

# CAREC INSTITUTE RESEARCH CONFERENCE

4-5 March 2021

## Session One

Digital CAREC and post-COVID-19 economic recovery

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# Financial Inclusion in the CAREC Region

## Promoting Fintech to Meet Underserved Needs in Trade Finance

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COVID-19 and Potential for  
Economic Recovery in CAREC

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# Introduction

WTO (2009) estimated that trade finance facilitates around 80-90% of international trade. Lack of adequate trade finance played an important role in the slump of global trade during the financial crisis.

Unmet demand for trade finance estimated at \$1.5 trillion in 2017 and expected to rise to more than \$2.4 trillion by 2025 (WEF and Bain & Company 2018).

Trade finance gap is disproportionately large among MSMEs as well as female-owned enterprises while they account for more than half of the trade finance applications in Asia and the Pacific.

***Trade Finance Gaps, Growth, and Jobs Survey*** (ADB 2019): 45% of rejected trade finance transactions from SMEs, higher than the 39% rejection incidence from large firms and 17% from MNCs.

More than half (57%) of trade finance applications from firms in Central Asia Regional Economic Cooperation (CAREC) were rejected in 2018 (Kim et al. 2019).

# Introduction

Trade finance rejections have far reaching effects, not only among MSMEs but also the overall economy.

Rejecting viable transactions from MSMEs makes trade less inclusive, missing a valuable potential source for economic diversity, innovation-led sustainable growth and resiliency.

From the micro-level, trade finance requests from firms are primarily hampered by insufficient collateral or guarantees, lack of a relationship with a financial institution, and insufficient credit or performance history.

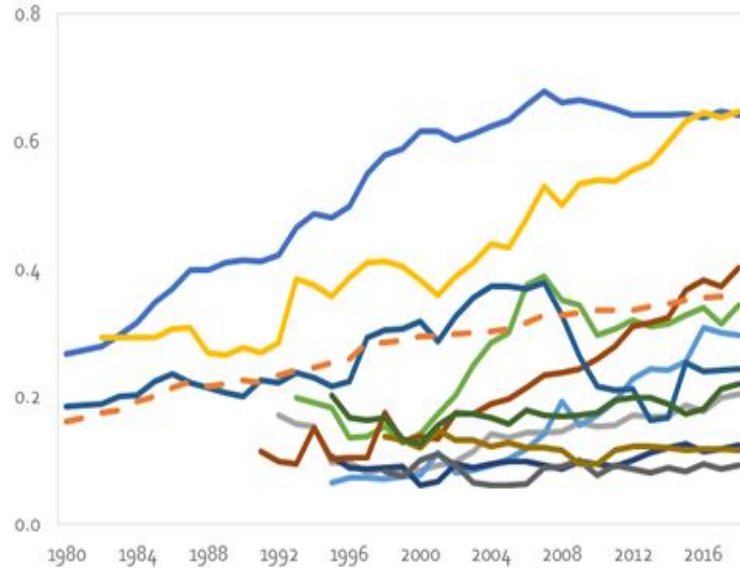
From the macro perspective, capacity to handle trade finance instruments efficiently hinges on the development of the local financial system and the integration of local firms in international trade.

Developed financial institutions enable to create financial products and services more attuned to the needs of the MSMEs.

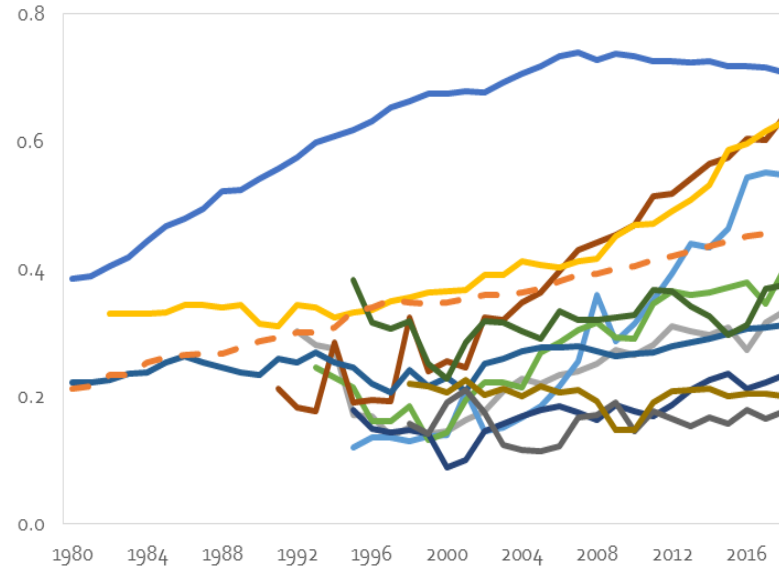
# Low Level of Financial Development in CAREC

Figure 1. Financial Development in the CAREC Region vis-à-vis Advanced Markets

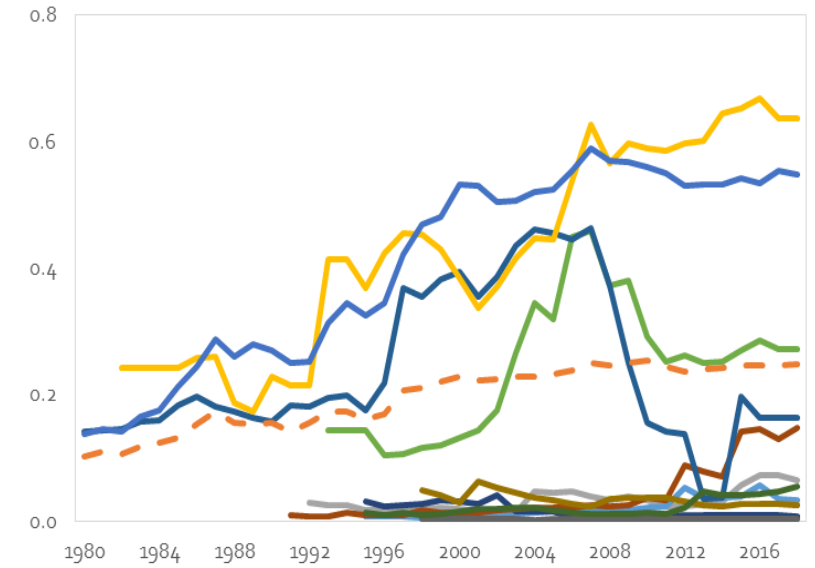
a. Financial Development Index



b. Pillar 1 - Financial Institutions



c. Pillar 2 - Financial Markets



Source: International Monetary Fund. Financial Development Index Database. <https://data.imf.org/?sk=F8032E80-B36C-43B1-AC26-493C5B1CD33B> (Accessed November 2020)

Legend:

- Azerbaijan
- Georgia
- Kazakhstan
- Kyrgyz Republic
- Mongolia
- Pakistan
- People's Rep. of China
- Tajikistan
- Turkmenistan
- Uzbekistan
- Asia and Pacific
- Advanced markets

PRC has made great strides during the 2000s leading to its at par status with that of advanced economies.

