

# GLOBAL STANDARD SETTING BODIES AND FINANCIAL INCLUSION

Insights and lessons from five countries:  
Brazil, Kenya, Mexico, the Philippines, and South Africa



# ACKNOWLEDGEMENTS

This report was produced on behalf of the G20's Global Partnership for Financial Inclusion (GPFI) by the Alliance for Financial Inclusion (AFI) in its capacity as an Implementing Partner of the GPFI.

This report was supported by a grant from Australian Agency for International Development (AusAID), and its compilation was coordinated by Cenfri. The authors and coordinators are grateful to all who participated in its development.

*Disclaimer:*

Suggestions made in this document do not represent the official views of any of the regulatory authorities consulted. All errors and omissions are those of the authors.



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# Preface

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The multi-year Financial Inclusion Action Plan approved by the G20 Leaders at the November 2011 Seoul Summit recognizes the commitments of the global financial sector standard-setting bodies (SSBs) to “support financial inclusion” and encourages SSBs “to further explore . . . complementarities between financial inclusion and their own mandates.” This call culminates a period of rapid development in global recognition of the importance of access to formal financial services for the billions of people around the world who currently lack adequate access – and a period of growing recognition of the critical role the relevant SSBs can play in closing the financial access gap. To support the SSBs on this important subject, and to implement the Financial Inclusion Action Plan more generally, the G20 launched the Global Partnership for Financial Inclusion (GPFI), an inclusive platform for G20 and non-G20 countries as well as other relevant stakeholders committed to peer learning, knowledge-sharing, policy advocacy and coordination on financial inclusion.

In its first year, two projects have been undertaken on behalf of the GPFI pursuant to the G20 Leaders’ call for engagement with the SSBs: Five country case studies, prepared under the leadership of GPFI Implementing Partner the Alliance for Financial Inclusion (AFI), explore the application of the SSBs’ standards and guidance at the country level in countries at the forefront of pursuing a financial inclusion policy agenda: Brazil, Kenya, Mexico, the Philippines, and South Africa; and a White Paper entitled “Global Standard Setting Bodies and Financial Inclusion for the Poor – Towards Proportionate Standards and Guidance,” prepared under the leadership of GPFI Implementing Partner the Consultative Group to Assist the Poor (CGAP), raises awareness and frames issues to inform ongoing work by the five SSBs to integrate financial inclusion into standards and guidance that can be effectively applied at the country level.

Both the country case studies and the White Paper take stock of the accomplishments of the SSBs to date and further steps the SSBs are taking to foster a more enabling environment for financial inclusion. They also suggest further work related to the standards and guidance of the SSBs – by the SSBs, but also by the GPFI and its stakeholders, and others – that can advance this shared objective.

# 1. Introduction<sup>1</sup>

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Financial inclusion is rapidly moving up the policy agendas of many countries, particularly developing countries, reflected in the G20 Leaders' creation of a *Global Partnership for Financial Inclusion* (GPFI) at their summit in Seoul, Korea, in 2010. However, one of the obstacles to more effective and widespread financial inclusion is that the international standards that guide the delivery of financial services were originally conceived for financially advanced developed countries. Yet the practical realities in developing countries, which are home to more than 90 percent of the world's "unbanked" or "financially excluded", are often quite different than those of their more financially sophisticated peers.

Moreover, many developing countries are pioneering innovations in the field of financial inclusion, such as mobile banking, that are not always clearly addressed by the international standard setting bodies (SSBs). Financial inclusion's focus on large numbers of low-income individuals also presents challenges to traditional notions of international standard setting.

The G20 Leaders' Financial Inclusion Action Plan, endorsed at the Korean summit in 2010, recognizes these issues and encourages SSBs "to further explore... complementarities between financial inclusion and their own mandates."

To help SSBs and developing countries jointly unlock the full potential of financial inclusion, GPFI commissioned a study of the challenges and opportunities faced by five very different developing countries in applying the standards set by five main SSBs to financial inclusion policies. Specifically, the study set out to identify insights and lessons that could both help SSBs design more "financial-inclusion-friendly" standards and enable developing countries to find ways to implement financial inclusion policies more effectively within existing standards, while respecting the stability that these standards are designed to engender.

This report synthesizes the cross-cutting themes and implications for SSBs that emerge from the five country case studies. Both this report and the case studies that underpin it were produced on behalf of the G20's GPFI under the leadership of the Alliance for Financial Inclusion (AFI) in its capacity as an Implementing Partner of the GPFI.

These documents are complemented by a separate White Paper, "Global Standard Setting Bodies and Financial Inclusion for the Poor – Towards Proportionate Standards and Guidance," prepared under the leadership of GPFI Implementing Partner the Consultative Group to Assist the Poor (CGAP).

## Countries and SSBs studied

This document represents the synthesis of five country case studies, covering<sup>2</sup>:

- the Philippines;
- Mexico;
- Brazil;
- South Africa;
- Kenya.

The case study series examines the impact on financial inclusion in the domestic context of the following five international standard setting bodies (henceforth referred to as SSBs), their principles, standards and guidance:

- Basel Committee on Bank Supervision (BCBS);
- Financial Action Task Force (FATF) regarding anti-money laundering and combating the financing of terrorism;
- Committee on Payment and Settlement Systems (CPSS);
- International Association of Insurance Supervisors (IAIS); and
- International Association of Deposit Insurers (IADI).

## Structure of the document

The rest of this document outlines the membership of the respective countries to each of the SSBs. It subsequently provides an overview of the salient country features, the current impact of each of the SSBs on financial inclusion and the implications for the SSBs and their interaction with developing countries going forward:

- Section 2 gives an introductory overview of each SSB's engagement with financial inclusion to date, as well as of the domestic context in each of the countries and the standard-setting body membership of each.
- Section 3 provides country evidence on the impact of each individual SSB on financial inclusion and where further or more specific guidance is needed of that SSB.
- Section 4 unpacks the themes emerging across countries in order to conclude on the cross-cutting implications for SSBs.

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<sup>1</sup> Note that, unless otherwise stated, all information is sourced from the five country case studies and their respective sources. For each SSB, the document refers interchangeably to the principles, standards and guidance of the SSB and the impact of the SSB itself.

<sup>2</sup> The individual case studies were prepared based on a detailed questionnaire completed by the regulators in each country, as well as follow-up interviews to explore their views and insights.

## 2. About the SSBs and countries studied

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### 2.1. SSBs and financial inclusion<sup>3</sup>

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#### Basel Committee on Banking Supervision (BCBS)

The objective of the BCBS is to enhance common understanding of key bank supervisory issues and improve the quality of bank supervision around the world. Toward this end, the BCBS sets standards and issues guidance for deposit-taking institutions (primarily banks) with a focus on systemic stability. It issued Core Principles on Effective Banking Supervision in 2006. In addition, the Basel Accord (with consecutive rounds referred to as Basel I, Basel II and, most recently, Basel III) set the international standard for banking supervision.

Several recent developments of relevance to financial inclusion have changed “business as usual” for banks and other deposit-taking institutions – and thus for regulators and supervisors overseeing the sector. This includes the expansion of bank branch networks and a growing diversity in the types of institutions in the market through the introduction of new delivery channels, products and providers (such as mobile payment systems and e-money) that challenge traditional definitions of deposit-taking and the business of a bank.

Traditionally, the BCBS has been focused on systemically important financial institutions and on customers that are already included in the formal financial system. However, the implications for a broader financial inclusion agenda will be discussed in the current process of revising the BCBS Core Principles. The BCBS has also issued guidance of relevance to financial inclusion in the form of a 2010 paper titled *Microfinance Activities and the Core Principles for Effective Banking Supervision*.

#### Committee on Payment and Settlement Systems (CPSS)

The principles governing the payments system landscape, internationally, are contained in the 2001 CPSS *Core Principles for Systemically Important Payment Systems*.

The CPSS is relevant for financial inclusion in that the implementation of the relevant CPSS standards and guidance should allow a greater proportion of the population to benefit from better quality payment services and at a lower cost. Although the CPSS has historically focused on systemically important payments systems and high-value payments, it has in recent years been more involved with the issue of

safe, modern and cost-efficient retail payment systems and instruments. This has brought financial inclusion-relevant innovations in payment models (including new delivery channels, new technologies and the rise of e-money) into the ambit of the CPSS. The CPSS has embarked on various financial inclusion-related work streams. Amongst others, it issued joint General Principles for International Remittance Services with the World Bank in 2007. In 2010, it formed a Working Group on Innovation in Retail Payments.

#### Financial Action Task Force (FATF)

FATF is the standard-setting body in the sphere of anti-money laundering and combating the financing of terrorism (AML/CFT). International norms are laid down through its 40 Recommendations on Money Laundering and 9 Special Recommendations on Terrorist Financing. Traditionally focusing on high-risk areas in the domain of the financially included, FATF has recently formally acknowledged the fact that financial exclusion can have adverse implications for financial integrity. Therefore, financial inclusion (by bringing more customers and transactions from the untraceable, opaque world of cash, into the traceable, transparent world of formal financial services) is complementary to FATF’s core objective of combating money laundering and terrorist financing. This stance is formalized in FATF’s groundbreaking *Guidance Paper on AML/CFT and Financial Inclusion*, published in June 2011.

#### International Association of Insurance Supervisors (IAIS)

International standards with regard to insurance supervision are contained in the 2003 IAIS *Insurance Core Principles and Methodology* (currently being revised). The IAIS has both a broad membership (including many jurisdictions with high levels of financial exclusion) and a strong market-development mandate. This means that financial inclusion is a central objective of the IAIS. Insurance supervision has largely arisen in order to protect consumers; therefore the IAIS differs from other SSBs who approach their mandates largely from a prudential or systemic stability standpoint.

