GPFI Global Partnership for Financial Inclusion

GPFI 1st Annual Conference on Standard-Setting Bodies and Financial Inclusion: Promoting Financial Inclusion through Proportionate Standards and Guidance

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Plenary Session 1:
Standard-Setting Body Engagement on Financial Inclusion:
Progress and Challenges

Issues Paper

Introduction

Together, the normative standards and advisory guidance of the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS), the Financial Action Task Force (FATF), the International Association of Deposit Insurers (IADI), and the International Association of Insurance Supervisors (IAIS) have significant influence on *how many poor households* get access to *what range* and *quality* of formal financial services and *at what cost*. While these five standard-setting bodies (SSBs) have varying relevance and importance to financial inclusion, all matter and all are increasingly engaged on the subject.

The SSBs have all recognized and in recent years paid increased attention to the importance of financial inclusion. For the SSBs, embracing the goal of full financial inclusion represents an additional objective and requires a commensurate evolution in thinking. The SSBs are at different stages in this evolution. Some of the issues related to financial inclusion to be considered are specific to the mandate of each SSB, while others are jointly relevant to multiples SSBs. This said, financial inclusion merits attention across all the SSBs, given the growing number of countries officially committed to a policy agenda to bring all their citizens into the formal financial system and the high level political commitment presented by the G20's multi-year Financial Inclusion Action Plan.

These topics – both the ramifications of SSB standards and guidance for financial inclusion and the ramifications of financial inclusion for the work of the SSBs – were explored in a white paper, "Global Standard-Setting Bodies and Financial Inclusion for the Poor – Toward Proportionate Standards and Guidance," and five country case studies (Mexico, Philippines, Brazil, Kenya, and South Africa) prepared on behalf of the G20 Global Partnership for Financial Inclusion (GPFI).[1] These issues are the subject matter of the first Conference Plenary and this Issues Paper, together with relevant activities undertaken by the SSBs since the publication of the white paper, recognized by the GPFI as significant progress within the framework of the actions called for in the GPFI "Report to the Leaders" put forth at the 2011 G20 Cannes Summit.[2]

[1] See GPFI publications "Global Standard-Setting Bodies and Financial Inclusion for the Poor – Towards Proportionate Standards and Guidance." 2011. (http://www.gpfi.org/knowledge-bank/white-papers/global-standard-setting-bodies-and-financial-inclusion-poor) and "Global financial sector standard setting bodies and financial inclusion – Case studies from Brazil, Kenya, Mexico, the Philippines and South Africa." 2011. (http://www.gpfi.org/knowledge-bank/case-studies).

[2] At their Cannes Summit in 2011, the G20 Leaders endorsed a recommendation calling upon the SSBs to "consider the recommendations and lessons learned from the GPFI white paper and 5 country case study on

Part I. Background

"Financial inclusion" refers to a state in which all working age adults have effective access to credit, savings, payments, and insurance from formal service providers.[3] "Effective access" involves convenient and responsible service delivery, at a cost affordable to the customer and sustainable for the provider, with the result that financially excluded customers use formal financial services rather than existing informal options.

Three themes of importance for SSBs in considering the process of financial inclusion

Working toward full financial inclusion is an ongoing and dynamic process, for which three linked themes are of particular importance for SSBs to consider.

First, *financial exclusion carries risks* within SSBs' spheres of interest (those of FATF, IAIS, and BCBS in particular). These include threats to financial integrity and international security (e.g., the money-laundering and terrorist financing risks of cash transactions, often across borders, through informal providers), social and political stability, and even potentially financial stability. Though FATF has explicitly acknowledged financial exclusion as an important risk,[4] the subject has not yet been systematically studied with respect to any of the SSBs.