However, the financial development in other CAREC member countries remain subdued by weak financial market framework, alongside slow improvement of their traditional banking sector.



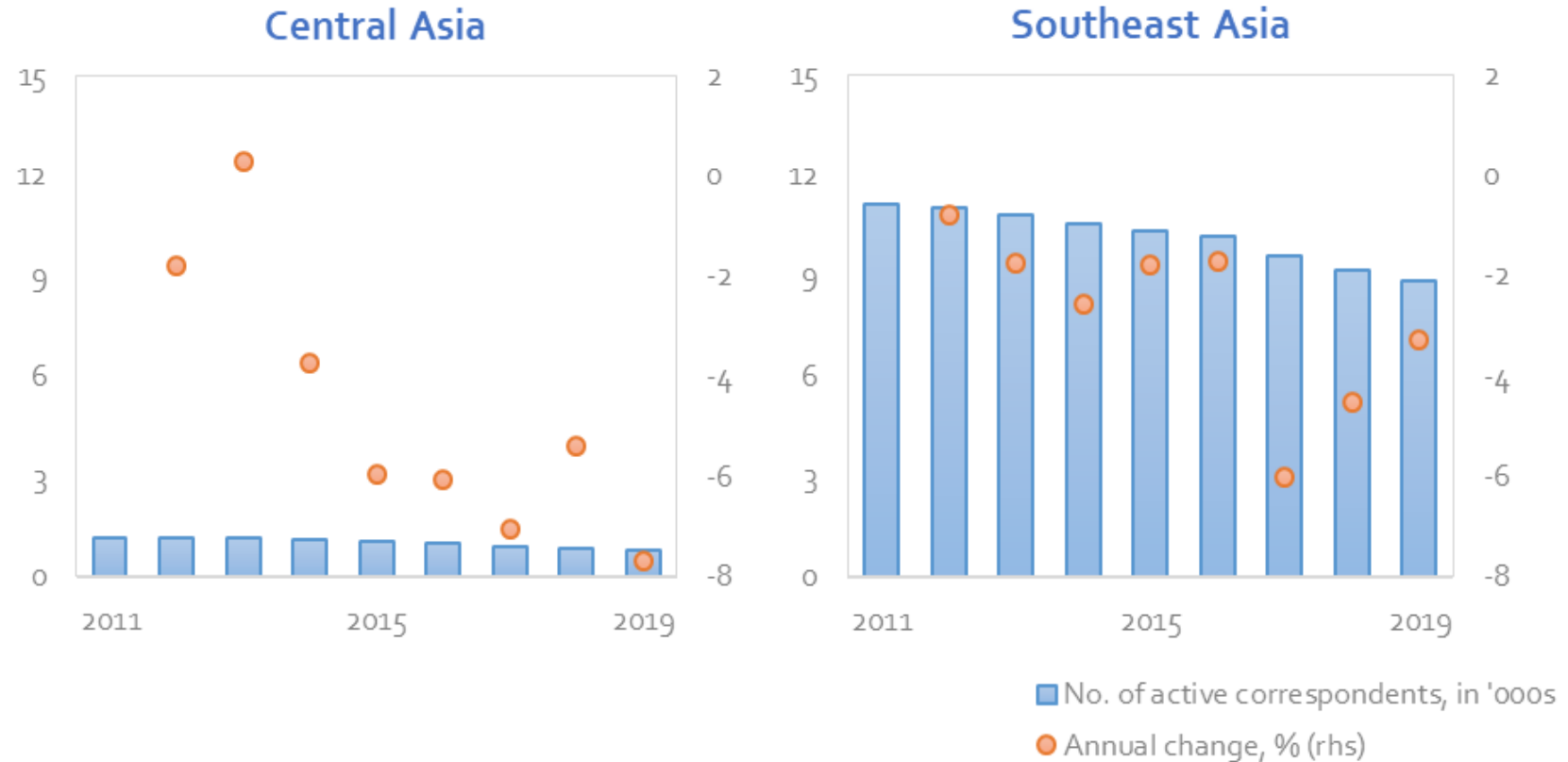
# Sustained Drop in Correspondent Banking Relationships

Correspondent banking, which is essential for international trade activities, is limited in Central Asia relative to regional peers from the Southeast Asia.

It exhibits sustained retreat, reaching 8% in 2019.

While the retreat of correspondent banks occurs globally, such situation is putting the CAREC region at more disadvantage.

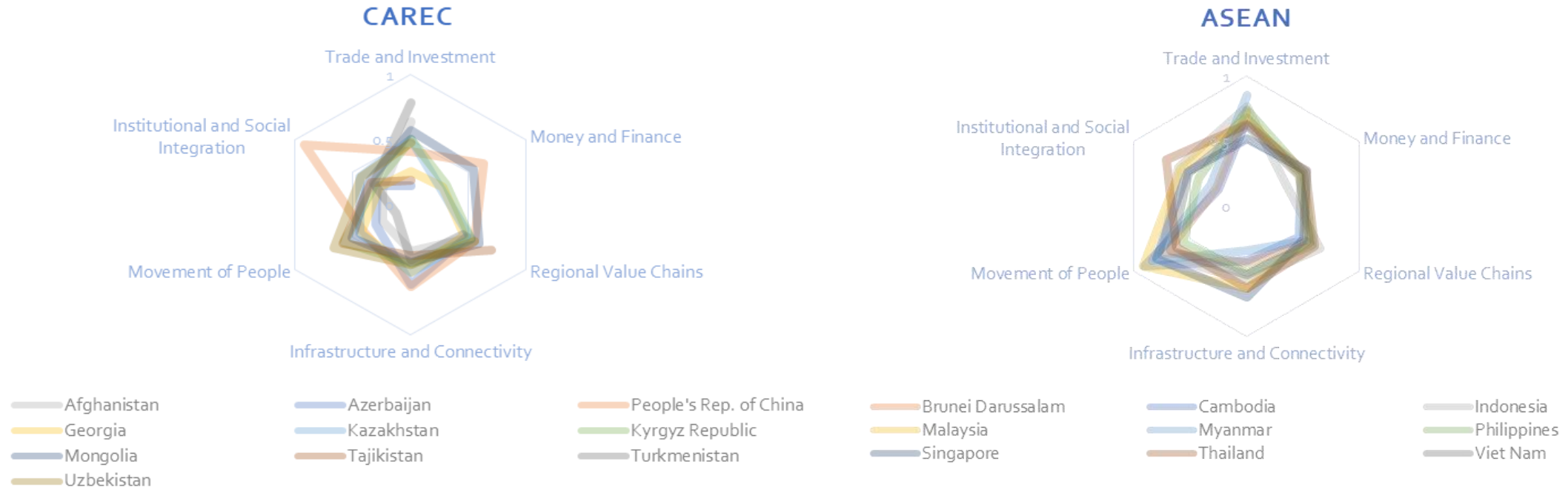
Figure 2. Correspondent Banking Landscapes in Selected Asia Subregions, 2011–2019



This situation risks the potential of many CAREC countries to providing access to safe, low-cost cross-border payment channels. As the IMF (2017) noted, addressing complications from such situation involves strengthened, coordinated, and collective action on the part of public and private stakeholders.

