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 2:
Proportionality in Practice across the Standard-Setting Bodies:
Applying Standards and Guidance while Supporting a Financial Inclusion Agenda

Issues Paper

Introduction

The proportionality principle — the balancing of risks and benefits against costs of regulation and supervision — is increasingly recognized as a common theme running through the highest level normative standards of the standard-setting bodies (SSBs).[1] The growing number of countries officially committed to a policy agenda to bring all their citizens into the formal financial system benefit from this recognition. At the same time, they face two broad types of challenges applying the proportionality principle in the financial inclusion context: first, though several of the SSBs have added considerable specificity to the concept of proportionality as set forth in their standards, there remains comparatively little guidance about how to apply it in the everyday practice of regulation and supervision; second, the application of proportionality triggers somewhat different issues in the case of each of the five SSBs that are the focus of the GPFI Conference on the SSBs and Financial Inclusion: 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 (IAIS), and the International Association of Insurance Supervisors (IAIS). These topics are the subject matter of the second Conference Plenary and this Issues Paper.

Part I. General Issues and Inherent Challenges with the Proportionality Principle

The G20 Principles for Innovative Financial Inclusion[2] counsel country-level policy makers to "[b]uild a policy and regulatory framework that is proportionate with the risks and benefits involved in innovative products and services and is based on an understanding of the gaps and barriers in existing regulation."

This is not necessarily easy. Historically, the SSBs have tended, to varying extents, to base their standards and guidance primarily on the experiences of developed countries' financial systems due to their greater importance to global financial stability and their longer and deeper track record with regulation and supervision. And, although each of the five SSBs now includes in its focus a

[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] See "G20 Principles for Innovative Financial Inclusion." (http://www.gpfi.org/knowledge-bank/publications/g20-principles-innovative-financial-inclusion).

much broader range of countries, incorporating a financial inclusion agenda requires each SSB to consider specifically the experiences of countries with large numbers of financially excluded households (especially those countries making substantial progress on financial inclusion, from which lessons may be learned).[3] Such a bottom up approach – looking at actual country experience designing proportionate regulatory and supervisory regimes in the implementation of a financial inclusion agenda – yields many questions not yet explicitly addressed by the SSBs (though a number of them are making important progress).

Similarly, until recently, the SSBs did not consider in their work (or factor explicitly into the proportionality calculus) the risks of financial exclusion, nor the changing nature (and sometimes also the level) of risks accompanying progress from financial inclusion. These latter changes result from a variety of factors including the characteristics of currently financially excluded customers and the nature of the products, services, and providers capable of reaching them (especially the innovative approaches needed to accomplish significant increases in financial inclusion). These must be weighed against the benefits of financial inclusion, such as economic growth, efficiency, and increased welfare, which both offset these changing risks and mitigate the risks of financial exclusion. 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.[4]

Another significant challenge to implementing a proportionate approach is that risks and benefits are often perceived and measured differently by different stakeholders. Moreover, some risks and benefits cannot be easily or definitively quantified, although qualitative analysis is possible.[5] These challenges of risk and benefit assessment multiply in complexity when the varied regulatory and supervisory standards of the SSBs are applied across different products, services, and institutions. The difficulty of implementing the differing standards and guidance will challenge even those policy makers, regulators, and supervisors in countries with relatively higher levels of regulatory and supervisory capacity and financial inclusion. For countries at the other end of the capacity and inclusion spectrum, the difficulty will be even greater. Nevertheless, a deeper examination to these

[3] Noteworthy instances of SSBs' standards and guidance seeking to accommodate varying country contexts (and, in particular, lower levels of regulatory and supervisory capacity) include FATF's recognition that its Recommendations will need to be implemented progressively, particularly in countries with lower regulatory capacity, and BCBS's inclusion of simpler "standard" approaches to measuring capital adequacy in Basel II and Basel III.

[4] For example, the involvement of CPSS (together with the World Bank) in the project to develop the General Principles for International Remittance Services (see Part II, "CPSS") was motivated not only by a connection between small value cross-border money transfers and CPSS's core mandate to promote the stability of systemically important payment systems, but also by an interest in the welfare gains that might result from the project.

[5] Whether a risk in fact exists is also important. As Chatain, Hernandéz-Coss, Borowik, and Zerzan note "[i]n order to balance perceptions against the fear of over-regulation, which can damage business, actual rather than perceived risks need to be identified." See Chatain, Hernandéz-Coss, Borowik, and Zerzan. 2008. "Integrity in Mobile Phone Financial Services." World Bank Working Paper No. 146. Washington, DC: World Bank, p. xiii. (http://siteresources.worldbank.org/INTAML/Resources/WP146_Web.pdf)

issues is being undertaken at both the SSB and country levels, leading to the development of proportionate approaches within the standards and guidance and in their application.