The IAIS recognizes the need to extend conventional insurance to reach excluded and under-served populations as well as the need to bring existing informal providers under the umbrella of supervision and into the realm of compliance through the Insurance Core Principles (ICPs). Through its Joint Working Group with the Microinsurance Network, it

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<sup>3</sup> This section draws on the forthcoming CGAP White Paper, which should be consulted for a more detailed overview.



issued a paper titled *Issues in the Regulation and Supervision of Microinsurance* in 2007, followed by another *Issues Paper on the Regulation and Supervision of Mutuals, Cooperatives and other Community-based Organisations in Increasing Access to Insurance Markets* in 2010. It is currently working on *Guidance on Regulation and Supervision Supporting Inclusive Insurance Markets*.

### International Association of Deposit Insurers (IADI)

IADI, together with the BCBS, issued a set of *Core Principles for Effective Deposit Insurance Systems* in June 2009.

IADI's basic mission of financial stability is highly compatible with financial inclusion. Explicit deposit insurance systems can play a potentially significant role in protecting consumers, increasing confidence in the banking sector and ensuring that low-income depositors are informed about safe methods of storing their money. In 2010, IADI formed a *Financial Inclusion and Innovation Subcommittee* to serve as a forum for members to discuss financial inclusion and deposit insurance issues (for example, expanding deposit insurance coverage to include non-traditional banking products). The Subcommittee recently launched a worldwide survey to measure the range of practices that relate to deposit insurance and financial inclusion.

## 2.2. Domestic context shapes priorities and challenges

Each of the five country narratives plays off against a unique financial sector backdrop. The domestic context will shape the priorities and challenges for regulators as well as their interaction with the international SSBs and standards. Here we give a brief summary of the financial inclusion context in each country. The reader is referred to the individual case studies for a more in-depth overview.

### Brazil

*Balancing financial inclusion and caution.* Regulators in Brazil regard financial inclusion as complementary to the pillars of stability and efficiency in the financial system. Although there is no official financial inclusion policy as yet in Brazil, it is viewed as an important element of government's broader emphasis on social inclusion. Various initiatives, from creating a special prudential regime for credit cooperatives, to creating a simplified bank account, to implementing regulation that has enabled the rolling out of more than 150,000 bank agents (called banking

correspondents), and to creating proposals for a micro-insurance regulatory framework, have combined to entrench the commitment to financial inclusion. The Central Bank of Brazil will now coordinate efforts through the creation of a National Partnership for Financial Inclusion planned for late 2011.

Due to a history of macroeconomic shocks in the country, supervisory entities have placed emphasis upon a cautious approach to financial regulation, often adhering to or exceeding international standards. Therefore, financial inclusion has been balanced alongside the self-enforced requirement to first and foremost adopt a cautious approach in policy and regulatory development.

### Kenya

*Broadening and deepening its financial sector, mobilized by electronic payment innovation.* Financial inclusion is a national priority in Kenya. It is unique among the case study countries in that the financial inclusion agenda in the country has been dominated by non-bank financial service providers. These non-bank providers include the internationally acclaimed M-PESA and other mobile money initiatives, savings and credit cooperatives (SACCOs) as well as micro-finance institutions (MFIs). Innovative electronic payment systems such as M-PESA have been instrumental in driving financial inclusion forward and have helped mobilization of other initiatives among banks, culminating in a broader expansion of financial services. Kenya has also seen significant innovation in micro-insurance to reach into the unserved market.

### Mexico

*Government-led promotion of financial inclusion.* Like Brazil, Mexico has followed a cautious approach in financial sector regulation, prompted significantly by the Tequila crisis of the mid-1990s which led to a series of reforms. At the same time, Mexico has had a long history of government financial inclusion policies in order to trigger a financial inclusion-friendly response from industry. Policies that have been instrumental to enhanced financial inclusion have included credit union regulation as well as campaigns to strengthen consumer protection and enhance financial literacy and information transparency. The government has encouraged the entry of new players to increase and complement banking infrastructure and to promote basic financial products. The state has also extended banking infrastructure, including an innovative electronic payment systems program. In 2009, regulation was introduced to allow non-financial entities to serve as banking agents.

## Philippines

### *Enshrining financial inclusion in government policy.*

Financial inclusion forms an element of The Philippine Development Plan (PDP) 2011-2016, the government's blueprint reform agenda. The PDP explicitly promotes equitable access to financial services and financial inclusion for enhanced financial sector development. It articulates the provision of a wide range of financial services (credit, savings, payment services, insurance, and innovative products) to serve the demands of different market segments, the development of financial products that are appropriately designed, priced and tailor-fitted to market needs and capacities; the participation of a wide variety of strong, sound and duly authorized financial institutions utilizing innovative delivery channels to provide financial services to more Filipinos; and the effective interface of bank and non-bank products/delivery channels, technology and innovation to reach the financially excluded. The Filipino government has also made measurement of financial inclusion a key priority as part of the 2011-2016 timeframe.

## South Africa

*A public and market commitment to financial inclusion.* In the post-apartheid era following 1994, the South African government has placed increasing emphasis on financial inclusion as part of its broader focus on empowering the previously disenfranchised. In 2003, industry and government negotiated a Financial Sector Charter whereby the financial sector committed itself to certain financial access targets. The Charter triggered various innovative financial inclusion initiatives among the banking and insurance sectors. Commitment to financial inclusion has also grown beyond the Charter, with industry now regarding

financial inclusion as a core business strategy. The urgency to reach into the unserved market has increased in line with enhanced competition from new entrants and new payments and other technologies. At the same time, the post-1994 era saw a strong drive for international integration. This created an imperative to adhere to international standards.

## 2.3. Standard-setting body membership

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Not all of the countries are members of all the SSBs: the Philippines, for example, is not a direct member of any of the SSBs (though it belongs to a FATF-style regional body and keeps abreast of BCBS programmes through the Basel Consultative Group for non-members), while Kenya is a member only of the IAIS and IADI (it also belongs to a FATF-style regional body). Mexico and Brazil are members of all the SSBs and South Africa is a full member of all but IADI, where it is an associate member.

Brazil, Mexico and South Africa became members of the BCBS and CPSS in 2009 as part of these bodies' membership expansion drive in light of the lessons from the global financial crisis, but have been FATF members since the early 2000s. All countries bar South Africa and the Philippines are founding members of IADI. Membership of the IAIS (to which all countries bar the Philippines belong) has likewise been longstanding. The exception is Kenya and the Brazilian health regulator, ANS, both of which gained membership only in 2007.

Standard-setting body membership across the five country case studies are summarized in table 1 on the following page:



Table 1. Overview of Standard-Setting Body membership across the five countries

|             | BCBS  | CPSS  | FATF  | IAIS  | IADI  |
|-------------|---|---|---|---|---|
| Brazil      | <ul style="list-style-type: none"> <li>● Member since 2009</li> <li>● Started implementing Basel accords already in the 1990s</li> </ul>  | <ul style="list-style-type: none"> <li>● Member since 2009</li> <li>● Participates in the Working Group on Innovation in Retail Payments and several other working groups in retail space.</li> </ul>   | <ul style="list-style-type: none"> <li>● Member since 2000</li> <li>● Participates in FATF working groups e.g., the International Cooperation Review Group and the Implementation Working Group</li> </ul>  | <ul style="list-style-type: none"> <li>● Private insurance regulator (SUSEP): <b>member since 1996</b>. Currently chairs the IAIS-Microinsurance Committee</li> <li>● Health insurance regulator (ANS): <b>member since 2007</b>, sits on solvency committee</li> </ul> | <ul style="list-style-type: none"> <li>● <b>Founding member (since 2002)</b></li> <li>● Part of IADI's Board of Directors</li> <li>● Participates in thematic peer review of deposit insurance systems benchmarked on the Core Principles</li> </ul>  |
| Kenya       | <ul style="list-style-type: none"> <li>● <b>Not a member</b>, but regulators participate in training events hosted by the Financial Stability Institute (FSI) and provide comments on draft BCBS pronouncements</li> </ul>                                  | <ul style="list-style-type: none"> <li>● <b>Not a member</b> and no official interaction</li> <li>● Implicit adherence to the Core Principles for Systemically Important Payment Systems in terms of high-level guidance on payment system structure and appropriate legislation</li> </ul> | <ul style="list-style-type: none"> <li>● <b>Not a direct member</b>, but is a founding member of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), which is an associate member of FATF.</li> </ul>                                      | <ul style="list-style-type: none"> <li>● <b>Member since 2007</b></li> <li>● Participates in working groups</li> </ul>  | <ul style="list-style-type: none"> <li>● <b>Founding member (since 2002)</b></li> <li>● Active committee participation (Audit, Research)</li> <li>● Participated in developing core principle application methodology, as well as methods for assessment of principle implementation</li> </ul> |
| Mexico      | <ul style="list-style-type: none"> <li>● Member since 2009</li> </ul>   | <ul style="list-style-type: none"> <li>● Member since 2009</li> </ul>   | <ul style="list-style-type: none"> <li>● Member since 2000</li> <li>● Member of FATF-style regional body in South America (GAFISUD)</li> <li>● Held FATF presidency in 2010</li> </ul>  | <ul style="list-style-type: none"> <li>● Member since 1994</li> <li>● Participates in Executive Committee, Technical and Implementation Committees, Supervisor Cooperation and Education Subcommittees</li> </ul>   | <ul style="list-style-type: none"> <li>● Member since 2002</li> </ul>   |
| Philippines | <ul style="list-style-type: none"> <li>● <b>Not a member</b>, but actively involved in the Basel Consultative Group for non-BCBS member countries</li> <li>● Central Bank participates in work stream that is revising the Basel Core Principles</li> </ul> | <ul style="list-style-type: none"> <li>● <b>Not a member</b>, but standards are consulted and at times implemented in drafting regulatory frameworks, as well as during the regulatory implementation phase</li> </ul>  | <ul style="list-style-type: none"> <li>● <b>Not a direct member</b>, but founding member of the Asia Pacific Group (APG) as FATF-style regional body</li> <li>● Central Bank participates in work stream that is revising the FATF recommendations</li> </ul> | <ul style="list-style-type: none"> <li>● <b>Not a member</b>, but standards are consulted and at times implemented in drafting regulatory frameworks, as well as during the regulatory implementation phase</li> </ul>  | <ul style="list-style-type: none"> <li>● <b>Not a member</b>, but standards are consulted and at times implemented in drafting regulatory frameworks, as well as during the regulatory implementation phase</li> </ul>  |