# Potential Solutions from Stronger Cooperation and Integration

Figure 5. Regional Integration Landscape in CAREC and ASEAN, 2018



**Key to financial inclusion in CAREC may involve a great deal of intra-regional efforts.**

A stronger economic cooperation and integration could take advantage of the in-house capabilities in some member countries in overcoming the weaknesses of the other members.

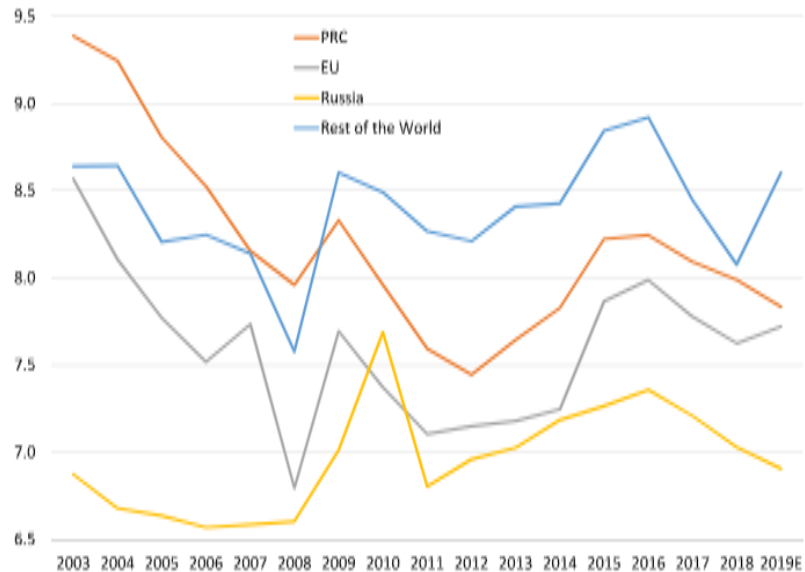
While the CAREC region has made great strides in “infrastructure and connectivity” and “regional value chains”, the region should exert more efforts on “money and finance”, “trade and investment”, and “institutional and social integration”.

In the area of “money and finance”, the CAREC region may benefit from the ADB project, setting up a multilateral trade credit and investment (re-)guarantee agency in the Central Asia, West Asia, East Asia, and South Asia subregions.



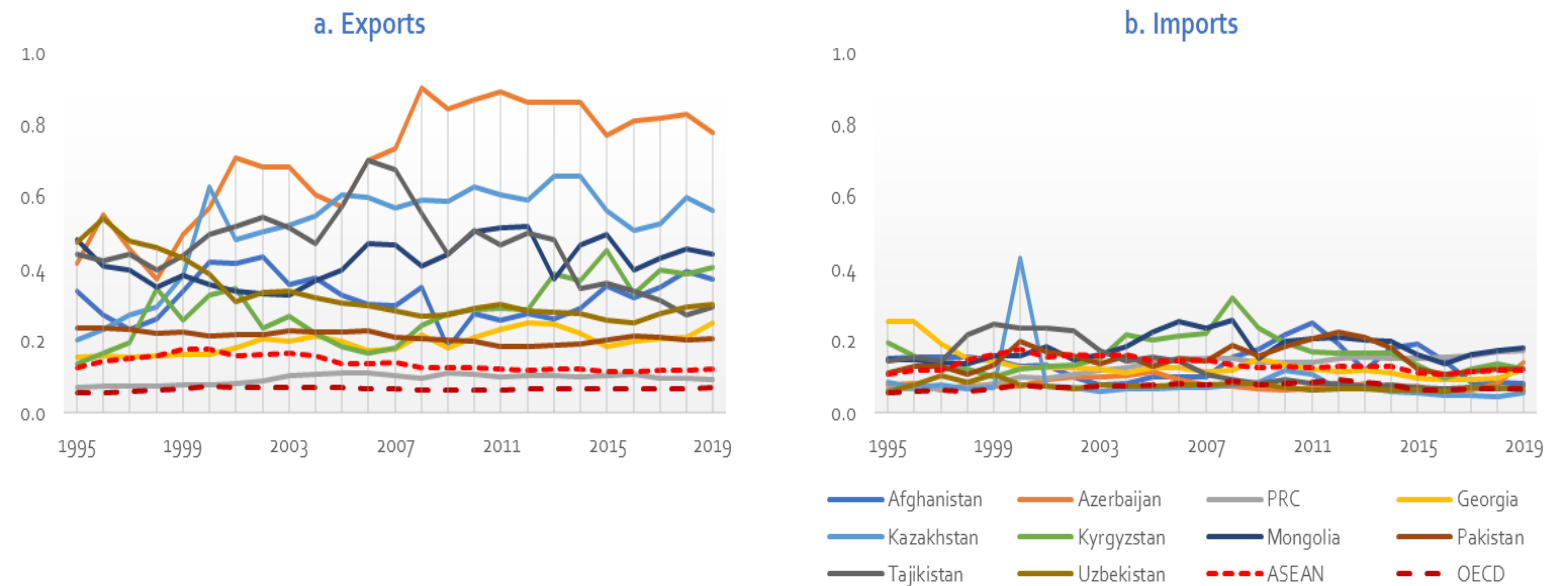
# Increasing market diversification; challenge remains with high product concentration of exports

Figure 6. Trade Distance of CAREC (excl. PRC) to Major Partners, 1995–2019



Source: Holzacker, Hans. 2020. Intra-CAREC Trade: Business as Usual or About to Change. CAREC Institute Economic Brief.

Figure 7. Product Concentration Index of (a) Exports and (b) Imports by Selected Economies, 1995–2019



Source: United Nations Conference on Trade and Development. <https://unctadstat.unctad.org/EN/> (Accessed November 2020)

While trade distance gradually shortened allowing for diversification of markets, it remains a challenge for many CAREC members to tackle high product concentration of their exports.

Product diversification may become more urgent as global decarbonization will reduce the use of fuels toward a green, sustainable development.

# Empirical Analysis of the Unmet Demand for Trade Finance: Data

## **Data: ADB's *Trade Finance Gaps, Growth, and Jobs Survey***

The report builds a cross-section of firms responding to the survey years 2015–2017 and 2019.

Data covers 91 countries including 9 CAREC members (exc. Georgia and Turkmenistan).

The survey asks firm respondents of percentage of total value of trade finance application that was rejected by service providers, as well as their perceived reasons for such an outcome.