Second, the processes of *increasing financial inclusion will change the nature* (and sometimes also *the level*) of *risks.* These changes result from a variety of factors, including the characteristics of currently financially excluded customers (which differ from the "already served" with which the SSBs are most familiar), as well as the nature of the products, services, and providers capable of reaching them, and especially the innovative approaches needed to accomplish significant increases in financial inclusion. The *benefits of financial inclusion,* such as economic growth, economic efficiency, and increased welfare, both offset these changing risks and mitigate the risks of financial exclusion.

Third, the *country context* in which SSB standards and guidance are being applied matters. Two parameters, in particular, merit reflection: the current nature and *level of financial exclusion* in the country in question and the *capacity* of policy makers, regulators, and supervisors to implement SSB standards and guidance. For some countries, particularly lower-income countries, with high current levels of financially excluded households, full compliance with existing SSB standards and guidance may be a long-term goal. Thus, while SSBs' normative standards of relevance to increasing financial inclusion may be designed to be applied flexibly in

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financial inclusion and the standards and guidance of the SSBs." At their Los Cabos Summit in June 2012 the Leaders reiterated this call and called further for the GPFI to report progress to the G20 Finance Ministers and Central Bank Governors at their meeting in November 2012.

[3] "Formal institution" refers to a financial service provider that has a recognized legal status and includes entities (and in some countries even some individuals) with widely varying regulatory attributes, subject to differing levels and types of external oversight.

[4] Asia/Pacific Group on Anti-Money Laundering, World Bank, FATF. 2011. "FATF Guidance: "Anti-money laundering and terrorist financing measures and Financial Inclusion." June 2011. (http://www.fatf-gafi.org/media/fatf/content/images/AML%20CFT%20measures%20and%20financial%20inclusion.pdf) and Declaration of the Ministers and Representatives of the Financial Action Task Force, Washington, 20 April, 2012 (http://www.fatf-gafi.org/topics/fatfgeneral/documents/ministersrenewthemandateofthefinancialactiontaskforceuntil2020.html)

all country contexts, advisory guidance that considers the implementation challenges encountered in varying country contexts may be needed.

Application of the Proportionality Principle

The application of the *proportionality principle*—the balancing of risks and benefits against costs of regulation and supervision—is the essential means for addressing these themes, both in the standards and guidance of the SSBs and in their country-level implementation. Risks and benefits are often perceived and measured differently by different stakeholders, and the complexity of the risk and benefit assessment multiplies when the varied regulatory and supervisory standards of the SSBs are applied across the different products, services, and providers that a broad financial inclusion agenda involves. Also, the proportionality calculus requires attention, not just to the risks of financial exclusion, but also to the benefits of financial inclusion beyond the mitigation of financial exclusion risks. While these benefits may be only indirectly related to the core mandate of a particular SSB, they can feature significantly among the SSBs' motivation to incorporate consideration of financial inclusion issues into their work and are priorities for many country-level policy makers seeking to apply the SSBs' standards and guidance.

Part II. SSBs and Financial Inclusion

Basel Committee on Banking Supervision. BCBS sets standards and issues guidance that are applied by many countries in the regulation and supervision of both banks and other deposit-taking institutions.

In August 2010, BCBS issued "Microfinance activities and the Core Principles for Effective Banking Supervision."[5] This first-ever publication by BCBS on a financial inclusion topic offers guidance for the application of the "Basel Core Principles on Effective Banking Supervision" (BCPs) to depository microfinance. It calls for specialized knowledge, but suggests that the BCPs generally offer a suitable framework for microfinance supervisors, with some tailoring required according to the type, size, and complexity of transactions. It also highlights the need to avoid adding unduly to the compliance costs of providers, and to apply the principle of proportionality in allocating scarce supervisory resources. The 2010 BCBS report offered a useful starting point for considering proportionate application of the BCPs to enable a broader financial inclusion agenda.