|              | BCBS  | CPSS  | FATF  | IAIS  | IADI   |
|--------------|---|---|---|---|--|
| South Africa | <ul style="list-style-type: none"> <li>● Member since 2009, but continuously followed and closely aligned policies and procedures with guidance and principles issued by the BCBS since the 1990s</li> <li>● Participated in sub-working groups (e.g. Validation, Operational Risk and Trading Book) before becoming member.</li> </ul> | <ul style="list-style-type: none"> <li>● Member since 2009</li> <li>● Before becoming a member, participated in various workgroups</li> </ul> | <ul style="list-style-type: none"> <li>● Member since 2003, held presidency in 2005/6</li> <li>● Member of ESAAMLAG</li> <li>● Participates in working and review groups as well as on various projects and mutual evaluations</li> <li>● Active participant in FATF's guidance paper on financial inclusion</li> </ul> | <ul style="list-style-type: none"> <li>● Founding member (since 1994), current member of the Executive Committee</li> <li>● Participates in a number of committees and sub-committees, including the IAIS Sub-Committee on Solvency and Actuarial Issues</li> <li>● Active participant in IAIS micro-insurance discussions</li> </ul> | <ul style="list-style-type: none"> <li>● Associate member</li> <li>● Uses IADI principles as a basis for reviewing the need for deposit insurance in the country.</li> </ul> |

Source: country case study questionnaires

### 3. The impacts of individual SSBs on financial inclusion

This section considers the impact of each SSB on financial inclusion according to the evidence gathered from the five country studies<sup>4</sup>. Each sub-section starts with a box that highlights the main message with regard to the particular SSB in the form of a summarizing statement that aims to capture the cross-country voice on a particular SSB and its impact on financial inclusion. Furthermore, the box highlights the key implications for the particular SSB in terms of supporting financial inclusion going forward.

#### 3.1. Basel Committee on Bank Supervision (BCBS)

##### Summary

##### Cross-country view of BCBS

*“The principles are quite general and not that challenging for financial inclusion. But how exactly do we apply proportionality in the risk-based capital framework and how do we keep up with growing complexity?”*

##### Where is specific BCBS guidance needed?

- How to create a regulatory framework that can accommodate non-bank financial institutions as well as non-financial institutions as providers of financial services?
- How to implement the Basel Accords in the face of capacity constraints at the level of the supervisor as well as of market operators?

<sup>4</sup> The reader is referred to the individual case studies for a more precise overview of the issues and context in each country.

## Assessment of BCBS

*None of the countries consider that the Basel Core Principles (BCPs) adversely impact financial inclusion.* Banking regulators and supervisors<sup>5</sup> across the five countries concurred that the Basel Core Principles themselves do not pose a barrier to financial inclusion. The principles are set at a general level and have allowed countries the leeway to implement a tiered regulatory system for banks and microfinance providers such as credit cooperatives.

Nevertheless, there is a sense across the sample countries that the need to promote financial inclusion means that “business as usual” in terms of banking supervision is no longer sufficient. Increasing complexity of standards under the Basel Accords creates compliance challenges for financial inclusion-relevant, smaller entities and new, unconventional entrants. This challenges traditional banking supervision paradigms.

Below we first consider the various challenges highlighted by the country case studies, before moving on to the implications for BCBS stemming from the country experience.

*Considering systemic importance on the basis of ‘size’ may not be sufficient.* Given the traditional focus on prudential risk, Basel principles consider the size of the institution (in terms of assets, operations and volumes of transactions), rather than the number of clients served in considering what would be systemically important. The issue of financial inclusion, however, at its core deals with the number of people served, regardless of the size of the institution. The focus on size makes it difficult for regulators and supervisors to prioritize entities that may be small in terms of assets or volumes, but that together have large client bases. Yet such organizations may have systemic impact in terms of trust in the system among a significant proportion of clients, or in terms of the exposures that they entail for larger institutions who lend to them.

*Capacity constraints make it difficult to stay up-to-date with evolving standards.* Each new round of Basel Accord introduces added complexity. In capacity constrained regulatory and supervisory environments, international standards may be difficult to implement fully, a phenomenon that is exacerbated by the relatively short period of time over which the progression from Basel I, to II, to III took place. Developing countries with capacity constraints struggle to keep up to date. The increasing complexity of standards not only has regulatory and supervisory capacity implications, but

also challenges the capacity of financial institutions in resource-constrained developing countries. The Brazilian regulators, for example, explained that Basel III is simply not feasible for all entities in the developing country context, as it is tailored in the first instance to large international financial institutions.

*Increased complexity underscores the need for guidance on proportionality.* Proportionality and a risk-based approach are inherent to many of the SSBs’ standards and guidance, but the focus thus far has largely been on increased regulation for higher-risk, systemically important areas, rather than guidance on reduced regulation for low-risk, low-income focused products (the latter being the domain of financial inclusion). All the countries emphasize the need for guidance on how to apply low-risk proportionality in the face of increased complexity of standards, given the capacity constraints found in developing countries. This applies to BCBS as well as to other SSBs. For example, in implementing BCP 7 (Risk management process)<sup>6</sup>, which asks for a “comprehensive risk management process”, the Philippines regulators noted that the question arises of what constitutes a “comprehensive” risk management process. When is a risk management system acceptable from a proportionality point of view? How do you effectively implement this principle? These are some of the practical questions developing country regulators and supervisors are grappling with.

*Guidance on proportionality in microfinance is starting to have an effect.* Microfinance is a good example of where a proportionate supervisory approach that focuses on clients rather than assets is called for. Mexico, for example, has implemented various attempts at appropriately accommodating credit unions and other non-bank financial providers. It employs a tiered system for credit unions, MFIs and so-called popular finance organizations (Sofipos). The tiered system distinguishes according to asset size; the smallest and least complex entities have a much simpler regulatory burden, consistent with their risk profile.

The August 2010 BCBS paper titled *Microfinance activities and the Core Principles for Effective Banking Supervision* was developed in response to the BCP recommendation that regulation of non-banks should be commensurate to the type and size of their transactions and should weigh the risks posed against supervisory costs and the role of microfinance in fostering financial inclusion. The paper therefore represents guidance for the application of the BCPs to micro-insurance activities (BCBS, 2010). Brazil is one

<sup>5</sup> Note that we separate regulation from supervision: the former connotes developing the regulatory frameworks, whereas the latter relates to on-going monitoring and supervision.

<sup>6</sup> BCP 7 reads: “Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.”

country example of where the paper did have its intended effect: the Brazilian central bank considered the paper in developing their prudential regime for credit unions to ensure that their approach will be acceptable. However, some regulators were not fully aware of its contents, indicating that the publication of the paper has not fully flowed through to country-level implementation.

*The developing country context matters when enacting standards.* Another area where proportionality comes into play is in the application of standards in the developed versus the developing country context. The case studies show that in some instances the financial sector is still underdeveloped, in others there may be a dual market with one part well developed, but another part consisting of new, small or largely informal players. Combined with the capacity constraints referred to above, this means that a regulatory framework suitable at the developed country level cannot simply be carried over into the developing country context. The standards allow for context-specific flexibility by incorporating space for proportionality. Yet, while standards are accommodating at the principles level, the system may in practice incentivize the adoption of conservative approaches at country level. Tailoring of standards require particular up-front capacity of regulators, which is not always available.

In practice, countries are assessed in terms of their compliance with the principles and recommendations are generated on areas for improvement towards compliance. Regulators then set out to draft regulation that aligns with international standards. In a capacity constrained environment, consultants are often employed to redraft regulation – typically using example regulation from compliant countries, usually developed countries, as a basis. The resultant “copy and paste” exercise may be ill suited to the particular developing country context.

*Integrating non-bank players into regulatory framework creates challenges.* New players and models, particularly in the payment space, are changing the overall risk landscape for bank supervision. On the one hand, this creates a challenge for regulators and supervisors in dealing with new players (they may not even have the mandate to regulate such entities) and on the other hand it blurs

the lines of demarcation between banking supervision and payment system supervision. For example, the Philippines, Kenya and Brazil case studies indicate that the Basel Core Principles do not yet specifically address the prudential regulation and supervision of non-bank entities and the evolving nature of the definition of deposit-taking – issues that all of these countries are faced with in practice. This requires a reconsideration of the definition and associated issues around deposit-taking under Principle 2 (*Permissible activities*)<sup>7</sup>. New players and models also have implications for BCPs 7 (*Risk management process*), 19 (*Supervisory approach*)<sup>8</sup> and 24 (*Consolidated supervision*)<sup>9</sup>, where the definition of “banking group” referenced in these BCPs needs greater clarity with regard to the role of non-bank entities.