Firm-level information such as sales, international trade transactions, major export and import markets, number of employees, the percentage of female employees, female ownership, and foreign ownership are also available.

# Empirical Analysis of the Unmet Demand for Trade Finance: Data

## Dependent variable: Trade finance rejection rate

Measured as the percentage of the total value of the company's trade finance application.

By firm size, MSMEs experience larger rejection rates relative to large firms, also true in CAREC.

By industry, in CAREC, the agriculture and mining sectors experience too high rejection rates, almost four times that of manufacturing and services sectors. This observation does not sit well with the fact that agriculture and mineral products dominate intra-CAREC and trade outside the region

Table 1. Rejection rates by Firm Size, % of trade finance application

Firm size	No. of observations	Mean	Std. Dev.	Min	Max
<b>a. All samples</b>					
Micro and small firms	571	19.9	35.6	0	100
Medium firms	965	16.6	30.7	0	100
Large firms	89	5.6	15.6	0	100
<b>b. CAREC samples</b>					
Micro and small firms	11	32.4	44.8	0	100
Medium firms	98	15.1	29.4	0	100
Large firms	25	5.9	21.6	0	100

Table 2. Rejection rates by Industry, % of trade finance application

Firm size	No. of observations	Mean	Std. Dev.	Min	Max
<b>a. All samples</b>					
Agriculture and mining	289	23.3	35.7	0	100
Manufacturing	430	15.0	29.9	0	100
Services	894	16.5	31.9	0	100
<b>b. CAREC samples</b>					
Agriculture and mining	11	47.7	43.9	0	100
Manufacturing	51	11.8	26.0	0	100
Services	72	12.0	27.7	0	100

# Empirical Analysis of the Unmet Demand for Trade Finance: Data

## Summary statistics (Explanatory variables)

Variables	No. of obs.	Mean	Std. Dev.	Min	Max	Variables	No. of obs.	Mean	Std. Dev.	Min	Max
Rejection rate, % of trade finance application	1,676	16.9	31.9	0.0	100.0	<b>Country-specific factors</b>					
Firm size	2,282	1.7	0.6	1	3	<i>World Bank country income classification</i>	2,551	1.6	0.8	0	3
Employment size	2,226	2.5	1.6	1	6	<i>Financial development index</i>	1,779	0.3	0.2	0.1	1.0
Sales (log)	1,590	12.3	3.2	0.0	23.4	<i>Basel AML index</i>	1,685	5.9	1.1	1.8	8.5
Age of firm	811	2.6	0.8	1	5	<b>Use and/or consideration of using digital or web-based financial instruments</b>					
Industry	2,336	2.4	0.8	1	3	<i>Crowd funding</i>	1,211	0.3	0.4	0	1
Foreign ownership dummy	1,568	0.1	0.3	0	1	<i>Peer-to-peer</i>	1,234	0.4	0.5	0	1
Female ownership dummy	1,562	0.5	0.5	0	1	<i>Debt-based securities</i>	1,153	0.2	0.4	0	1
<b>Company financial health and structure</b>						<i>Others</i>	576	0.3	0.5	0	1
<i>Insufficiency of collateral and guarantee</i>	2,135	0.2	0.4	0	1						
<i>Lack of documentation requirements</i>	2,135	0.1	0.3	0	1						
<i>Lack of business relationship with financial institutions</i>	2,135	0.1	0.3	0	1						
<i>Lack of credit and financial performance history</i>	2,135	0.1	0.3	0	1						

Source: Authors' calculations using ADB's Trade Finance Gaps, Growth, and Jobs Survey.

Company's financial health and banking relationship also help explain their incidence of trade finance rejections. This information is weakly measured by firms' responses to survey questions asking them which factor they think made their trade finance applications rejected.

# Empirical Analysis of the Unmet Demand for Trade Finance:

## An Empirical Analysis

**Empirical Strategy: Heckman-type two-step selection model to obtain unbiased estimates with**

- (i) survey's non-standard sampling strategies,
- (ii) non-response on some important questions, and
- (iii) non-random missingness in the outcome variable, observable only for a portion of data.

Analysis involves two separate equations (the main and sample selection equations):

$$y_i = x_i' \beta + \mu_i \quad (1)$$

$$s_i^* = k_i' \gamma + v_i \quad (2)$$

Equation 1 refers to the response equation with outcome  $y_i$ , while Equation 2 is the selection equation where  $s_i^*$  is a latent variable, with  $y_i$  only observed when  $s_i^* > 0$ .

The vectors of explanatory variables are given in  $x_i'$  and  $k_i'$ , where  $x_i'$  is assumed to be a subset of  $k_i'$  suggesting that the factors predicting the main outcome of interest  $y_i$  also predict the selection  $s_i$ .  $\mu_i$  and  $v_i$  are error terms assumed to be normally distributed.

# Key Empirical Findings



**Table 4. Trade Finance Rejection Model Results**

Dependent variable: Trade Finance Rejection Rate	(1)	(2)	(3)
Firm size (Base: Micro and small enterprises)			
Medium enterprise	-12.378*** (3.234)		-8.635** (3.355)
Large enterprise	-17.867* (10.787)		-10.519 (10.930)
Number of employees (Base: 1-25 employees)			
26-50 employees		-4.122 (4.848)	
51-100 employees		-9.242 (6.067)	
100-200 employees		-11.090 (7.555)	
200 employees and above		-11.247 (8.282)	
Annual sales (log)		-1.605*** (0.520)	-1.611*** (0.517)
Age of firm (Base: Less than 10 years)			
11-30 years	-1.453 (3.220)	1.272 (3.239)	0.582 (3.218)
31-50 years	-10.169 (6.743)	-4.492 (6.824)	-6.922 (6.709)
more than 50 years	-13.676 (13.264)	-6.541 (13.004)	-10.471 (13.178)
Foreign ownership dummy (1 for firms with foreign ownership, 0 for domestic firms)	4.613 (6.080)	3.484 (5.937)	3.972 (6.014)
Female ownership dummy (1 if firm is owned or founded by a woman, 0 otherwise)	-0.985 (3.246)	-2.458 (3.225)	-2.744 (3.230)
Sector (Base: Agriculture and mining)			
Manufacturing	4.839 (7.221)	4.998 (7.187)	5.103 (7.144)
Services	2.496 (3.560)	1.174 (3.548)	1.068 (3.532)
World Bank Country Income Classification (Base: Low and lower middle income)			
Upper middle income	-5.536 (3.827)	-3.641 (3.698)	-5.311 (3.791)
High income	-7.790* (4.702)	-4.638 (4.555)	-6.742 (4.638)
CAREC member countries	6.857 (7.964)	8.412 (7.861)	7.792 (7.869)
Constant	52.231*** (6.446)	66.588*** (8.971)	71.372*** (8.975)
Inverse Mills ratio	-37.428***	-40.494***	-40.258***
Observations	864	860	862
Wald chi2	23.98	29.81	32.41
Prob > chi2	0.021	0.013	0.002

Standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1  
Source: Authors' estimates.