Part II. Proportionality as Understood and Interpreted by the Five SSBs

In fact, the five SSBs already explicitly or implicitly incorporate a proportionate approach in their standards and guidance, and three – BCBS, FATF, and IAIS – have revised their highest level normative standards recently to strengthen the treatment of proportionality. But there is still much work to be done to incorporate proportionality into the SSBs' standards and guidance and notably to elaborate how the proportionality principle should be applied at the country level in implementing the SSBs' standards and guidance while pursuing a broad financial inclusion agenda. For example, BCBS's focus to date has been primarily on banks and their existing customers. As a consequence, there is as yet little guidance on how to apply proportionality to the types of nonbank deposit-taking institutions and "deposit like" products that, in some countries, are of greatest relevance to financial inclusion.[6] Similarly, FATF's primary focus to date has been specifically on high-risk providers, products, services, and clients. And, though FATF has recently taken the groundbreaking step of recognizing financial exclusion as a money laundering and terrorist financing risk,[7] uncertainty remains about applying in practice FATF's risk-based approach to the activities, products, and providers most relevant to financial inclusion. Similar challenges lie ahead with respect to the other SSBs as well. Overcoming them requires putting aside preconceptions of risk based solely on the "already served" and the products, services, and providers that serve them — recognizing, in the risk-and-benefit assessment, the benefits that will result from bringing financially excluded households into the formal financial system, and considering proportionate approaches that can enable this to happen; these approaches may include "test and learn" (testing ideas in a small number of locations or customers to predict impact), phased implementation, and tiering of regulatory and supervisory treatment based on the nature, scale, and complexity of the financial service activities in question.

Basel Committee on Banking Supervision: The concept of proportionality is embedded in the revised (2012) Basel Core Principles for Effective Banking Supervision (BCPs),[8] underlining that supervisory practices need to be commensurate with the risk profile and systemic importance of the banks being supervised, thereby accommodating smaller, less complex deposit taking institutions. While the new language on proportionality does not specifically address the application of the concept to promote financial inclusion, it is in general harmony with the guidance put forward in the 2010 BCBS guidance paper "Microfinance Activities and the Core Principles for Effective Banking Supervision" regarding the tailoring of supervisory approaches in the context of deposit-taking institutions engaged in microfinance. The pursuit of a broader financial inclusion

[6] Basel Committee on Banking Supervision (BCBS). 2010. "Microfinance activities and the Core Principles for Effective Banking Supervision." Basel: BIS. (www.bis.org/publ/bcbs175.pdf).

[7] 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 FATF. Financial Action Task Force Mandate (2012 – 2020). 20 April 2012. (http://www.fatf-gafi.org/media/fatf/documents/FINAL%20FATF%20MANDATE%202012-2020.pdf)

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

workstream by the Basel Consultative Group[9] offers the opportunity to further examine the concept of proportionality in direct relation to financial inclusion issues, such as for example the potential differential treatment of nonbank deposit-taking institutions and the application of the BCPs to "deposit like" products such as e-money.

Committee on Payments and Settlement Systems: In its focus on systemically important payment systems, the CPSS mandate itself can be seen as an expression of the proportionality principle. Although CPSS guidance generally does not deal extensively with the subject of proportionality in retail payments (of specific interest in the financial inclusion context), the 2007 CPSS/World Bank "General principles for international remittance services"[10] call for "proportionate legal and regulatory frameworks." In this context "proportionate means that the legal and regulatory framework for remittances should not be overly restrictive and burdensome relative to the possible issues it is designed to tackle or the number and value of transfers involved."[11]

Financial Action Task Force: FATF recently strengthened the principle of proportionality in its standards. Its revised 2012 Recommendations[12] require countries to follow an assessment-informed risk-based approach — in essence a proportionate approach — in certain key respects, allowing an exemption from AML/CFT controls for certain limited transactions and services, as well as the application of reduced or simplified customer due diligence procedures to lower-risk financial services.

International Association of Deposit Insurers: Exploring what constitutes a proportionate approach to applying the BCBS/IADI Core Principles for Effective Deposit Insurance Systems[13] is at an early stage of consideration, challenging country level policy makers for the time being to examine this issue in the financial inclusion context largely at their own initiative. Among the topics that might call for country-level policy makers to implement a proportionate approach are extending deposit insurance coverage to nonbank deposit-taking institutions and "deposit-like" products, such as e-money.