*Lines of delineation are becoming unclear.* As discussed above, the lines of delineation between deposit taking and payments are increasingly blurred. Another area where there are overlaps between the mandates of different SSBs is with regard to “know your client” (KYC requirements) under BCP 18 (*Abuse of financial services*)<sup>10</sup>. The client identity verification requirements under Principle 18 can prove challenging in countries without a national identity system, or where many citizens may find it difficult to prove residential address through conventional means (this was raised as a particular issue in the Kenyan case study). The FATF recommendations and financial inclusion guidance also talk to these issues.

### Implications for BCBS to consider

The country experience outlined above has a number of implications for the BCBS:

*Provide more developing country examples of acceptable proportionality.* Recognizing that developing countries with more limited supervisory resources may find it difficult to tailor international standards to domestic realities, the BCBS should seek out and devise more examples of compliant developing country models of proportionality that could be used as a basis for more tailored implementation among developing countries. Such examples need to address (i) capacity constraints and (ii) domestic priorities, as well as informing the specific approach taken.

<sup>7</sup> BCP 2 reads: “The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.”

<sup>8</sup> BCP 19 reads: “An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.”

<sup>9</sup> BCP 24 reads: “An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis,

<sup>10</sup> BCP 18 reads: “Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities and “adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.”

*Acknowledge the role of non-traditional players and models.* The BCPS should explicitly acknowledge the role of non-bank financial institutions as well as non-financial players, for example telecommunications companies or others providing payment services. Accommodating the latter may require reviewing the mandate of the central bank, as it does not traditionally extend beyond certain defined categories of deposit-taking institutions. Some of these alternative providers are quite large and can pose systemic risks. Furthermore, even if they do not present a risk to the financial system on an individual level, systemically important banks may have significant exposures to such non-bank providers. Finally, these non-traditional players often serve large numbers of clients and are, therefore, important from an inclusion perspective. Guidance from the BCBS is needed to explicitly fit these non-traditional players into the regulatory framework (this includes aspects of BCPs 2, 7, 19 and 24 as noted above).

*Recognize the “risk of the many” and not just the “risk of the large”.* Related to the previous point is the need for a fresh view of systemic importance: review the risk framework and approach to accommodate the systemic implications of institutions with many low-value clients (what we term “the risk of the many”), in addition to the focus on systemic importance in terms of assets and size of operations (the “risk of the large”). Develop guidance to explicitly fit these entities into a proportionate regulatory framework (this includes aspects of BCP 7 as noted above).

*Coordinate with other SSBs.* The country case studies highlight the need for increased coordination between the BCBS and CPSS where matters regarding the blurring lines between jurisdictions and in the delineation between payments and deposits is concerned. Coordination between BCBS and FATF with regard to requirements for client identification will also be welcomed. There is furthermore overlap between prudential supervision under the BCBS mandate and deposit insurance. There is already close cooperation between BCBS and IADI. This cooperation can be extended to the topic of financial inclusion.

*Disseminate guidance on financial inclusion more widely.* The consultations showed that some regulators were not even aware of all the latest BCBS guidance (for example the 2010 paper titled Microfinance Activities and the Core Principles for Effective Banking Supervision). This highlights the need for better dissemination of guidance and information produced by the SSBs to make sure that they reach their intended purpose and a wide audience, also beyond the member countries.

## 3.2. Financial Action Task Force (FATF)

### Summary

#### Cross-country view of FATF

*“Will our risk-based approach be considered appropriate?”*

#### Where is specific FATF assistance required?

- Defining low risk and guiding countries in appropriately identifying low levels of risk.
- Embed financial inclusion in the FATF evaluation methodology.
- Clarify the risk assessment and mitigation of terrorist financing risk in relation to financial inclusion products.

### Assessment of FATF

In this section, we explore the perceived impact of the FATF standards on financial inclusion efforts in the case study countries. Based on this, we then suggest possible actions for the FATF to create a more enabling environment for financial inclusion in the context of anti-money laundering and combating the financing of terrorism (AML/CFT) regulation.

*Penalties for non-compliance are substantial.* All country case studies identified the FATF as the SSB with the most significant impact on regulatory innovation in relation to financial inclusion. The degree of impact is mainly driven by concerns regarding the substantial potential penalties for non-compliance with the FATF Recommendations. The FATF framework is the only standards surveyed in this study with significant punitive measures for non-compliant jurisdictions, most notably the potential loss of correspondent banking relationships. These punitive measures may apply to members as well as non-members. Such penalties may have far-reaching economic impacts on the non-compliant country if it results in economic and financial isolation. As a result, regulators are understandably hesitant to adopt measures that may expose their countries to reputational damage and the potential loss of corresponding banking relationships.



*Financial inclusion impact and alignment are recognized.* AML/CFT measures are of direct relevance to financial inclusion. This was recognized by the FATF in its recent guidance paper on financial inclusion<sup>11</sup>. Overly-conservative national AML/CFT requirements, in particular customer due diligence requirements, face-to-face origination principles and record-keeping rules, may present barriers for many potential new customers in developing countries, increase transaction costs and inhibit financial inclusion innovations. The FATF guidance paper also recognizes that financial inclusion and AML/CFT are pursuing complementary national policy objectives. Financial inclusion provides consumers with more secure financial services, thereby shrinking the cash economy. This in turn mitigates the AML/CFT risks relating to financial exclusion.

*A risk-based approach can mitigate negative financial inclusion impact.* In principle, financial inclusion and AML/CFT policy objectives can be aligned effectively by implementing a risk-based approach. The current version of the FATF Recommendations allows countries to adjust the level of AML/CFT countermeasures to the money laundering or terrorist financing risks posed by particular products, clients and countries. Where risk is lower, simplified due diligence measures that can facilitate financial inclusion may be employed.

The Philippines' implementation of a new AML/CFT circular (Circular 706) in January 2011 provides an example of such an approach. Relying on an appropriate and comprehensive risk assessment that informs it, the circular provides for a simplified, risk-based approach to customer due diligence (CDD), with reduced CDD for low-risk clients and enhanced CDD for high-risk clients. It also allows for the outsourcing of face-to-face CDD in account origination, provided that the outsourcing arrangement is formally documented, and subject to existing outsourcing rules. In addition, it allows for banks to rely on the representation of a third-party that has already conducted face-to-face account origination for its own customers. Given that Circular 706 and related recent initiatives manage the risk of financial exclusion while still adhering to the requirement for appropriate CDD, the Filipino regulators expect that their approach will be endorsed when they are subjected to a FATF mutual evaluation.

Another example of risk-based, tiered AML/CFT requirements that are explicitly aimed at facilitating financial inclusion stems from Mexico. Five account categories were introduced with category one being the most restrictive and, therefore, the lowest risk and category five being the least restrictive and, therefore, the highest risk category from an AML/CFT

perspective. Following a risk-based approach, CDD requirements were proportionally adjusted across these tiers. The first four account levels all have differing levels of simplified procedures and are subject to different balance and transaction limits. Only the first level is anonymous, but with various restrictions regarding uses and payment mechanisms. The fifth level, for accounts without any limits, is subject to full CDD requirements. The Mexican authorities are confident that these CDD requirements comply with FATF requirements, as the Mexican approach was used as an example of inclusion-friendly compliance in the aforementioned FATF financial inclusion guidance paper.

*Countries with the most severe compliance challenges are not part of key FATF discussions.* Much of the development and understanding of the risk-based approach is achieved within FATF member discussions. Although the FATF published guidance notes on the risk-based approach, different evaluation approaches by, for example, different teams of assessors reflect the lack of alignment around key elements of the approach. While discussions continue within the FATF membership, countries that are not party to those processes find it challenging to anticipate how the FATF will view elements of risk-based approaches that they employ.

While Brazil, South Africa and Mexico are active FATF members and have all held the FATF presidency at different stages<sup>12</sup>, the Philippines and Kenya are not members of the FATF and exemplify the membership challenge. They are active members of their FATF-Style Regional Bodies (FSRB), namely the Asia/Pacific Group on Money Laundering (APG) in the case of the Philippines and the Eastern and Southern African Anti-Money Laundering Group (ESAAMLG) in the case of Kenya, but being one step removed from key FATF discussions poses a challenge to them. Many issues pertinent to financial inclusion are discussed formally and informally at FATF meetings and those who cannot actively participate in such meetings do not have the same information or confidence in their knowledge as actively-participating member countries.

*Countries find it difficult to present credible risk evidence that supports low-risk categorization.* In the FATF evaluation process the country carries the burden to provide evidence supporting why particular products, services or providers were classified as posing a "low risk". A country that wishes to adopt a risk-based approach must undertake a credible national risk assessment. The national risk assessment should inform more detailed business and product risk assessments. Risk assessments are ideally informed by data and statistics relating to crime. The evaluators consider the quality and rigour

<sup>11</sup> FATF Guidance: Anti-money laundering and terrorist financing measures and Financial Inclusion, FATF/OECD, June 2011. Available at: <http://www.fatf-gafi.org/dataoecd/62/26/48300917.pdf>

<sup>12</sup> South Africa recognizes its membership and presidency of FATF in 2005/06 as a key factor contributing to its confidence to enact inclusion-friendly exemptions, while Mexico's presidency of FATF in 2010/2011 provided it the opportunity of formally introducing the topic of financial inclusion into the FATF. Brazil held the FATF presidency in 2008/2009.



of the risk assessment when they assess the country's risk-based approach. Developing countries grapple with the challenge of accurate collection and collation of risk data.

