations were isolated, in respect of the architecture and scope of legislation, as well as weaknesses in the risk based supervision framework. A key shortcoming that also emerged from the regime analysis is related to the lack of a cohesive financial product regulation and governance regime. Taken together, these findings form the basis for our conclusion that there is need for more appropriate regulation to address the identified weaknesses. This may entail a multiplicity of measures aimed at clarifying grey areas, removing inconsistencies and plugging the undeveloped or under-developed aspects in the current legal and regulatory framework.

Chapter 4 explored themes relevant to the structuring of a coherent financial product regulation and governance regime for the Kenyan market. We isolated the inattention to conduct aspects of regulation in the Kenyan regime, as revealed by the framing and scope of CBK's *Prudential Guidelines.* As these Guidelines are applicable only to banks and regulated institutions, as defined under the Banking Act, they would therefore exclude providers such as FinTechs firms and MNOs. The NPS provisions that are applicable to providers such as MNOs are similarly limited, as they would only apply to

[10] Julia Black and Robert Baldwin, 'Really Responsive Regulation (2010) 32 *Law and Policy* 181-213.

authorized payments service providers, including mobile payments service providers.

To address the identified weaknesses in the existing regulatory framework, a number of suggestions have been made. We have recommended the development of a more comprehensive product regulation and governance regime that is more prescriptive and addresses the risks presented by the offering of financial products by different categories of providers, including banks, MNOs and FinTechs. To address the conduct issues, we recommended that Kenya develop and implement an overarching conduct regime that addresses *inter alia* conduct regulation in relation to consumer products. Such an explicit conduct regime would incorporate aspects of product regulation and additionally embody high-level principles, as well as a product governance approach, and thereby address the weaknesses intrinsic in product regulation.

Another shortcoming in the regulatory framework is that not enough weight is given to product intervention options. We discussed the need for regulators to re-evaluate the supervisory approach, and consider integrating appropriate product intervention options. We have recommended that regulators consider the adoption of early intervention options as additional tools in the regulatory toolkit, in order to form a holistic regulatory framework. Effective intervention options that would ensure better outcomes for financial services consumers would be those that are attentive to the entire product life cycle-development and distribution, as well as point of sale and post-sale stages. The establishment of a robust product regulation and governance approach for Kenya would help to reduce the innovation and product specific risks that could be generated in the wider financial products context, and for MFS/MC in particular. In this way, innovation risks that could cause consumer harm or threaten the stability of the financial system would be minimised.

This study has also noted the post-GFC rise in the application of behavioural insights (BIs) to regulation in several jurisdictions. Prior to the crisis, the dominant narrative was an assumption of the rationality of financial market actors, including consumers and firms. However the crisis revealed the fallacy

of this thinking. The influence of Behavioural Economics (BE) and BIs more broadly is a distinctive feature in the post-crisis approach to regulation and supervision.[11] The behavioural element is inescapable for regulators, as behaviour modification is central to their activities. Indeed, one of the elements of responsive and really responsive regulation, as articulated in the literature, is the need for regulators to take into account the behaviour and peculiarities of the regulated. Regulation discourse emphasises that there are different approaches that can be applied to modifying behaviour. These have largely been grouped into compliance and deterrence based approaches.[12] While recognising that regulatory regimes require both to be effective, this work has explored how BIs, and particularly how 'nudge', one of the applications of BE, may be used by regulators to modify the behaviour of the regulated in order to improve regulatory outcomes. We have termed this concept 'regulatory nudging' (RN) and characterised it as a non-coercive, compliance-oriented strategy.

In chapter 1, we highlighted that nudges were originally conceptualised as alternatives to conventional regulation. Beyond that, they are also understood as representing a move towards less restrictive and lower costs controls of behaviour.[13] In chapter 5, we explored applications of RN. Based on our analysis, we have argued that RN has the capacity to address the limits of command, and have strongly recommended it for adoption by regulatory regimes to enhance the robustness of financial regulation. We also showed, through the examination of several illustrative examples of nudge applications, that RN can help to minimise risk and uncertainty that arises in the course of regulatory supervision and enforcement, as well as within product regulation and governance processes. We suggest that RN might be particularly beneficial for countries searching for cost effective regulatory approaches, especially given the limited regulatory resources that many regimes have to contend with. From the examples discussed, one of the key proposals that we

[11] Holly Powley, and Keith Stanton, 'The Post-crisis Approach and New Challenges to Banking Regulation' (2017) 1 *Institute of Law Journal* 58-80.
[12] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press 1992).
[13] Robert Baldwin, 'From Regulation to Behaviour Change: Giving Nudge the Third Degree (2014)77 (6) *Modern Law Review* 831.

recommend for exploration in the first instance is the use of traffic light labelling for financial products. Chapter 5 closed with an overarching exhortation to regulators to use the knowledge of what nudge reveals about decision-making behaviour among market participants (firms and consumers), and also about their own susceptibility to biases and heuristics. This would allow them to reframe their approach to the regulation and supervision of financial services.