Smaller firms experience higher incidence of trade finance rejections relative to larger firms.

**Table 5. Company-level Financial Health and Structure Driving Higher Trade Finance Rejection Rates Among MSMEs**

<b>Dependent variable: Trade Finance Rejection Rate</b>	<b>(1)</b> Insufficiency of collateral and guarantee	<b>(2)</b> Lack of documentation requirements	<b>(3)</b> Lack of business relationship with financial institutions	<b>(4)</b> Lack of credit and financial performance history
Company financial health and structure	37.062*** (3.088)	25.425*** (4.667)	15.018*** (4.124)	26.399*** (4.394)
Annual sales (log)	-1.477*** (0.456)	-1.537*** (0.502)	-1.714*** (0.510)	-1.614*** (0.498)
Age of firm (Base: Less than 10 years)				
11-30 years	2.481 (2.880)	0.185 (3.180)	0.524 (3.233)	1.929 (3.166)
31-50 years	-3.897 (6.012)	-6.278 (6.695)	-6.076 (6.812)	-6.199 (6.632)
more than 50 years	-13.439 (13.677)	-20.424 (15.602)	-12.884 (15.797)	-6.623 (15.350)
Foreign ownership dummy (1 for firms with foreign ownership, 0 for domestic firms)	3.796 (5.565)	4.306 (6.205)	3.107 (6.312)	3.956 (6.147)
Female ownership dummy (1 if firm is owned or founded by a woman, 0 otherwise)	-3.050 (2.936)	-1.818 (3.228)	-1.992 (3.283)	-1.008 (3.212)
Sector (Base: Agriculture and mining)				
Manufacturing	2.399 (6.361)	3.576 (7.192)	1.998 (7.310)	0.480 (7.100)
Services	-0.295 (3.118)	1.691 (3.484)	1.811 (3.544)	0.956 (3.450)
World Bank Country Income Classification (Base: Low and lower middle income)				
Upper middle income	-2.625 (3.283)	-3.489 (3.688)	-4.193 (3.751)	-5.306 (3.651)
High income	-3.422 (4.127)	-3.612 (4.571)	-5.043 (4.640)	-7.692* (4.548)
CAREC member countries	9.090 (6.953)	5.048 (7.758)	7.990 (7.875)	6.415 (7.671)
Constant	40.481*** (8.555)	59.802*** (9.490)	63.465*** (9.685)	58.791*** (9.393)
Inverse Mills ratio	-20.997***	-43.099***	-44.104***	-38.587***
Observations	767	767	767	767
Wald chi2	171.7	51.38	34.71	58.64
Prob > chi2	0.000	0.000	0.000	0.000

Standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1  
Source: Authors' estimates.

Relatively weak company financial health and history among smaller firms significantly explain why their trade finance applications are more often rejected.

Table 7. Fintech Use and Trade Finance Rejection Rates Among MSMEs

Dependent variable: Trade Finance Rejection Rate	(1) Crowd funding	(2) Peer-to- peer lending	(3) Debt- based securities	(4) Others
Use and/or consideration of fintech-enabled trade finance	-5.237 (3.514)	1.341 (3.490)	-8.431** (3.712)	2.003 (4.423)
Annual sales (log)	-2.611*** (0.611)	-2.399*** (0.586)	-2.483*** (0.647)	-2.464*** (0.773)
Age of firm (Base: Less than 10 years)				
11-30 years	-0.600 (3.646)	0.454 (3.641)	1.038 (3.741)	1.595 (4.559)
31-50 years	-8.201 (8.255)	-8.118 (7.631)	-6.750 (8.142)	-11.618 (9.958)
more than 50 years	-13.417 (16.072)	-14.454 (16.346)	-25.976 (20.692)	-23.122 (21.107)
Foreign ownership dummy (1 for firms with foreign ownership, 0 for domestic firms)	4.349 (6.842)	4.722 (6.954)	3.518 (6.870)	7.041 (8.451)
Female ownership dummy (1 if firm is owned or founded by a woman, 0 otherwise)	-2.401 (3.680)	-2.908 (3.691)	-2.434 (3.765)	-0.369 (4.446)
Sector (Base: Agriculture and mining)				
Manufacturing	1.691 (7.703)	1.629 (7.678)	2.552 (7.956)	4.861 (9.561)
Services	1.934 (3.996)	2.841 (3.962)	1.113 (4.091)	3.417 (4.919)
World Bank Country Income Classification (Base: Low and lower middle income)				
Upper middle income	-4.190 (4.128)	-4.384 (4.179)	-3.111 (4.252)	-4.124 (4.978)
High income	-6.655 (5.236)	-5.183 (5.245)	-4.012 (5.277)	-4.521 (6.732)
CAREC member countries	7.193 (8.485)	7.832 (8.908)	6.262 (8.827)	3.552 (9.834)
Constant	83.385*** (10.892)	77.132*** (10.894)	83.062*** (11.455)	80.216*** (13.909)
Inverse Mills ratio	-43.762***	-43.805***	-44.182***	-40.336***
Observations	678	696	655	537
Wald chi2	27.65	25.31	26.98	19.17
Prob > chi2	0.006	0.013	0.008	0.085

Standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1  
Source: Authors' estimates.

The use of fintech could aid in lowering incidence of trade finance rejections disproportionately experienced by MSMEs.

Table 9. Channels on Fintech Impact on Trade Finance Rejection Rates Among MSMEs

## C. Use of web-based platform for Debt-Based Securities

Dependent variable: Trade Finance Rejection Rate	(1) Insufficiency of collateral and guarantee	(2) Lack of documentation requirements	(3) Lack of business relationship with financial institutions	(4) Lack of credit and financial performance history
Use and/or consideration of fintech-enabled trade finance	-3.208 (3.907)	-6.403* (3.807)	-8.790** (3.995)	-6.616* (3.822)
Company financial issues	38.948*** (4.173)	29.165*** (6.435)	16.498*** (5.424)	30.108*** (5.715)
Interaction term	-7.714 (6.951)	-19.312* (10.837)	2.654 (9.284)	-6.519 (9.855)
Observations	655	655	655	655
Other explanatory variables	YES	YES	YES	YES
Inverse Mills ratio	-18.529*** (6.765)	-40.827*** (7.794)	-39.648*** (7.809)	-35.937*** (7.554)
Wald chi2	143.8	49.61	42.78	64.04
Prob > chi2	0.000	0.000	0.000	0.000

Standard errors in parentheses. \*\*\* p&lt;0.01, \*\* p&lt;0.05, \* p&lt;0.1

Source: Authors' estimates.

The lower rejection rates of some MSMEs can be attributed to the use of fintech in overcoming the challenge of lack of documentation requirements necessary for successful applications.