Revised BCPs were formally approved in September 2012.[6] The review was undertaken by a group consisting of BCBS member countries, non-member countries, and regional groups of banking supervisors, as well as the IMF, the World Bank and the Islamic Financial Services Board. One of the most important dimensions in the revision of the BCPs is the reinforcement of the concept of proportionality throughout the BCPs, whereby a proportionate approach is expected in the assessment of all criteria, even if not explicitly referenced in the criteria. This is of great significance for financial inclusion. By explicitly reinforcing the proportionality concept throughout the revised BCPs and the assessment criteria now integrated into the BCPs, the new document accommodates a more diverse range of banking systems and validates supervisory

[5] Basel Committee on Banking Supervision. 2010. "Microfinance Activities and the Core Principles for Effective Banking Supervision." Basel: BIS. August 2010. (http://www.bis.org/publ/bcbs175.htm)

[6] Basel Committee on Banking Supervision. 2012. "Core Principles for Effective Banking Supervision." Basel: BIS. September 2012. (http://www.bis.org/publ/bcbs230.htm)

approaches that are commensurate with the risk profile and systematic importance of a broad spectrum of banks (from large, complex, internationally active banks to the smallest, simplest, and most geographically limited forms of deposit-taking institutions).

The Basel Consultative Group (BCG), the BCBS body created to provide a forum to deepen the Committee's engagement with supervisors around the world and facilitate dialogue with non-member countries and regional groups of banking supervisors, offers a forum to discuss the need for, and develop, further guidance on financial inclusion topics of relevance to BCBS. A decision has been taken to establish a new BCG workstream on financial inclusion to consider such topics raised in the GPFI white paper and country case studies as differentiated treatment of different types of deposit-taking institutions based on the nature, scale, and complexity of their activities and supervisory ramifications of innovative financial services delivery. The workstream may also consider reviewing the August 2010 document on Microfinance activities and the Core Principles for Effective Banking Supervision.

Committee on Payment and Settlement Systems. CPSS has historically focused on large-value payments and systemically important payment systems, though in recent years, it has expanded its involvement with the issues of safe and efficient retail payment systems and payment instruments. In principle, all the work of CPSS is potentially positively correlated with the goal of financial inclusion to the extent that implementation of relevant CPSS standards and guidance leads to a larger share of the population benefiting from better quality payment services at a lower cost. Current CPSS standards permit this goal to be pursued while also allowing space for innovative payment platforms and instruments (such as e-money) that provide new ways of reaching financially excluded customers and are gaining transaction volume, particularly in the emerging market and developing economy countries, where the majority of financially excluded people live.

Currently, the Committee is engaged in two main workstreams on retail payment systems and payment instruments: the CPSS Working Group on Innovations in Retail Payments and the CPSS-World Bank Forum on Retail Payments, which aims to foster an exchange of views on relevant topics of mutual interest and to keep abreast of the key global developments in retail payments.

In May 2012, the Working Group on Innovations in Retail Payments released a report on "Innovations in retail payments."[7] To gain an overview of innovative retail payment activities, the CPSS conducted a fact-finding exercise that attempted to cover influential developments in retail payment instruments and schemes over the past decade. From this exercise, the report identifies a number of trends in retail payments, one of which relates to financial inclusion: "Financial inclusion has served as an important driving force for innovations in many countries, either under a government mandate or because of the new business opportunities opened up by an untapped market."[8] In this context, the report notes that cheaper and/or simpler payment services to meet the needs of the unbanked or underbanked could be provided by innovative developments such as (i) special limited-service bank accounts and/or prepaid accounts with non-banks; (ii) the use of business correspondents/agents; and (iii) new means of initiating and authenticating transactions. The Committee has agreed to do follow-up work on retail payments. One topic under consideration is the role of non-banks in retail payment systems.

[7] Committee on Payments and Settlement Systems. 2012. "Innovations in Retail Payments: Report of the Working Group on Retail Payments." Basel: Bank for International Settlements. May 2012. (http://www.bis.org/publ/cpss102.htm)

[8] ibid., p. 1.