The finance sector is considered vital in many jurisdictions, and Kenya is no exception. Kenya hopes to achieve middle-income status by 2030, as outlined in the country's development blueprint, Vision 2030, which covers the period 2008-2030. As outlined in this document, the financial services industry is considered one of the key sectors and a driver of growth. The document also lists it as one of the priority sectors under the Economic Pillar. This is supported by statistical data. According to recent publicly accessible data, the sector accounted for 76.09 percent of nominal GDP in 2018.[14] Kenya hopes to continue to grow this sector, and, as further elucidated in the Vision blueprint, the end goal is to become the leading financial centre in Eastern and Southern Africa.[15]

The analysis in this work has been undertaken through the lens of the GFC to draw lessons of pertinence for emerging markets, such as Kenya. In respect of regulatory design, the principal takeaway from the GFC experience is that, in order to achieve its objectives, regulation must be well-designed, and properly implemented. Moreover, as revealed in the discussion in chapter 2, financial crises have been characterised as knowable uncertainties. The point was made that uncertainties are 'tameable,'[16] and this knowledge can provide regulators some level of comfort. That is, even if we know not when the next crisis will strike, regulators can, provided they remain vigilant, minimise their effects in the event of their materialisation. Staying vigilant requires an appreciation of the limits of approaches like RBA, which lend themselves to a

[14] CBK, The Kenya Financial Sector Stability Report 2018 (September 2019, Issue No. 10) <https://www.centralbank.go.ke/uploads/financial_sector_stability/7955935_KFSSR%202018%20%20sept%20(issue%20no.%2010)%20v4.pdf> accessed 10 January 2020.
[15] Kenya Vision 2030, *Second Medium Term Plan* (2013-2017) 63-67 <https://www.scribd.com/doc/185950316/Kenya-Vision-2030-Second-Medium-Term-Plan-2013-2017-2-a-Summary-of-Key-Investment-Opportunities-in-Kenya> accessed 10 October 2019.
[16] Power, *The Risk Management of Everything* (n 9) 53.

retrospective approach. Additionally, it demands the adoption of strategies and techniques that are also attentive to future risks. Consequently, judgement-led, forwarding looking approaches, such as Judgement-based regulation, will need to become an integral part of a coherent approach to the regulation of risk and uncertainty in financial markets. Overall, it is notable that pre-emptive, forwarding-looking and more interventionist regulation and supervision is a distinctive feature of the post-crisis approach.

In summing up we emphasise that, in the matter of regulatory design, there is no 'one size fits all' approach for regulating risk and uncertainty in the financial system. Consequently, a holistic approach to regulation is recommended as necessary because regulatory experience has shown that, for financial regulation to be effective, regulators have to rely on a mixed bag of strategies and techniques.[17] This has become especially apparent in the wake of financial disasters, whereby it has emerged in some cases that there was over reliance on one strategy, leading to failure.

The overarching lesson from the GFC has been that regulation is complex and multi-dimensional, that regulators need to understand the strengths and vulnerabilities of the strategies they adopt, and that they also need to engage in self-critical learning to determine whether they are engaging in the right tasks. However, this does not mean that things will not go wrong.[18] This research has been part of that learning process. Having drawn several lessons throughout this thesis, an indicator of true learning is how these are employed towards reforming the regulation and supervision landscape. A number of proposals have been made in this regard that target the specific shortcomings of the Kenyan regime. These include: making enhancements to risk-based regulation, revamping product regulation and governance, and the adoption of regulatory nudging. While not suggesting that reforms in these areas are a silver bullet, we assert that they will make an important contribution to the building of a more robust regulatory and supervisory framework, and financial

[17] Neil Gunningham, Peter Grabosky and Darran Sinclair, *Smart Regulation: Designing Environmental Policy* (Oxford University Press 1998).
[18] Julia Black, 'Paradoxes and Failures: 'New Governance' Techniques and the Financial Crisis' (2012) 75(6) *Modern Law Review* 1062.

market. At the same time, there is need to appreciate that regulatory strategies that are effective in one context may be unsuccessful in another. This may be explained, for instance, by varying legal and political systems.[19] Additionally, and specifically with regard to the application of nudge, interventions have been shown to be sensitive to culture and context, which may lead to different outcomes when these interventions are adopted elsewhere. This may necessitate the tailoring of approaches. Finally, although this work has sought to distil lessons for the Kenyan financial market, the analysis conducted will undoubtedly be valuable for other regulatory regimes to inform learning and continued general reflection on the contemporary challenges of regulating financial markets and how these can be addressed.

[19] Baldwin, Cave and Lodge (n 1) 74.

