TLP ADVISORY

Overcoming Banking Barriers: What's Next for African Founders Amid Stringent Financial Regulations

Client Briefing Note

August 2024

TLP ADVISORY

Table of contents

Introduction

On 23 July 2024, Mercury, a San Francisco-based digital bank, announced plans to close all accounts of users in 37 countries by 22 August 2024. Interestingly, 13 of these countries are in Africa. In follow-up communication, the management of Mercury disclosed that the decision was informed by significant compliance obligations which had to be fulfilled in order to open and maintain the accounts of users in the affected countries.

This announcement follows the near-collapse of Silicon Valley Bank in March 2023, and the recent bankruptcy filing of Synapse, banking partners of multiple African startups. These incidents have created a significant gap in banking options for startups on the continent, which will greatly impact their fundraising endeavours and operations.

The rise of capital injection in tech startups from foreign investors has coincided with the adoption of business structures where African startups with operational entities in Africa have foreign investment holding companies ("holdcos") in western countries, including the U.S. and the UK. Across jurisdictions, banking is a crucial component of business models and for these entities, the use of offshore banks in the U.S. or other western countries in Europe and North America is informed by a range of factors including the fundraising currency, the domicile and preference of the investors, scarcity of stable domestic banking systems, and domestic currency fluctuations.

The Background

For African startups, the increased availability of dollar-denominated investments from both local and foreign investors has informed the need for a holistic, efficient, and convenient banking system to fund and operate their businesses. In the last decade, banks headquartered in Western countries have become crucial for African tech startups as they rely on these foreign banks to manage their investments, maintain accounts in foreign currencies, and facilitate cross-border transactions. As this reliance increased, startups around the world, including those in Africa soon realised that the stringent requirements of traditional banks in countries like the United States are not tailored to their needs. This led to the adoption of neobanks which until recently, permitted startups, especially those with U.S. holdcos to open and operate business bank accounts regardless of the domicile, residence or citizenship of their founders.

The Challenge

To provide banking services, banks, including digital banks and other financial institutions are required to carry out extensive due diligence and Know Your Customer ("KYC") procedures with their customers, not only to comply with anti-money laundering and anti-terrorism regulations, but also to guard against reputational, operational, legal, and concentration risks.

In practice, traditional brick-and-mortar banks in the United States for instance, typically require beneficial owners of companies to provide verifiable personal data such as a Social Security Number ("SSN"), especially if the account is being opened via online or telephone banking channels. Exceptions may be made for customers who are able to physically walk into a bank with a government-issued form of identification. On the surface, this appears to be an easy requirement but in today's global market, this poses a problem for founders in other parts of the world who, for operational reasons, require business bank accounts in countries like the United States.

Enter digital banks, *aka* neobanks, the solution to this dilemma. In the past decade, neobanks with less stringent requirements gained popularity for their flexibility among new and emerging businesses across the world, including African startups. A major attraction was the ability to open and operate a bank account online, without the need for unique identifying information such as a SSN. This solution was short-lived.

The Pitfall

The compliance obligations of banks and, by extension, their customers do not end with the completion of onboarding but continue throughout the term of the banking relationship as they are subject to a roster of ongoing international and domestic regulations. For example, the Financial Crimes Enforcement Network ("FinCEN") Customer Due Diligence Requirements for Financial Institutions[1] (the "CDD Rule") 2018 mandates banks operational in the United States to collect information on

[1] https://www.fincen.gov/resources/statutes-and-regulations/cdd-final-rule#:~:text=The%20CDD%20Rule%20has%20four,owners%20of%20companies%20opening%20accounts

customer companies' beneficial owners and disclose the same to law enforcement agencies upon request.

International bodies such as the Financial Action Task Force ("FATF") develop and promote policies to combat cross-border financial crimes, including money laundering, terrorist financing, and the proliferation of weapons of mass destruction. These policies influence the compliance requirements for financial entities globally.

The FATF has black and grey lists where it identifies countries that are yet to adopt and implement its standards against money laundering and terrorist financing. The black list identifies high-risk countries, while the grey list identifies countries who are under increased regulatory scrutiny due to significant deficiencies, but have committed to resolving these deficiencies. As of June 2024, the FATF grey list includes 12 African countries with significant startup presence, notably some of Africa's Big Four - Kenya, Nigeria, South Africa.