Financial Action Task Force. FATF sets standards for national regimes on anti-money laundering and combating the financing of terrorism (AML/CFT). The FATF Ministers acknowledged financial exclusion as a real risk to achieving effective implementation of the FATF standards.[9] Because financial inclusion brings more customers and transactions from the untraceable world of cash into the traceable world of formal financial services, it bears a highly complementary relationship to FATF's core objective of combating money laundering and terrorist financing.

FATF's newly revised Recommendations ("International Standards on Combatting Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations"[10]), adopted in February 2012, embrace and elaborate on a comprehensive risk-based approach (RBA). It will enable countries to specifically address their identified higher ML/FT risks, while taking into account the importance of financial inclusion, both from an AML/CFT perspective and from a social policy point of view. The RBA will permit countries to exempt from some AML/CFT controls certain financial institutions and activities, as well as services provided on occasional and limited basis, based on a proven low risk of ML/FT. It will also enable countries and financial institutions to adopt simplified measures where justified by a lower level of risk. An interpretive note provides a non-binding list of potential lower risk products, services transaction and channels that includes: "[f]inancial products or services that provide appropriately defined and limited services to certain types of customers, so as to increase access for financial inclusion purposes."[11]

FATF's facilitative approach to financial inclusion was heralded in its June 2011 guidance paper "Anti-money laundering and terrorist financing measures and Financial Inclusion." The guidance paper provides country examples of AML/CFT regulation relevant to financial inclusion products as well as industry risk-mitigation measures. Although the examples are not necessarily endorsed as FATF-compliant, they help regulators consider creative solutions that will align financial inclusion and money laundering and terrorist financing risks and risk mitigation within their own jurisdictions. The guidance paper is currently being revised to align it with the newly revised Recommendations. This offers an opportunity to go beyond the groundbreaking acknowledgement of the 2011 paper that financial exclusion constitutes a money-laundering and terrorist financing risk to offer countries more specific guidance on mitigating that risk through proportionate AML/CFT requirements.

In addition to its work focused directly on financial inclusion, FATF is also working on "new payment methods" (NPMs), which include a broad range of innovations, some of particular relevance to financial inclusion. This work follows on the publication of FATF's 2010 paper on NPMs, "Money Laundering Using New Payment Methods." A guidance paper on pre-paid cards, mobile payment services and internet-based payment services is expected to be released in February 2013. Further work relevant to financial inclusion includes FATF's broad guidance paper on global risk assessment and its forthcoming guidance on national risk assessment.

[9] "Declaration of the Ministers and Representatives of the Financial Action Task Force," op. cit.

[10] Financial Action Task Force. 2012. "International Standards on Combatting Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations." Paris: FATF/OECD. February 2012. (http://www.fatf-gafi.org/topics/fatfrecommendations/documents/internationalstandardsoncombatingmoneylaunderingandthefinancingofterrorismproliferation-thefatfrecommendations.html)

[11] ibid., p. 64.

International Association of Deposit Insurers. IADI provides a forum for international cooperation among deposit insurers, central banks and international organizations on issues related to financial stability, deposit insurance, and resolution activities. IADI's "Core Principles for Effective Deposit Insurance Systems"[12] were developed and approved jointly with BCBS in June 2009, reflecting the fact that deposit insurance is part of an effective financial "safety net" that also includes robust prudential regulation and oversight. Public awareness in countries that have explicit deposit insurance systems can play a significant role in ensuring that low-income depositors are informed about safe methods of storing their money, and safe and effective systems of deposit insurance can also potentially increase public trust in institutions holding insured deposits, spurring greater participation by financially excluded poor households in the mainstream banking system.

In 2010, IADI formed the Financial Inclusion and Innovation Subcommittee (FIIS) to study issues related to financial inclusion and deposit insurance. This year, IADI's FIIS finalized a draft Research Paper on Financial Inclusion and Deposit Insurance that includes the results of a survey of a sample of deposit insurers focusing on their range of practices on issues related to financial inclusion and deposit insurance, including membership, coverage, funding, and public awareness. The draft report, which is currently under review within IADI, contains a number of preliminary observations and recommendations for the association to consider on topics related to deposit insurer practices and financial inclusion.