# Bridging the Gap Digitally: Policy Relevance to the CAREC Region

## Strong global efforts to curb trade finance gaps

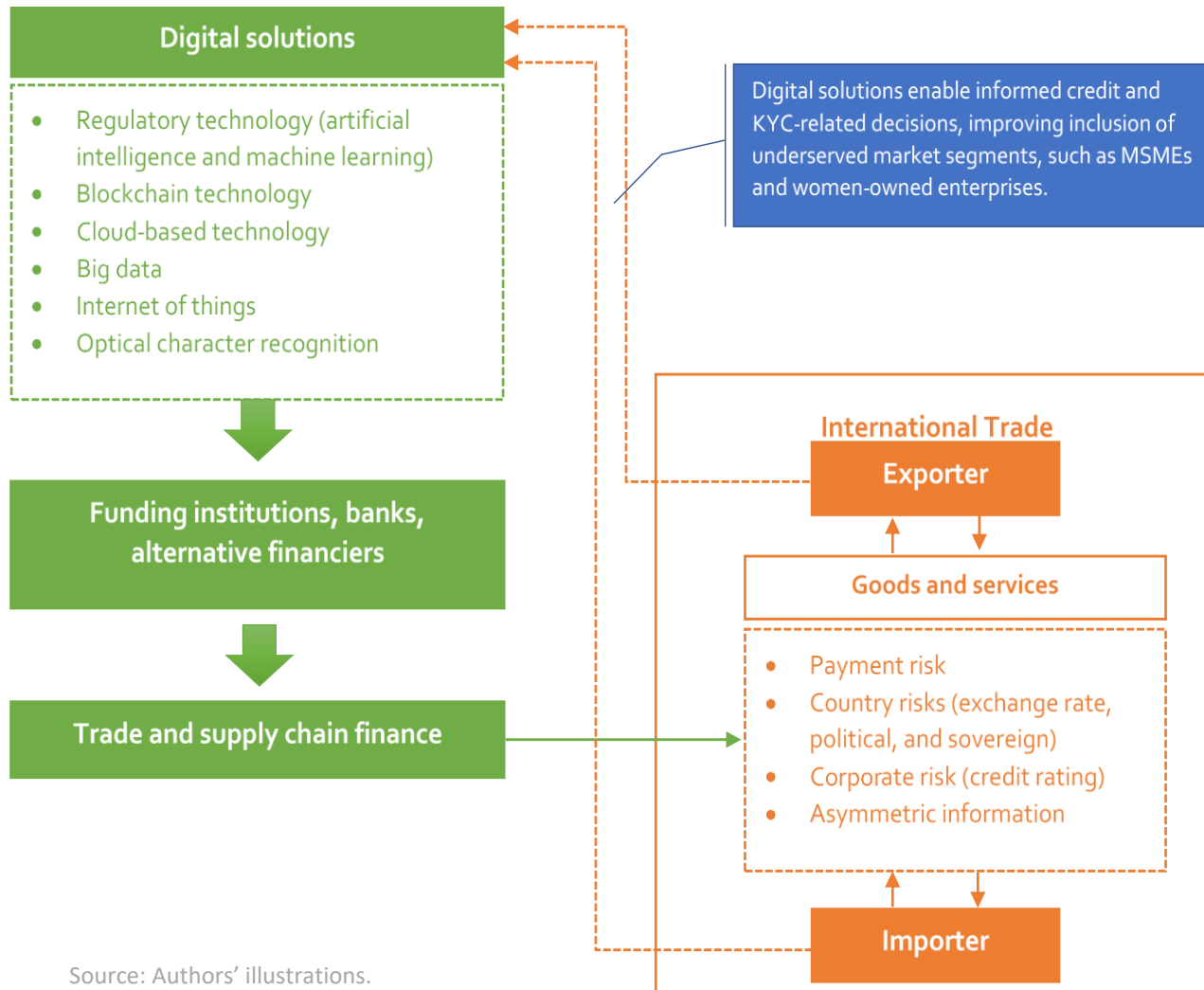
- MDBs' financing and guarantees supporting around \$30 billion in trade transactions in low-income countries, with a greater focus on smaller firms, increased 50% from 2016 to 2018 (Auboin and Behar 2020).
- ADB's *Trade and Supply Chain Finance Program* (TSCFP) has supported 4,832 transactions amounting to \$5.4 billion, including \$3.5 billion in co-financing, and helped 4,069 SMEs in 2019. The most active TSCFP countries are Armenia, Bangladesh, Pakistan, Sri Lanka, and Viet Nam.



The growing unmet demand in trade finance, alongside abovementioned efforts, calls for the introduction of financial innovation in the form of new delivery channels, products, and providers.

# Bridging the Gap Digitally: Policy Relevance to the CAREC Region

## Tech-facilitated Inclusive Trade in CAREC



Source: Authors' illustrations.

Cornelli et al. (2020) found strong empirical association between fintech credit volumes and unmet demand for credit (density of bank branch network), fintech helps serve clients in underbanked areas.

Blockchain technology can enhance the flow of information and overcome compliance challenges (e.g., Hong Kong Monetary Authority's eTradeConnect is blockchain based platform).

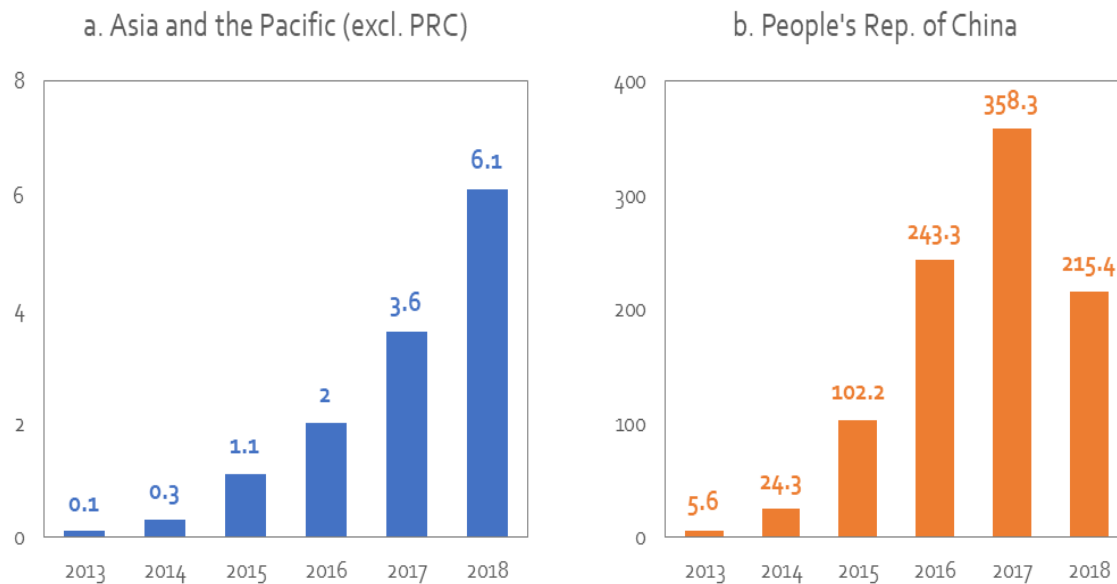
ADB-backed cloud-based banking app in the Philippines and branchless banking in Indonesia have contributed to financial inclusion in ASEAN. Distributed ledger technology could reduce trade finance operating costs by 50%–70% and improve turnaround times three- to fourfold, depending on the trade finance product (WEF and Bain & Company 2018).