International Association of Insurance Supervisors: In the case of IAIS, the proportionality principle is present throughout the original Insurance Core Principles (ICPs), with risk being measured by "nature, scale and complexity," and was made more explicit in the revised ICPs

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[9] The Basel Consultative Group (BCG) provides a forum for deepening the Committee's engagement with supervisors around the world on banking supervisory issues. It facilitates broad supervisory dialogue with non-member countries on new Committee initiatives early in the process by gathering senior representatives from various countries, international institutions and regional groups of banking supervisors that are not members of the Committee.

[10] Committee on Payments and Settlement Systems/World Bank. 2007. "General principles for international remittance services." Basel: BIS. January 2007. (http://www.bis.org/publ/cpss76.htm).

[11] Ibid., p. 24.

[12] 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)

[13] 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)

(2011).[14] Throughout the 2012 IAIS "Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets,"[15] the need for supervision to be proportionate with the objective of enhancing inclusive insurance markets is underlined; consideration is given as to how the principle of proportionality should be applied in the design and implementation of regulatory requirements, in supervisory assessments of the adherence of insurers to regulatory requirements and in the manner in which supervisory powers are exercised.

Part III. Examples from Three Countries Applying Proportionality in the Financial Inclusion Context[16]

Among the numerous countries that have publicly committed to a financial inclusion policy agenda, Mexico, Pakistan, and the Philippines have each been recognized for their leadership in the proportionate adaptation of their regulatory frameworks to make progress on financial inclusion while also striving to implement the standards and guidance of the SSBs. The discussions below cannot cover exhaustively the challenges they have faced – or the approaches they have tried – to increase access to and use of a full range of formal financial services by those low-income households and SMEs that currently lack adequate access. They nonetheless provide some leading examples of efforts to operationalize the proportionality principle across the types of products and providers likely to contribute significantly to progress in closing the financial access gap.

Mexico: As far back as the early 2000s, Mexico took pioneering steps to bring under regulation and supervision scores of highly heterogeneous and hitherto unsupervised financial cooperatives that had grown up, mostly in rural areas, over generations. In the absence of guidance from BCBS on how such institutions, which presented serious depositor protection challenges but no significant systemic impact, should be supervised, Mexico adopted a delegated supervision model, with four levels of authorized financial institutions (in function of the value of assets). The level determined the kind of products that the financial institution could offer, the applicable prudential regulation and the reporting required. This approach compelled the larger cooperatives to join in federations responsible for their supervision, which were themselves prudentially supervised by the Banking and Securities Commission. Although the regime has taken much longer to implement than initially

[14] 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*)*

[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)

[16] Mexico and the Philippines were the subject of two of the GPFI country case studies complementing the GPFI white paper ("Mexico's Engagement with the Standard Setting Bodies and the Implications for Financial Inclusion" (2011) and "The Philippines' Engagement with the Standard Setting Bodies and the Implications for Financial Inclusion" (2011) (http://www.gpfi.org/knowledge-bank/case-studies)). All three countries were the subject of diagnostic analyses that contributed to the development of the G20 Principles for Innovative Financial Inclusion (See CGAP notes on "Regulation of Branchless Banking in the Philippines." January 2010. (http://www.cgap.org/publications/regulation-branchless-banking-philippines), CGAP "Update on Branchless Banking Policy and Regulation in Mexico." January 2010. (http://www.cgap.org/publications/regulation-branchless-banking-mexico), and CGAP "Update on Regulation of Branchless Banking in Pakistan." February 2010. (http://www.cgap.org/publications/regulation-branchless-banking-pakistan)).

anticipated, it remains one of most ambitious attempts globally at formalization of informal deposit-taking institutions.[17]

Later in the decade, Mexico embarked on a new wave of reform, this time aimed at expanding access to financial services through the adoption of new regulation permitting agent banking by commercial banks and establishing a new category of banking license for so-called "niche banks" serving the low income population. The new regulation was thought by some would-be providers to be disproportionately complex and burdensome; the uptake was initially disappointing to financial inclusion advocates in the relevant Mexican public bodies, but the market subsequently responded positively.

Mexico's most recent policy initiative to promote financial inclusion through adoption of proportionate regulation is both its most ambitious and, from results to date, most successful. The new regime of tiered bank accounts is characterized by increasing functionality, higher transaction limits, and more demanding provisions on identifying customers and prudential supervision with each successive tier. Designed with careful attention to both FATF and BCBS standards, the new regime is already showing dramatic potential to reach previously unbanked and under-banked customers, reaching a total of 9.4 million Level 1 – 3 accounts in July 2012, following the enactment of the new regime in August 2011.