For example: Kenya was recently listed by the FATF as one of a number of countries with "strategic deficiencies" in its AML/CFT framework. That means that Kenya has not yet made sufficient progress to move towards compliance with key FATF Recommendations. At the same time, Kenya needs to adopt a risk-based approach to support its financial inclusion initiatives. Due to the absence of sound data on the risk levels associated with certain products or providers, Kenya has been hesitant to exempt or impose lighter CDD requirements for transactions below certain thresholds conducted through foreign exchange bureaus.

*Concerns were expressed regarding the correct categorization of "low" risk.* Although the FATF endorses a risk-based approach and recognizes the importance of financial inclusion as complementary to AML/CFT objectives, it has not provided sufficient clarity regarding the concept of "low" risk or the definition of "risk" itself. In the absence of conceptual clarity, countries risk being rated negatively on elements of their risk-based approach. This happened, for example, during Brazil's 2010 mutual evaluation, where it was rated partially compliant on a number of Recommendations (including in relation to Recommendation 5 on Customer Due Diligence and Recommendation 23 on Regulation, Supervision and Monitoring) and was not successful in defending its risk-based approach to the evaluators. Brazil, but also other developing countries, will find it beneficial if the FATF provided more certainty regarding its views of the concept of "low risk". It is also critical that the ultimate position should be integrated into the mutual evaluation assessment criteria.

*Assessment criteria do not accommodate proportionate approaches to financial inclusion.* While the risk-based approach is accepted and financial inclusion is referenced as an important issue by the FATF, this is not yet comprehensively factored into the assessment criteria applied in mutual evaluations. In the 2010 mutual evaluation Brazil, as mentioned above, unsuccessfully defended elements of its risk-based approach to the evaluators and was rated partially compliant on Recommendation 5 on CDD and Recommendation 23 on Regulation, Supervision and Monitoring. Similarly, South Africa's Exemption 17 that allows for simplified CDD on low-transaction products was listed as one of the exemptions that erode South Africa's ability for effective record keeping with regards to client identification and verification (Recommendation 5) in its 2009 mutual evaluation report. Despite its negative comment about Exemption 17, the FATF's guidance paper on financial inclusion highlighted it as an example of good practice with regards to a simplified CDD regime. Both cases highlight the need for a clear and consistent assessment of a risk-based approach in the mutual evaluation methodology.

*The challenge of applying the risk-based approach to CFT.* While money laundering often involves large amounts, the FATF points out that terrorist financing often involves low value transactions. While transaction value may be a key factor in judging the money laundering risk of products and services, it is not necessarily helpful in respect of terrorist financing risk assessment. The FATF provided guidance on a risk-based approach to money laundering but has been more reticent to provide guidance on terrorist financing risk assessment.

Regulation that is designed to mitigate money laundering risk may therefore be held to be ineffective in relation to terrorist financing risk. This is a particular concern of Kenya on the implementation of terrorist financing legislation. Kenya faces the double challenge that it is internationally perceived to be subject to high terrorist financing risk, while at the same time also wanting to develop its financial sector to extend financial inclusion. In the absence of clarity regarding the risk assessment and mitigation of terrorist financing risk in relation to financial inclusion products, countries such as Kenya find it challenging to design regulatory frameworks that mitigate both ML and TF risk while facilitating financial inclusion.

### Implications for FATF to consider

The country case studies suggest a number of possible actions for the FATF to create a more enabling environment for financial inclusion in the context of AML/CFT regulation. We explore these possible actions in greater detail below.

*Create FATF-supported discussion platforms on compliance issues facing developing countries with some platforms particularly focusing on financial inclusion.* Country regulators mentioned that the challenges of meeting the FATF standards extend beyond financial inclusion and that discussion on the broader issues of compliance is also required. These discussions should not be training events but workshops where mutual problems and practical solutions can be discussed. It may also be helpful to create opportunities where the private sector can be included in compliance analysis forums. Such forums are ideally established by the FATF-style Regional Bodies (FSRBs) but discussions ranging beyond regional borders are also required. These discussion forums should especially include developing countries and those who are identified by the FATF as countries with strategic deficiencies.

*Build a compliance evidence base in developing countries.* This will entail identifying best practice compliance efforts by developing and developed countries in managing financial exclusion risk as part of compliance with the AML/CFT standards as was recently done in the FATF's guidance paper on financial inclusion. These approaches may not carry formal FATF endorsement but may be endorsed as legitimate efforts in applying the recommendations. Best practices in challenging areas such as dealing

with CFT or non-face-to-face origination of financial products should be prioritized in this evidence base.

*Embed financial inclusion in the FATF evaluation methodology.* The experiences of some of the case study countries indicate a need to embed a risk-based approach better in the FATF mutual evaluation methodology. The amendment of the methodology following the current revision of the Recommendations would provide an ideal opportunity to do so.

*Guide countries to consider financial exclusion risk mitigation when designing new AML/CFT regulation.* The FATF identified financial exclusion as an AML/CFT risk. Official guidance to ensure that regulators consider this risk when designing new AML/CFT laws will assist in aligning financial inclusion and financial integrity policies. Additional guidance on matters to be considered in relation to financial exclusion would also be beneficial.

*Guide countries to gauge low levels of risk appropriately.* The country experiences reviewed in the case studies suggest that regulators struggle with the concept and definition of risk and, specifically, with the meaning of “low risk”. Cautious regulators equate low risk with a total absence of any risk. Unpacking the concept of “low risk” will assist countries in understanding the tolerance levels for “low risk” products, providers and services.

### 3.3. Committee on Payment and Settlement Services (CPSS)

#### Summary

#### Cross-country perspective of the CPSS

*“We await the CPSS outputs on the implications of innovation. This is relevant for us in terms of financial inclusion goals and dealing with new entities and business models.”*

#### Where is specific CPSS assistance required?

- Build the ongoing work on impact of innovation into explicit CPSS guidance and principles on treating new models and non-traditional players.
- Coordination with BCBS (for prudential regulation) where new payment models push payment system boundaries and move into the area of prudential stability.

#### Assessment of CPSS

*Countries did not report any problems with regards to CPSS principles and financial inclusion.* Similar to the impact of the BCBS on financial inclusion, none of the countries had any specific criticism against the CPSS. However, it is important to mention that while the principles are not experienced as explicit barriers to financial inclusion, they have also not to date provided much guidance in dealing with new and innovative business and payment models that often form the drivers of financial inclusion in the case study countries.

*Countries recognize the work of the CPSS that supports financial inclusion.* Each of the case study countries recognizes the work of the CPSS on various fronts, often in partnership with the World Bank, to address financial inclusion-relevant retail payments issues. Specific reference was made to the General Principles for International Remittances and the General Guidance on National Payment System Development published in 2007, as well as the ongoing work of the International Advisory Group for Government payments and the World Bank Payment System Development Group. Considered of most direct relevance to financial inclusion is the study into implications of innovation in retail payments launched by the CPSS Working Group on Innovation in Retail Payments at the end of 2010. One of the Working Group’s initiatives will be to further explore the link between retail payment systems and financial inclusion. Countries noted the need for further guidance to assist in accommodating new financial inclusion innovations that push the boundaries of current regulatory and supervisory frameworks.

*Membership shapes the impact of CPSS on countries.* Brazil has been an active participant in CPSS working groups and can therefore inform the international discussion and gain confidence from participating in such forums. However, in contrast, Kenya and the Philippines are currently not members of the CPSS and, while they follow its principles and guidance, they are unable to directly influence the internal debate and overall direction of regulatory thought. Rather, for Kenya, regional decisions within the East African Community regarding payment system reform have a much larger impact since Kenya is able to directly participate in the discussion at the highest political level. The directives issued by the Monetary Affairs Committee under the East African Community offer guidance that is of more direct relevance and contextualized to the region and, therefore, have a greater impact on Kenyan payment system evolution. This regional cooperation is not in conflict with the principles of the CPSS. Rather, East African countries at similar stages of payment system development can move toward common goals in concert. This not only requires coordination and best practice sharing at the principle level, but often requires discussion and consensus on more technical issues in payment system reform that the participating countries find very useful.

*CPSS principles emphasize systemically important payment systems.* The case study regulators experience the CPSS principles to be tailored to well-developed financial markets and focused on systemically important payment systems. This excludes a number of the inclusion-orientated payment system issues a country like the Philippines is grappling with. Specifically, the concept of a systemically important payment system typically emphasizes large value payment systems as opposed to many-user but low-value (retail) payment systems. As innovative inclusion-friendly payment system solutions tend to be focused on low-value retail payments, this implies the absence of clear guidance with regards to the integration of such participants into the overall payment system framework.

*New business models are pushing the boundaries of regulation.* The CPSS principles and guidance do not yet explicitly address the issue of new, emerging business models in the payment system space. Innovation continuously pushes the boundaries by giving rise to new payment system players, channels and retail payment products, challenging regulators and supervisors to respond. One example is the issue of e-money, mobile payments and what should be regarded as “deposit-taking”. Different countries have followed different approaches:

- The Philippines and Kenya do not define e-money as deposit-taking. This has enabled them to allow telecommunications companies as payments providers (and e-money issuers) in the mobile financial services space.
- Other countries, such as South Africa, follow a strict bank-based approach (in the e-money context this implies that e-money can only be issued in partnership with a bank; likewise, mobile payment models need to have a bank as partner).
- Brazil and Mexico do not yet have e-money regulation and are debating the bank-based approach. Both have implemented agent banking (correspondent) regulation but do not yet explicitly allow for telecommunications or other third party companies to play in the financial services space.