# Fintech Market in the CAREC: An Overview

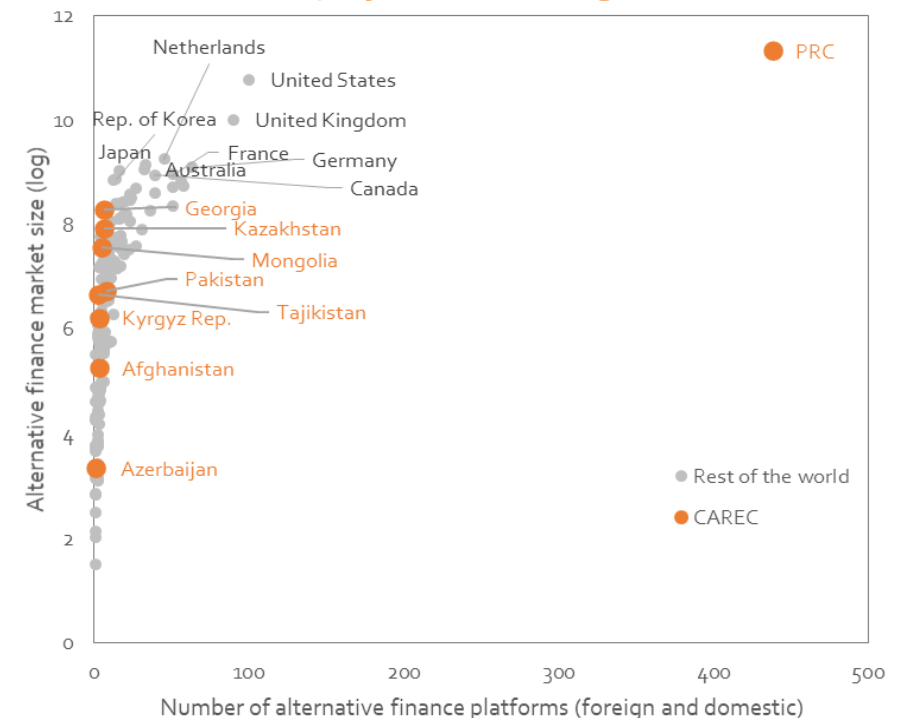
- The fintech market size across Asia and the Pacific, excluding the PRC, is estimated at \$6.1 billion in 2018, up 69% from \$3.6 billion in 2017 (Fig 9). PRC accounts more than half of the global alternative finance industry. **Fintech market in other CAREC members are still in its infancy** (Fig 10).
- The online alternative business funding (P2P etc) for start-ups and smaller firms across the region surged to \$3.5 billion in 2018 from \$2.2 billion in 2017.

**Figure 9. Alternative Finance Market Volume (\$ billion) in Asia and the Pacific and the PRC, 2013–2018**



Source: Authors' illustration using information from the CCAF Global Alternative Finance database.

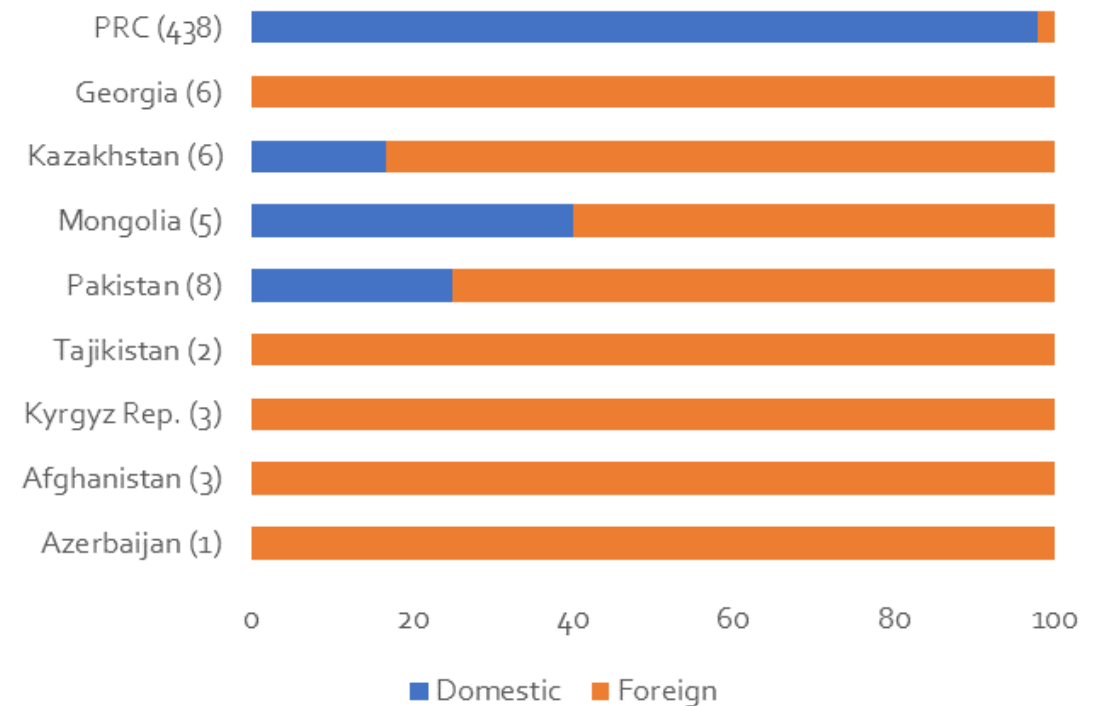
**Figure 10. Alternative Finance Landscape (Market Size and Platforms) by Selected Region, 2018**



# Fintech Market in the CAREC: An Overview

- Homegrown or domestic-based alternative finance platforms account for larger proportions of firms especially in countries with fairly developed alternative finance ecosystems (Ziegler and Shneor 2020).
- Other member economies depend heavily on foreign firms, particularly Georgia, Tajikistan, Kyrgyz Republic, Afghanistan, and Azerbaijan.
- The fintech ecosystem in the region remains dominated by the payments segment, such as e-wallets. Innovations leading to the emergence of RegTech, trade processing, Market Place Lending, and crowdsourcing remain in the nascent stage (Davletov et al 2020).

Figure 11. Alternative Finance Firms Operating in CAREC, 2018



PRC = People's Rep. of China

Source: Authors' illustration using information from the CCAF Global Alternative Finance database.