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Interview Guides

[I] Financial regulation and supervision in the Kenyan context—interview guide for semi-structured expert interviews

Section A: Risk regulation

I am going to ask you some questions concerning the regulation/management of risk in the financial sector.

1. What is the regulator's approach for addressing risk in the financial sector?
2. Does the regulator apply the Risk Based Approach to regulation? **If yes**;
    a. When did the regulator begin applying risk based supervision?
    b. To your knowledge, what is the rationale for adoption of this approach?
    c. Could you tell more about how risk based supervision is implemented?
    d. Are there advantages of applying this approach? If yes, please explain.
    e. Are there challenges that you have had to deal with when employing this approach? If yes, please tell me more about these.
    f. Does the regulator require regulated firms to apply RBA?
        - If yes, how are they to implement it?
        - If not mandatory, are you aware of regulated firms who apply this approach? If yes, **why** and **how** are they using it?

Section B: The legal/regulatory framework

I am going to ask you some questions about the existing legal/regulatory framework that is applicable to the financial services sector, and in particular mobile/digital financial services.

1. What do you consider challenges/shortcomings in the current legal and regulatory framework governing the financial services sector?
2. How are these currently being addressed?

a. Any additional recommendations you would make for addressing them?

3. Please describe what the current financial services regulatory architecture looks like *(who are the regulators and what are their roles*);

    a. Are there complexities presented by the architecture? If yes, please explain

4. Rule design;

a. Is the regulator involved in issuing rules to govern the finance sector? If yes, what is the extent of the regulator's involvement in issuing rules?

b. Are there concerns about the adequacy of existing rules governing the financial services sector?

c. How these being addressed /what are some recommendations you would make for addressing them?

Section C: Product regulation

I am going to ask you some questions about product regulation.

1. How is the regulator keeping pace with financial innovation in the financial services sector?
2. What is the regulatory approach in place? Please explain how it is implemented?
3. Are there financial products in the market that the regulator is concerned about? If yes, please elaborate.
4. Are there cases you would consider examples of success stories in product regulation? If yes, please explain.
5. What in your expert opinion are the remaining concerns or challenges in this area?

    a. How would you propose that they are addressed?

6. Is the regulator concerned about mobile/digital credit? If yes, what risk or challenges does it present?

    a. In your view is the current legal/framework adequate for the regulation of this product? Please explain.

Section D: Regulatory use of informal/soft approaches

I am going to ask you some questions about enforcement.

1. What is the regulatory approach to enforcement?
2. Does the regulator use soft/informal approaches? **If yes;**

    a. Please tell me more about this. Please provide some examples and explain how these are used.

    b. How would you judge the effectiveness of informal approaches that are in use?

    c. To what extent do you think regulators should use informal approaches?

3. Are you familiar with the concept of 'nudge'? If yes, please explain.
4. Do you think that this concept could be beneficial in the Kenyan regulatory context? If yes, in your opinion is this an approach you think the regulator would be interested in exploring?

Section E: General/Concluding questions

To finalise, I would like to ask you some general questions.

1. What are the current areas of concern in the financial services sector from a regulatory perspective?
2. Are there any compliance concerns in the financial services sector?

3. What are the areas of regulatory focus in the near term (1-2 years)?

[II] Interview guide for semi-structured expert interviews—FCA

Section A: Regulatory application of Behavioural Economics/ Nudge:

1. What is your understanding of how Behavioural Economics (BE) can be used in a regulatory context?
2. Is the FCA using BE and specifically 'nudge' in the context of product regulation/ intervention?
    a. If yes, please explain?
    b. What issues have there been, if any, with respect to the design/ operation/implementation of nudges?
3. To what extent do you think nudge/nudging can be used outside of a rules context i.e., on the cusp of rules?

Section B: Traffic Light Labelling Systems:

Explain proposal to use of TLS for financial products as a nudge before proceeding with questions. We propose that these can be used alongside product intervention options e.g., product bans.

1. Are you familiar with Traffic Light Labelling systems?
2. In your view, would traffic light (TL) labelling help nudge consumers away from unsuitable financial products? Please explain.
3. Which financial products would and would not be suitable for TL labelling?
4. To your knowledge has the FCA (or other financial sector regulator) considered TL labelling for financial products?
    a. If considered but not adopted, what were the reasons for this?

b. If this has been adopted, for what financial products? and;

c. What issues have there been in implementation/operation of TL labelling?

Section C: Product Intervention:

1. What issues have there been in implementation/operation of product intervention?
2. How were product intervention powers exercised in the recent mini-bonds scandal?

Section D: Lessons for other regulators:

1. What lessons if any would you offer other regulators who may be contemplating adopting BE/nudge for regulation & supervision?
2. What lessons if any would you offer other regulators who may be contemplating adopting Product intervention options?