Pakistan: Pakistan's history of proportionate regulation to encourage financial inclusion got a major boost in 2001 with the adoption of a law allowing for the establishment of deposit-taking microfinance banks, with careful consideration given to BCBS's Core Principles. The regulatory framework has supported the creation of a micro-banking industry in Pakistan and facilitated the commercialization of microfinance through a multi-institutional approach, by encouraging the establishment of new Microfinance Banks (MFBs) at district, regional, provincial, and national levels, with varying capital requirements. The proportionate regulations have also created the opportunity for existing informal microfinance institutions/NGOs to transform into MFBs providing holistic financial services with scale and sustainability. MFBs have become an important part of Pakistan's financial system, contributing significantly to financial inclusion.

In 2008, regulation was adopted that permits all banks to transact business through agents and provides for simplified customer identification procedures for accounts with very low transaction limits, thus leveraging technology and agent networks for financial inclusion. Although the 2008 regulation did not permit mobile network operators (MNOs) to offer financial services directly, in 2009 Pakistan's central bank took the globally unprecedented step of permitting one of the country's largest MNOs to acquire a controlling stake in a microfinance bank with national coverage and an ambitious program to expand outreach through agents.

In June 2011, responding to data from the industry which showed how transactions limits and customer identification provisions for the simplest accounts were limiting their ability to reach unbanked customers, the State Bank of Pakistan adopted a tiered structure of accounts with increased transaction limits, making it easier for these customers to sign up for accounts and

[17] Proportionality and formalization are intertwined concepts, as proportionate regulation can be critical to formalization. Where regulatory and supervisory approaches are not proportionate, informal institutions may not be able to formalize.

improving the utility of the accounts. The result has been a significant increase in uptake for the MNO-controlled microfinance bank and the entry of the country's other large MNOs into similar business combinations. The market has seen two full-fledged branchless banking deployments offering financial services to the unbanked and low-income clients. Moreover, the regulator has adopted a "test and learn" approach to the deployment of branchless banking operations by allowing six additional banks to rollout pilots prior to their full-scale launch of the operations.

Philippines: The Philippines also offers an example of the 'test and learn' approach to adopting proportionate regulation that considers standards and guidance of the SSBs while also paying due attention to access barriers for unbanked and under-banked customers (such as limited penetration of formal IDs) and the commercial realities for service providers. After a thorough concept review to assure that e-money schemes proposed by the country's two largest MNOs (one bank-based and one MNO-based) each adequately addressed perceived risks and could be reconciled with both Philippine regulation and SSB standards and guidance, the Philippine central bank, Bangko Sentral ng Pilipinas, approved their launch on the condition that each furnish detailed operational data as the two systems were rolled out. Four years later, based on its observations of the market's development, the central bank issued in 2009 e-money regulations carefully tailored to the Filipino market realities. For example, the regulation was focused on the nature and characteristics of e-money as well as the requirements for the institutions that can issue the same, both banks and non-banks. The regulations made it very clear that e-money is a surrogate for cash and is not a deposit, thereby not earning interest and not insured by the deposit insurer. This delineation allowed a more flexible and proportionate approach in regulating such e-money issuers. The requirements for the issuers, particularly the non-banks, were also proportionate while taking into considerations all the risks identified after the full understanding of the business model and operations. These included capital requirements, liquidity requirements, transaction limits and consumer protection requirements among others. As a result, the policy and regulatory environment allowed the creation of an e-money ecosystem that can expand its touch points in areas that are underserved. Banks are also given the opportunity to become e-money issuers or create linkages with e-money service providers to expand the reach of their financial services using the e-money channel.

Part IV. Some Questions Meriting Further Consideration

- How should countries address differing assessments of risks and benefits of financial inclusion (bearing in mind that some benefits such as increased welfare, growth, and efficiency are not closely related to risk concerns of the SSBs)?

- How should countries gather the evidence base for proportionality analysis (particularly in capacity and resource constrained countries)?

- What risks does financial exclusion pose, and how should countries assess and factor them into their proportionality calculus?

- How does the changing nature (and potentially level) of risk associated with increased financial inclusion affect the proportionality calculus? How is this question different in the context of nonbank financial institutions targeting financially excluded populations and in the context of innovations such as e-money offered by banks and nonbanks through agents?

- What kind of guidance from SSBs on proportionality is needed to embolden countries not to refrain from applying the principle in practice, out of the fear of adverse assessments? What other actions may be needed, such as guidance and training for assessors?

- What specific challenges do countries face in adopting a proportionate approach across the full range of products that poor people want and need? Which of these challenges might be addressed through further guidance from the SSBs? Which of these challenges are associated with resource constraints, given the complexity of applying proportionality?

- What level and type of coordination among country-level policy, regulatory, and supervisory bodies is needed to implement proportionate approaches in practice in the context of the application of standards and guidance?