Furthermore, the Philippines experience Core Principle VII<sup>13</sup> as posing a challenge to innovative business models. Such models need to be continually

assessed and evaluated in conformity to Principle VII to ensure there are no significant disruptions or risks to the system. While regulators felt that the principle itself is clear, more information and more specific evaluation criteria is required to assist in the evaluation of individual payment systems providers.

In addition, recent technological developments such as cloud computing systems<sup>14</sup> particularly highlight the need for greater guidance on Principle VII. In their recent endeavours to better understand the implication of cloud computing for payment system regulation, the Filipino regulators had nowhere to turn to for guidance or information exchange. They also expressed the need for further guidance on the evaluation of risks that may arise from non-banks accessing the real time gross settlement system network (RTGS)<sup>15</sup>. Similarly, in the face of various new business models, Mexico expressed the need for further guidance on the challenges of regulating interoperability.

*Regulatory mandates for new innovations need clarification.* Brazil is faced with the question of the comparative roles and advantages of banks, non-bank financial institutions and non-financial institutions in the overall payment system, indicating that this requires dedicated attention at SSB level. According to Brazil, systematic discussion is also required on the legal mandate of regulators in the face of payment system innovations, including the treatment of non-financial institutions providing retail payments (notably mobile operators).

*Practical implementation of proportionality remains a challenge.* Brazil raised the issue that further discussion and clear guidance is required on how to achieve appropriate proportionality in tailoring regulatory requirements for retail payment systems not regarded as systemically important<sup>16</sup>.

## Implications for CPSS to consider

The country case studies suggest a number of possible actions for the CPSS to consider in creating a more enabling environment for financial inclusion. We explore these possible actions in greater detail below.

*Create platforms for discussing approaches to new and innovative business models.* Developing countries will benefit from the opportunity to learn from inclusion-friendly approaches adopted by peer

<sup>13</sup> Principle VII prescribes a high degree of security and operational reliability (along with contingency arrangements) on the payment systems.

<sup>14</sup> The Cloud Security All and the US National Institute of Standards and Technology define cloud computing as a model for enabling convenient, on-demand access to a shared pool of computing resources (e.g., networks, servers, storage, applications, services) that can be rapidly established and released with minimal interaction from either the organization or the service provider. Another way to view cloud services is as a public utility. Organizations subscribe to a pay-as-you-go model for things like electricity or water, and they now have the option of paying for IT software, security and network services on a consumption basis (Young, 2011).

<sup>15</sup> The RTGS system typically settles large value funds transfers between commercial banks on a real time basis. By real time, it is meant that final settlement of interbank funds transfers are on a continuous, transaction-by-transaction basis throughout the processing day.

<sup>16</sup> The fact that the CPSS principles focus only on systemically important payment systems in itself already represents proportionality, as it implies that regulators and supervisors do not need to apply the full scope of the principles to non-systemically important payment systems. Yet they are in need of guidance and standards also with regard to new and alternative payment systems that would not traditionally be regarded as systemically important – a vacuum in this regard in the principles is not helpful for regulators and supervisors at a practical level.

countries and their successes and failures (similar to the platform for exchange and learning on the impact on innovation through the innovation working group established in 2010). The sharing of such experiences within the safety of platforms or discussion papers associated with the CPSS (even if the approaches are not officially endorsed) may enhance such an exchange. In establishing these platforms, it will be beneficial if both new and even non-members could be accommodated in the discussion. Non-members' participation will be especially important where they have experience with new and innovative payment models that are driving financial inclusion efforts in their countries.

*Recognize the presence of non-bank and non-financial players in retail payments.* Countries considered the CPSS and its principles to still be bank-centric in its view of the payment system environment. With the rise of various non-bank and non-financial players in the provision of retail payments, it may be necessary to interrogate the degree to which this view of the payment system space is shaping the implementation of the principles. Consideration should be given to develop further guidance to facilitate appropriate regulation of non-bank and non-financial players in the payment system space. Consideration should also be given to the mandate of payment system supervisors to deal with new players and the degree to which this overlaps with other supervisory authorities.

*Coordinate initiatives with the BCBS.* As payment system and prudential regulation and supervision issues begin to converge, there is need for dialogue and coordination between CPSS and BCBS. The CPSS principles need to specifically consider the implications arising from new business models or technologies and how to regulate and supervise them in an inclusion-friendly manner. More specifically, guidance notes may be required on how to apply the principles in the face of new business models. Explicit guidance on specifically Core Principles VII would prove very useful.

## 3.4. International Association of Insurance Supervisors (IAIS)

### Summary

#### Cross-country view of IAIS

*"The IAIS's long-standing engagement and global dialogue platform on microinsurance has given us a way to input our learning and learn from others, but we need more guidance on supervision and proportionality more broadly."*

#### Where is specific IAIS guidance needed?

- More guidance on ongoing supervision (especially following formalization) and not just regulatory design.
- Guidance on implementing risk-based capital in constrained capacity environments.
- More extensively building financial inclusion into the mainstream IAIS agenda.

### Assessment of IAIS

#### *Long-standing engagement with financial inclusion.*

Of all the SSBs, the IAIS has the longest-standing direct engagement with the topic of financial inclusion. It has been formally involved in a Joint Working Group on Micro-insurance with the Micro-insurance Network (MIN) since 2006 and has a subgroup on micro-insurance that forms the basis for its involvement in the Joint Working Group. The IAIS is also a founding partner of the global Access to Insurance Initiative<sup>17</sup> aimed at promoting access-friendly policy, regulation and supervision and supporting regulators and supervisors to be champions of insurance sector change. The IAIS-MIN Joint Working Group is in the process of formalizing micro-insurance guidance through a Guidance Paper on Regulation and Supervision Supporting Inclusive Insurance Markets. Once published, it will provide the basis for a toolkit for self-assessment by countries of their observance of the ICPs as per the financial inclusion guidance. This toolkit is to be developed in collaboration with the Access to Insurance Initiative.

*An inclusive forum.* The IAIS is the SSB with the broadest membership base, covering supervisors from almost 140 jurisdictions, most of them developing countries. This means that developing country realities, including the need to promote market development alongside consumer protection

<sup>17</sup> [www.access-to-insurance.org](http://www.access-to-insurance.org)



and stability, are integrated into the IAIS agenda. With the exception of the Philippines, all of the case study countries are members of the IAIS.

*International engagement informs country approaches.* Most of the case study countries have engaged in or drawn on the international debate on micro-insurance, to which the IAIS is a key party, in informing their domestic approach:

- The Kenyan supervisor has been participating in regional dialogue events organized by the Access to Insurance Initiative to share learning from Kenya and learn from peers. This has assisted their thinking of micro-insurance, but the challenge is now to put thinking into practice.
- Brazil and South Africa have both been active participants in the IAIS-MIN Joint Working Group, inputting learning into the Joint Working Group and in turn drawing on the discussions globally in devising their own micro-insurance regulatory frameworks (a process that both countries are still engaging with).
- As one of the micro-insurance regulation pioneers, learning from the Philippines has informed the outputs of the Joint Working Group, including two micro-insurance related issues papers published in 2007 and 2010 respectively and the forthcoming *Guidance Paper on Regulation and Supervision Supporting Inclusive Insurance Markets*. The Philippines is drawing on international guidance and assistance in the ongoing challenge of supervising the micro-insurance market.

*Principles and standards do not hamper financial inclusion, but also do not sufficiently guide.* The regulators consulted share the sentiment that the IAIS standards are not problematic for financial inclusion per se. Nevertheless, they would welcome more specific guidance on mainly two aspects:

- (i) formalization;
- (ii) applying the proportionality principle.

Both of these topics are extremely relevant for financial inclusion, but also extend beyond micro-insurance to the broader regulatory and supervisory challenges facing developing countries. The three main formalization issues emerging from the case study countries are:

- (i) whether informality is regarded as a risk demanding a regulatory response;
- (ii) if so, how should informal providers be formalized;

- (iii) once formalized, how should newly-formalized players be supervised on an ongoing basis?

*The risk of informality.* Country experience regarding the risk of informality varies: Though Kenya does not experience any of the IAIS Insurance Core Principles (ICPs) as problematic, the ICPs also do not really assist them in their main supervisory challenge, namely understanding and quantifying risks associated with informal insurance provision. They plan to undertake a survey on the extent and nature of informality to inform them, but do not have a clear plan in this regard yet. In South Africa, the risk of consumer abuse stemming from informality is one of the key considerations underlying the proposed microinsurance regulatory framework. At the same time, it is recognized that not all community-based risk pooling structures can feasibly be formalized (in fact, where benefits are not guaranteed, formalization may not be needed whatsoever). Likewise, the Philippines recognized the risks to consumers (and to the reputation of the industry as a whole) of previously pervasive informal insurance practices. Brazil and Mexico, on the other hand, are not prioritizing formalization as they do not regard the provision of funeral insurance on an informal basis<sup>18</sup> by funeral service providers as part of the definition of insurance<sup>19</sup>. Hence informality is not seen as a risk to the reputation and soundness of the insurance market. In this way, the definition of insurance shapes the regulatory mandate and interventions. In the health insurance sphere, however, the need for formalization was one of the core determinants of the creation of the private health insurance regulator, the ANS, in 2001.

*Formalizing the informal.* Countries that do see the need for regulatory intervention to respond to informal provision of insurance cover are then faced with the challenge of bringing hitherto informal entities into the regulatory fold. The Philippines passed a joint Memorandum Circular between the Insurance Commission, the Securities and Exchange Commission and the Cooperatives Development Authority in 2010 as part of a formalization drive. It required all entities providing insurance without being licensed to do so to be licensed with the Insurance Commission or to partner with an insurer – regardless of who their institutional regulator is. This is an important element of inter-agency cooperation to strengthen and build the micro-insurance market. South Africa plans to implement a strong enforcement drive, accompanied by a transition period, to ensure formalization once the proposed new micro-insurance regulatory framework creates the regulatory space for hitherto informal entities to formalize into.