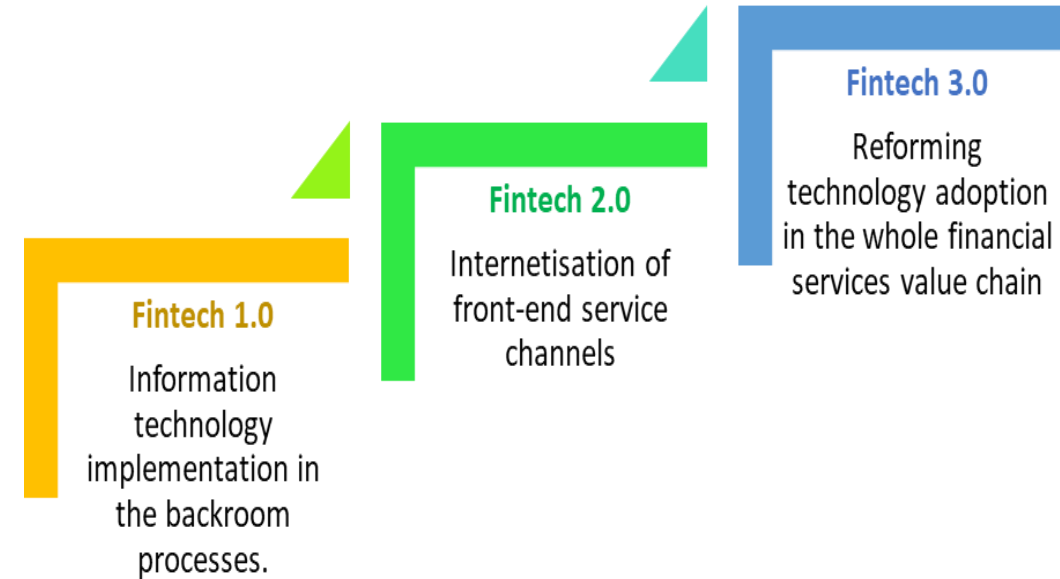
# How to Leverage Fintech in Narrowing Trade Finance Gap in CAREC

For the CAREC region to become Asia's next fintech hub, member countries need to bring financial, regulatory, and technology infrastructure into the 21st century, following the **three-stage fintech upgrade**.

1. In the short to medium term, CAREC should focus on building its fintech foundation and facilitating greater use of fintech in trade and supply chain finance for the development of e-commerce.

The successful implementation of cross-border paperless trade could bring huge benefits by cutting transaction costs across Asia and the Pacific, as well as increasing regulatory compliance and preventing illicit financial flows.

Figure 13. Stages of Fintech Upgrade and Development



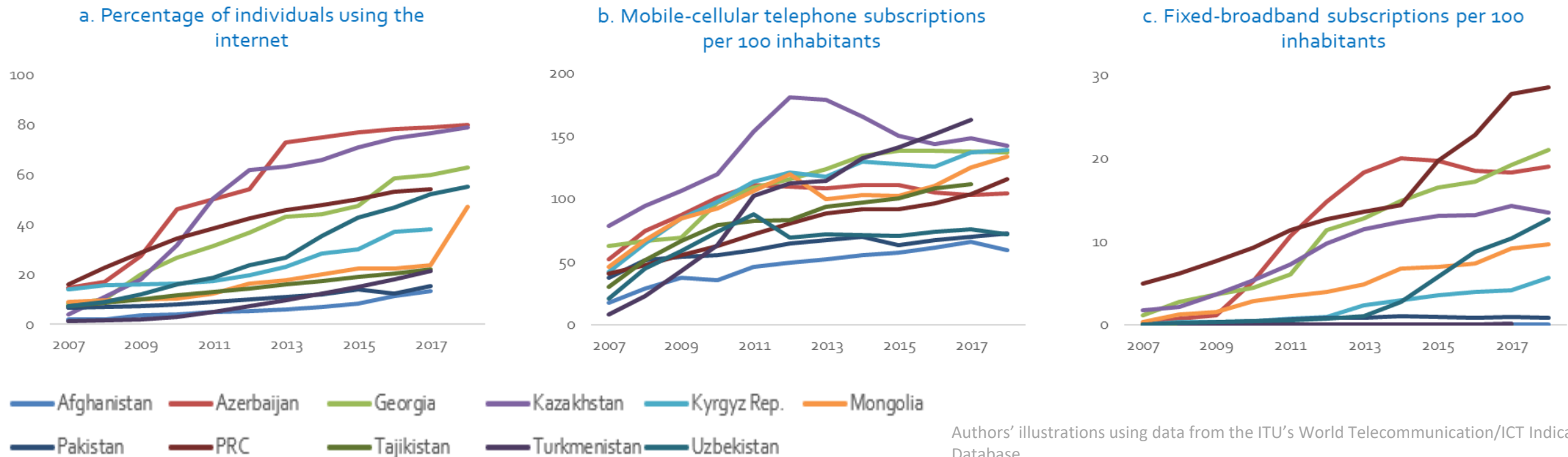
Source: Sinai Lab from Academy of Internet Finance (AIF), Zhejiang University International Business School, Zhejiang University-Institute of Data & Risk, Zhejiang Association of Internet Finance, and Beijing Frontier Institute of Regulation and Supervision Technology. 2020. Global FinTech Hub Report 2020.

## 2. CAREC region needs to further bolster the ICT and digital infrastructures.

Region's growing mobile and broadband use, and internet penetration can be leveraged for the growth of fintech and other digital financing solutions.

The volume of digital payments in Kazakhstan increased more than 2 times in 2019, to \$35 bil. E-commerce also exhibit steady expansion led by Kazakhstan and Uzbekistan.

Figure 14. ICT Infrastructure Landscape in CAREC, 2007–2018



## **3. Ensure regulatory quality (e.g., cybersecurity and other technical vulnerabilities, data governance, and privacy protection).**

Across Asia and the Pacific, cybersecurity breach is consistently cited by alternative finance players as the major risk that needs to be tamed.

Fintech firms are also concerned about uncertainty surrounding changes in regulation as another major risk.

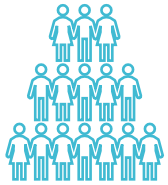
**Nevertheless, the global fintech infrastructure needs strengthening.**

As the fintech revolution is quite new, the proliferation of competing platforms complicates its financial infrastructure because there are no standardized processes or procedures yet.

# Lessons from Global Fintech Leaders

*In the Global FinTech Hub Report 2020, forces leading towards fintech development, taking the case of global fintech leaders from the PRC, the US, and the UK:*

## Market, Technology, and Regulations.



The PRC's success is mainly driven by large consumer base embracing technological advances in financial services.



The US has benefitted from technological revolutions while building adequate and relevant infrastructures.



The UK hinges largely on regulatory innovations, focusing on improving the regulatory systems and ecosystem improvements.





**Thank you!**