International Association of Insurance Supervisors. IAIS's insurance market development mandate and very broad membership (including many jurisdictions with high levels of financial exclusion) make financial inclusion a fundamental priority for IAIS, intertwined with its prudential and consumer protection objectives. Since the inception of its work in the area of microinsurance (which has become synonymous with the concept of inclusive insurance markets), IAIS has recognized two distinct classes of relevant issues: (i) those applicable to extending conventional insurance to reach excluded customers and (ii) those applicable to bringing existing informal providers of insurance products into compliance with the "Insurance Core Principles, Standards, Guidance and Assessment Methodology"[13] (ICPs) and ultimately under supervision.

In late 2005, IAIS became the first of the five SSBs to establish a formal mechanism to consider financial inclusion issues, co-founding with the Microinsurance Network (formerly the CGAP Working Group on Microinsurance) a joint working group on regulation and supervision of microinsurance, which brings together supervisors and interested industry stakeholders, organizes seminars, and recommends activities for IAIS in the area of financial inclusion.

[12] Basel Committee on Banking Supervision/International Association of Deposit Insurers. 2009. "Core Principles for Effective Deposit Insurance Systems." Basel: BIS/IADI. June 2009. (http://www.iadi.org/core.html)

[13] International Association of Insurance Supervisors. 2011. "Insurance Core Principles, Standards, Guidance and Assessment Methodology." Basel: IAIS. 1 October 2011. (http://www.iaisweb.org/view/element_href.cfm?src=1/13037.pdf)

In June 2007, IAIS published jointly with the Microinsurance Network its first issues paper on microinsurance, "Issues in Regulation and Supervision of Microinsurance."[14] Its second microinsurance paper, "Issues Paper on the Regulation and Supervision of MCCOs in increasing access to Insurance Markets," deals with the specific issues relating to regulation and supervision of mutuals, cooperatives, and other community-based organizations in microinsurance (particularly relevant to financially excluded poor households)

Revised ICPs making more explicit and strengthening the proportionality principle were adopted in fall 2011. IAIS has prepared guidance on the implementation of the ICPs in the context of inclusive insurance markets, the "Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets," approved in October 2012.[15] This document includes both explanations of the issue of inclusion and the regulatory and supervisory issues that arise, as well as guidance on how to apply the revised ICPs in practice, including application of the proportionality principle, to promote inclusive insurance markets. The paper also reiterates the need for formalization of informal providers and transitional arrangement for achieving this, as well as guidance on the application of pilot schemes and innovations to overcome barriers in access to insurance. IAIS plans to follow this with further material for training and self-assessment on market access aspects of regulation and supervision by IAIS members. Furthermore, the IAIS has established a dedicated working group, the Financial Inclusion Subcommittee, to promote, in particular in emerging markets and developing economies, the application of IAIS Insurance Core Principles and other supervisory material to support regulation and supervision of inclusive insurance markets. As part of its work plan, this working group will address the follow-up of the white paper, will develop additional guidance on the application of proportionality in practice and develop an Issues paper on market conduct, distribution and consumer protection in relation to inclusive insurance markets.

Part III. Looking Forward

For all SSBs, pursuing the ambitious agenda inherent in the concept of financial inclusion will take time. All five SSBs have demonstrated interest to continue their work on financial inclusion. Three of five (BCBS, FATF, and IAIS) have recently revised their highest level normative standards, strengthening the proportionality principle and providing an opportunity to ensure that they offer a workable framework within which more detailed guidance on specific topics relevant to financial inclusion can be developed. In all these activities, the SSBs may want to consider what is different about financially excluded households and the products and providers capable of reaching them responsibly and sustainably, and what will change in bringing them into the formal financial system in increasing numbers.