*Ongoing supervision of newly-formalized entities.* The formalization move has placed large supervisory

<sup>18</sup> These benefits are mostly paid out in-kind in the form of funeral services.

<sup>19</sup> Though funeral benefits not underwritten by an insurer are widespread in Mexico, the supervisor does not regard formalization as a concern, as these practices are defined as “prepaying” for funeral expenses and are therefore not regarded as insurance. This is also the case in for example Colombia and Brazil. A large chunk of what would elsewhere be regarded as part of micro-insurance is thus defined to fall outside of the regulatory sphere.

capacity requirements on the Philippines Insurance Commission. In the initial formalization phase, new entities are required to register and put up capital. After that, ongoing on-site and off-site supervision becomes a challenge. It is hoped that the new IAIS Guidance Paper on Regulation and Supervision Supporting Inclusive Insurance Markets will inform the supervisory approach. Ongoing supervision will also be a practical challenge in South Africa once the proposed micro-insurance regulatory regime is implemented. The South African non-bank financial services regulator, the Financial Services Board, will make consumer protection an explicit focus area as part of its new micro-insurance regulatory framework and has identified the need for enhanced supervisory capacity in doing so. Capacity for ongoing supervision was likewise raised as a challenge in Kenya. In Brazil, the health insurance supervisor has found IAIS membership helpful in prudential supervision for the recently formalized health insurance sector.

In addition to formalization, proportionality was highlighted as a major consideration. The IAIS Insurance Core Principles strongly endorse proportionality – that is, regulation proportionate to the risk posed. Two main sub-topics were raised as challenges in effectively implementing proportionality:

*Implementing tiered systems.* The Philippines and Mexico have already implemented micro-insurance regulation as part of a financial inclusion approach. Brazil<sup>20</sup> and South Africa<sup>21</sup> have been designing a micro-insurance regulatory framework for a number of years and Kenya is now starting to consider the matter. Insurance supervisory authorities from all the countries recognize the need for regulation to be proportionate to the risk of micro-insurance. A proportionate or tiered regulatory approach asks for micro-insurance to be defined so as to entail only a certain category of low-risk products. There is however no standard approach to defining micro-insurance or in tailoring of regulation and supervision to it. Mutual learning and practical international guidance is needed that allows for the specific country context to be taken into account.

*Implementing risk-based capital approaches.* The Philippines already has a tiered capital requirement framework. In starting to implement risk-based capital and solvency requirements, the following country experience was noted:

- In implementing international solvency standards, the Brazilian supervisory authorities for health and private insurance, respectively, are coming up against capacity constraints among smaller insurers. Strong arguments are made that the level of capital required and overall compliance burden is simply not viable for many.

- The Kenyan Insurance Regulatory Authority has started to include risk-based principles in its legislation as part of its ongoing insurance legislation reform process. This is likely to also influence capital requirements. The Kenyan Insurance Regulatory Authority anticipates that the risk-based supervision process will be particularly resource intensive, requiring actuarial skills and management information systems that the country and insurance companies do not necessarily have.
- In the micro-insurance sphere, the implementation of risk-based solvency regimes calls for practical alignment of micro-insurance with the new solvency approach. South Africa proposes to create a separate and simplified solvency framework for micro-insurers that will be excluded from the proposed new solvency framework, but proportionately aligned with its requirements for capital and reserving.

### Implications for IAIS to consider

The need for more specific IAIS guidance stemming from the country evidence highlighted above can be summarized as follows:

*Facilitate learning from different countries' implementation experiences.* Countries are trying different approaches across a variety of issues. More extensive sharing of experiences through the IAIS structures will enhance mutual sharing. One area where countries can learn from one another is in considering the impact of different approaches. For example: the Philippines and Mexico have followed very different approaches in regulating micro-insurance. South Africa and Brazil are currently developing micro-insurance regulatory frameworks, once again following different approaches. As countries move towards implementation, further guidance from the IAIS in terms of supervisory implications will be helpful.

*Place particular emphasis on the supervisory response.* The case studies point to a strong need for guidance specifically with regard to supervision. This resonates for example in the formalization challenge: how to approach formalization, what to monitor, what reporting to require and in what way to approach on-site supervision resource-efficiently? It is hoped that the upcoming *Guidance Paper on Regulation and Supervision Supporting Inclusive Insurance Markets* will provide enough clarity in this regard.

*Apply a risk-based approach in the developing country context.* Another area where a need for guidance was expressed is on the application of risk-based capital as part of new solvency approaches (as was emphasized in the case of Brazil) and in risk-based supervision more broadly. This need

<sup>20</sup> In Brazil, a Micro-insurance Bill was submitted to Congress in 2008, but has yet to be passed. In parallel, the insurance supervisor, SUSEP, is working on subordinate legislation under the current Insurance Act to facilitate micro-insurance.

<sup>21</sup> South Africa published its final policy document containing detailed proposals for the micro-insurance regulatory framework in July 2011. This will form the basis for the drafting of legislation from 2012.



stretches beyond just the micro-insurance topic and deals with the capacity constraints faced by supervisors in enforcing regulation, as well as the capacity constraints of smaller and recently formalized insurers in meeting solvency and other requirements. It also reflects the need for explicit developing country-relevant guidance in the midst of increasingly complex international standards.

**Mainstream micro-insurance.** While all countries appreciate the attention that the financial inclusion topic is receiving at the IAIS level through the work of the Joint Working Group on Micro-insurance, not all attend Joint Working Group meetings (held a few times in a year in different regions of the world) or dialogue events organized by the Access to Insurance Initiative. The need was expressed to more effectively build micro-insurance into the mainstream IAIS agenda at triannual meetings, as these sessions are more broadly attended by supervisors.

### 3.5. International Association of Deposit Insurers (IADI)

#### Summary

##### Cross-country view of IADI

*"IADI has only now started to engage on financial inclusion and, to tell the truth, we have also not given this much thought. We'll watch the IADI space with regard to innovation and inclusion, including how to deal with the expansion of the deposit insurance landscape."*

##### Where is specific IADI guidance needed?

- Introduction to the financial inclusion topic in the context of deposit insurance.
- How to extend cover to new types of deposits and non-bank entities taking deposits?
- For incorporating new entities: create a separate fund or integration in current fund?
- How to avoid moral hazard?
- Whether and how to apply the pass-through principle.
- How to link deposit insurance to prudential regulation and supervision across different supervisory authorities?

#### Assessment of IADI

**Financial inclusion issues in deposit insurance need greater attention.** Deposit insurance is the area that has so far attracted least attention in terms of financial inclusion among the case study countries. Countries recognize how relatively recent the discussion is. Indeed, the IADI Core Principles for Effective Deposit Insurance System themselves are still very new, as they were only published in June 2009. None of the countries are very advanced in thinking about financial inclusion in the context of deposit insurance:

- Mexico has not yet started to consider financial inclusion in the deposit insurance space. IADI guidance will play an important role in introducing authorities to the topic. Nevertheless, Mexico already has a proportionate approach to deposit insurance in that it has a separate private deposit insurance scheme<sup>22</sup> for credit unions and popular finance organizations (Sofipos). Deposit insurance for credit unions is used to create public awareness, increase savings and help with formalization efforts.
- Brazil has likewise not started to engage on the topic of expanding deposit insurance, apart from discussions (still at an early stage) regarding broadening the deposit insurance base to credit cooperatives. The current thinking is to do so under a separate fund so as not to impact on the risk nature of the current fund, which is tailored towards the mainstream banking sector. The Brazilian authorities play an active role in IADI and were interested to learn more from IADI's recently-initiated work stream on financial inclusion and innovation.
- Given the very different business models of non-banks and non-financial institutions to banks, the Philippines acknowledges that deposit insurance to non-banks may need to be done through a separate deposit insurance fund. The topic is so new and the Philippines regulators are so averse to moral hazard that they will not be proactive in pursuing it unless IADI gives guidance (even though they are not a member of IADI). They will therefore be reactive to IADI guidance, rather than proactive through a "test and learn"<sup>23</sup> approach.
- The Philippines furthermore recognizes that the "pass-through" mechanism could in theory be applied to non-bank financial institutions providing e-money and mobile financial services, but have not yet started to consider the matter in concrete terms. The pass-through mechanism refers to the phenomenon whereby each client

<sup>22</sup> The private deposit insurance scheme is administered under a fiduciary arrangement by BANSEFI, a state owned development bank.

<sup>23</sup> "Test and learn" refers to a regulatory approach whereby pilots are used to determine risks and vulnerabilities before a regulatory response to market developments is entrenched. The test and learn approach is core to Principle 7 (Knowledge) of the G20 Principles for Innovative Financial Inclusion. Principle 7 reads: "Utilize improved data to make evidence based policy, measure progress and consider an incremental "test and learn" approach acceptable to both regulator and service provider."

whose funds are kept in a joint trust account with a bank receives deposit insurance, rather than just the single underlying account (in which case the cover limit would imply that individual end-clients have negligible cover). The Kenyan M-PESA example illustrates: M-PESA clients regularly use their M-PESA accounts for short-term savings. Yet, under the current model, all M-PESA funds held in trust at a specific bank would only be entitled to total joint cover of KSh 100,000 (just more than US\$ 1,000 – the deposit insurance cover limit for a single account), should the bank experience financial difficulties and be liquidated.