In H1 2024 alone, Nigerian startups received $183 million[2] in funding, their South African counterparts received $65.8 million, while Kenyan startups topped the Big Four list with $194.25 million. With a combined 5,000+ startups in these countries[3], the fallout from being on FATF's grey list will not only impact their growth and attractiveness to investors but also potentially affect their overall development and operational dynamics.

The Implication

Being on the FATF grey list increases regulatory scrutiny for businesses and startups connected to these countries. The FATF expects these countries to implement stringent anti-money laundering ("AM"L) and counter-financing of terrorism ("CFT") measures to address the risks it has identified. For banks, choosing to bank with customers from or domiciled in these countries results in heightened due diligence and KYC processes, increase in compliance checks and reporting to regulators which overall escalates costs and time spent.

To avoid the risk of regulatory infractions, financial institutions often defensively limit their exposure to customers from high-risk countries, a risk-averse business decision which ultimately leads to the offboarding of certain customers. A notable example of this occurred in early 2022 when Mercury abruptly restricted accounts linked to African tech startups

2 https://www.benjamindada.com/african-startups-funding-h1-2024/

3 https://www.forbesafrica.com/entrepreneurs/2023/10/31/accelerating-startup-growth-nigerias-incubators/

across 14 countries. Among the affected were well-established, YC-backed startups that had displayed activity deemed by Mercury as unusual. No further explanation beyond this was provided by Mercury. This sudden decision disrupted the financial operations of numerous startups across the continent, preventing them from meeting critical obligations such as payroll, tax payments, and other time-sensitive responsibilities.

Close observers opine that Mercury's most recent decision to close down certain bank accounts may be linked to an enforcement action issued on June 11 2024 against Evolve Bank & Trust by the U.S. Federal Reserve Board, for deficiencies in its AML, risk management and consumer compliance programs. Evolve Bank & Trust is a preferred partner of various digital banks, including Mercury.

Sadly, this is not an isolated incident as there have been reported account closures and refusal to approve new account openings of customers in certain jurisdictions by other neobanks including Wise and Grasshopper.

Navigating the Crisis

As noted above, this is not Mercury's first rodeo with bank account closures, and similar announcements from other banks might be expected. The decision to close accounts of users from high-risk countries highlights a fundamental issue, one which is larger than short-term alternatives and underscores the broader vulnerability of African startups dependent on external financial systems.

Long term, the solution lies in establishing a business, legal, and regulatory landscape that encourages foreign direct deposits in local banks. In the short to mid-term, affected companies may consider seeking support and advice on navigating international financial system changes, establishing a physical presence in the country of interest, exploring visa and immigration options for founders and key employees, ensuring continuous compliance monitoring, and staying updated on regulatory changes.

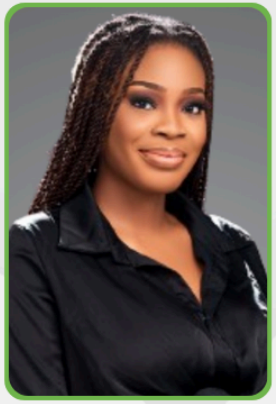
Conclusion

Overcoming banking barriers is crucial for African founders to sustain and grow their startups amid changing financial policies. The complexity of international compliance standards, particularly for countries on FATF's grey list adds to the already-existing banking challenges, increases regulatory scrutiny, and necessitates operational adjustments. These recent incidents with U.S. banks, including digital banks like Mercury, who cater to African startups highlights the urgent need for accessible and diverse banking options for African businesses, both in the U.S. and globally. It is crucial that these options include achievable AML and CFT compliance standards. The growth and sustainability of the African entrepreneurial ecosystem depend on inclusive, well-regulated financial services. Without these, businesses across the continent remain vulnerable to the decisions of a limited number of banks and financial service providers.

As a global venture law practice that serves founders, startups and investors with interests and operations in Africa, we're constantly looking for ways to navigate the issues highlighted in this paper. With law offices in Lagos, London, New York and Dubai, TLP Advisory is well-positioned to assist you in navigating cross-border legal and regulatory challenges. To get started, please send an email to clientservices@tlpadvisory.com.

TLP ADVISORY

The Authors



Chidinma Anuforo
Associate
TLP Advisory

Emmanuella Keshinro
Associate
TLP Advisory

Daniel Igiekhumhe
Senior Associate
TLP Advisory