*Deepening understanding of financial exclusion risks***.** More needs to be known about the risks of financial exclusion. Thus far, the ramifications of high levels of financial exclusion for institutional and systemic stability and integrity are understood from anecdotes and specific

[14] International Association of Insurance Supervisors and CGAP Working Group on Microinsurance. 2007. "Issues in Regulation and Supervision of Microinsurance." Basel: IAIS. June 2007. (http://www.iaisweb.org/view/element_href.cfm?src=1/2495.pdf)

[15] International Association of Insurance Supervisors. 2012. "Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets." Basel: IAIS. October 2012. (http://www.iaisweb.org/Application-papers-763)

occurrences. While these examples can be powerful, the SSBs could develop a stronger empirical basis to reflect these risks properly in proportionate standards and guidance.

Deepening understanding of changing risks and benefits of financial inclusion. Similarly, each SSB's standards and guidance could be shaped by a deeper understanding of the changing risks accompanying increased financial inclusion. These will continue to change over time as large numbers of financially excluded households join the formal financial system. While some of the specific providers, products, and delivery channels most promising for increasing financial inclusion are already well understood by some of the SSBs, others—particularly the more innovative ones—raise new issues for all five. Equally important, proportionate standards and guidance call for a deeper understanding of the benefits that result from increased financial inclusion, as discussed above.

Considering country context. To date, the SSBs' normative standards have appropriately aimed for the flexibility necessary to be applicable across all (or most) country contexts. But their advisory guidance has also not yet reflected the widely varying situations of country-level policy makers, regulators, and supervisors and the specific challenges faced by countries with higher current levels of financial exclusion and lower levels of regulatory and supervisory capacity. These countries would benefit, in particular, from guidance on prioritizing risk areas. This work calls also for deeper understanding of the profile of financial excluded customers entering the formal financial system on the part of SSBs and the countries themselves.

Proportionality principle applied to financial inclusion. All the above observations underscore the importance of proportionality, in crafting both SSB standards and guidance relevant to financial inclusion and at the country implementation level. Given the dynamic nature of the picture, assessing risks and benefits and balancing them against the costs of regulation and supervision will be an ongoing process (particularly as experience is gained with new products, providers, and delivery channels). Various approaches—such as "test and learn," gradual implementation, and tiering of regulatory and supervisory treatment based on the nature, scale, and complexity of the activities in question—have been used successfully in countries pursuing a financial inclusion agenda and warrant consideration and controlled experimentation more broadly.

Enhancing coordination and collaboration among SSBs on financial inclusion. Joint work among the SSBs on issues of relevance, and perhaps even joint guidance, will help countries balance the potentially competing policy objectives introduced by a broad financial inclusion agenda. The development of consistent policy positions on financial inclusion among the SSBs will also benefit from coordination among the delegates of countries and organizations participating in the activities of multiple SSBs.

Part IV. Some Questions Meriting Further Consideration

- What are the main challenges for each SSB in integrating consideration of financial inclusion into standards and guidance?
- What initiatives would be most helpful to deepen the understanding of the risks of financial exclusion and of the changing risks and benefits of financial inclusion? How can a stronger empirical base be built?
- What specific issues arise in applying the proportionality principle in relation to financial inclusion and what kinds of guidance from SSBs might address these issues?

- What is the potential for joint work among the SSBs on issues of relevance to financial inclusion? For joint guidance?

- What coordination among the delegations of countries and organizations participating in multiple SSBs would be useful in promoting the application of a proportionate approach across the SSBs?

- How can greater voice and representation be given to the interests and concerns of emerging market and developing countries in the processes of shaping SSB standards and guidance of relevance to financial inclusion? What further advisory guidance from the SSBs can be provided to countries that reflect the widely varying situations of country-level policy makers, regulators and supervisors?

- What is the potential for differentiated guidance on the regulation and supervision of various types of financial institutions and innovative delivery systems that today serve large numbers of poor households, often without effective regulation and supervision?