- The rapid expansion of bank accounts to many small depositors witnessed in Kenya in recent years has raised concerns on the low coverage of the Kenyan deposit insurance fund, while the large-scale roll-out of M-PESA accounts has raised concerns about the absence of deposit insurance for funds kept in m-payment products. The Kenyan authorities have developed a Deposit Protection Fund Bill that will establish the Deposit Protection Fund as fully independent from the Central Bank, with much greater powers in taking preventative measures before the Central Bank's involvement in bank liquidation is required.
- South Africa is an associate rather than a full member of IADI, as it does not have an official deposit insurance scheme or legislation mandating the existence of such a scheme yet. However, policy papers on deposit insurance for respectively commercial banks and cooperative banks are currently being developed (with the IADI principles as reference point). The planned deposit insurance schemes will be limited to banks, including commercial and cooperative banks. It is not foreseen that deposit insurance will cover non-bank deposit-taking financial institutions such as savings and credit cooperatives.

*Extending the reach of deposit insurance.* The main financial inclusion challenge with regard to deposit insurance would be to extend the reach of deposit insurance beyond the traditional deposit-taking entities such as banks to also incorporate savings cooperatives, deposit-taking microfinance institutions or NGOs or new forms of “deposits” such as e-money and mobile wallets. Many of the new players may be recently formalized, may follow a totally different modus operandi to banks, or may lack capacity. In this context, what would be the appropriate approach to deposit insurance? Some of the practical questions faced by authorities in the case study countries are:

- *Different funds for different categories.* How does extension of deposit insurance coverage impact the risk exposure of the fund? Should a

separate deposit insurance fund be created for alternative versus traditional deposit-takers? Or should new entities be incorporated in the current fund?

- *Managing moral hazard.* Mitigating moral hazard (Core Principle 2<sup>24</sup>) is a very important principle for deposit insurance. Extending coverage to non-traditional deposit takers may create moral hazard concerns. In the Philippines, for example, regulators were cautious about the possibility of expanding deposit insurance to providers other than banks/banking institutions. These other deposit taking institutions and non-deposit taking entities such as e-money issuers may not be supervised and regulated as tightly as the current members (namely banking institutions). This may ultimately result in increased moral hazard risks. How, then, to avoid moral hazard when extending the deposit insurance frontier?

*Protecting intermediated deposits.* Another important issue with regard to deposit insurance relates to how to apply the pass-through principle to scenarios where individuals' money is bulked up and kept in a float or trust account. None of the countries have embarked on this route yet, but at least two (Philippines and Kenya, being the leaders in terms of mobile money) acknowledge the need to consider it in the future. Financial inclusion is often delivered in an intermediated manner through non-traditional and non-financial intermediaries. Addressing the pass-through mechanism is essential, should the goal be to extend cover to all end-clients.

*Limiting cost impacts on financial inclusion.* Financial inclusion calls for large volume, low-value business where margins are often thin and clients are cost-sensitive. Even a small impact on cost may therefore make the business unviable or serve as a disincentive for potential clients. It is therefore important to design and implement deposit insurance in such a way that it does not unduly impact on costs. But how to do so? Kenya, for example, asked for particular guidance on how to achieve better coverage given current resource constraints and without impacting the costs associated with the provision of a bank account.

*Managing cross-border risk pools.* A last challenge, mentioned in the case of Kenya, relates to deposit insurance in a scenario of cross-border expansion by domestic financial institutions. The ongoing expansion of Kenyan banks into the East-African region (often into what is considered quite risky environments) raises the question of how the regulator should assess the risk of financial difficulties in other countries and manage the impact thereof on the health of local financial institutions and, hence, of the local deposit insurance regime.

<sup>24</sup> Core Principle 2 reads: "Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net."

## Implications for IADI to consider

*Lead the way.* The fact that financial inclusion in deposit insurance is still largely uncharted territory creates an opportunity for IADI to actively shape approaches going forward by leading the debate and providing a platform for exchange on the financial inclusion and innovation topic. All countries are following the IADI processes around financial inclusion (such as the current survey on financial inclusion among members) with interest. As this is such a new topic in the deposit insurance sphere, they are likely to follow a wait and see approach, looking to IADI for guidance on how to approach the topic and what the details should be in implementing deposit insurance for non-traditional players and channels.

*Guide countries in extending deposit insurance coverage.* As each country tackles its country-specific challenges with regard to the extension of deposit insurance to cover financially included clients outside of the traditional banking/deposit-taking sphere, IADI guidance on some of the practical questions outlined

above is called for. Such questions include prevention of moral hazard, jurisdiction, the appropriate structuring of the fund, limiting of the cost impact and application of the pass-through mechanism.

*Provide practical coordination for new players and models.* The IADI core principles place strong emphasis on coordination with other safety net organizations (Core Principle 6: Relationships with other safety-net participants<sup>25</sup>). Recognizing the important synergies between prudential supervision and deposit insurance, the Core Principles for Effective Deposit Insurance Systems were issued in conjunction with the BCBS. This coordination needs to translate to the country level. Some of the questions faced include: how to coordinate effectively with the prudential supervisory authorities in a scenario where new players are incorporated in the deposit insurance net and it is not clear under whose jurisdiction they should be? With whom to coordinate and in what way with regard to entities that fall outside of the prudential supervisory authority of the Central Bank or Ministry of Finance? Countries will look to IADI for guidance on these questions.

## 4. Cross-country themes and implications for SSBs

Section 3 provided a summary of the country experiences with regard to each of the five SSBs and the impact of international standards on financial inclusion. Below we summarize the cross-cutting themes emerging across countries and SSBs, in order to inform the recommendations and implications for SSBs following in Section 4.2.

### 4.1. Cross-cutting themes

#### An emerging developing country agenda

*The developing country context needs to be considered when applying standards.* Financial inclusion and financial sector development are priorities for developing countries, yet are not traditionally the focus of international standards, as the standards were largely derived from developed country experiences. While the standards may not present explicit barriers to inclusion, they may also not create a supportive environment for inclusion. With the introduction of the financial inclusion topic comes increasing recognition of the need for standards and guidance to more explicitly take account of the developing country context. As the SSB membership broadens beyond developed countries, the standards have to evolve accordingly. This is one of the central challenges for the SSBs.

*Mutual learning is in the interests of both developing countries and SSBs.* Financial inclusion is one of the topics where the developed world stands to learn most from its developing counterparts. Financial inclusion therefore gives developing countries a voice on the international arena. Lessons from all the case study countries' experiences to some extent feed into international platforms; at the same time regulators and supervisors watch whatever comes from the SSBs with interest to see if it can help them with the many regulatory and supervisory challenges that they face. The dialogue is therefore mutually beneficial.

*Membership structure matters.* To take part in the dialogue, a country must however have access to the forum. The case studies show that whether a country is a direct member or not, when it gained membership and in what way it can participate in the working groups/sub-groups are all determinants of how strong its voice is. Countries with a higher degree of participation are more confident and better able to tailor the implementation of standards to domestic circumstances to accommodate inclusion. The more open the forum for debate and feeding in of country learning even of those countries who do not qualify for direct membership, the better.

<sup>25</sup> Core Principle 6 reads: "A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized."

## The balancing act challenge

*An emphasis on financial inclusion can lead to seemingly conflicting objectives.* All of the governments consulted in some way place emphasis on financial inclusion. Yet they also value adherence to international standards. Some have experienced turbulent economic episodes in the past and are particularly concerned with stability of their financial systems. The combination of the need for financial inclusion on the one hand and stability, caution and adherence to international standards on the other hand can be complementary. However, achieving that complementarity and effectively managing trade-offs can be a tricky balancing act in practice.

*Objectives can be reconciled through a test-and-learn approach.* By default a balancing act means that neither of the objectives is pursued to the extreme and some level of compromise is required. This implies that it is not tenable to pursue a zero-risk approach under the stability objective if this comes at the cost of financial inclusion. In a balancing act scenario, you have to recognize that sometimes things may go wrong. The “test-and-learn” approach has proven to be a useful approach to manage and respond to new scenarios of which the regulator does not yet have a thorough knowledge. Further discussion on this approach and its challenges will be required, for example: how do you reconcile test-and-learn with the various SSBs’ evaluation criteria? Will it be acceptable as part of a risk-based or proportionate approach?

## The practical challenges of proportionality

Proportionality and/or a risk-based approach are the preferred models<sup>26</sup> used by standard-setting bodies to accommodate financial inclusion issues and to achieve the necessary balancing act. Yet these concepts do not always promote financial inclusion, as there are a number of challenges in implementing proportionality in practice:

*Understanding risk when full and accurate data are unavailable.* The first challenge with implementing a proportionate approach is that it assumes that the data and capacity is available to accurately judge and quantify risk and to motivate risk-based decisions on all aspects of regulation (including financial inclusion). Even the most advanced of the developing countries struggle with providing accurate data to support risk-based decisions and are uncertain when a risk-based approach will be acceptable and how exactly to define low(er) risk. Caution is also needed against placing all financial inclusion hopes on

proportionality as such an approach assumes that all financial inclusion-relevant issues are low risk. This is not necessarily the case and should be assessed in the country context.

*Recognizing the impact of the degree of sanction.* The second challenge is that, if the penalties of getting the risk assessment wrong are substantial, countries will tend to err on the conservative side in their compliance response:

- *The threat of sanction determines actual impact.* The threat of sanction is an important determinant of the actual impact at country level of international standards and the extent to which a country would like to see standards change or specific guidance issued. Their financial sector openness and engagement in international platforms mean that none of the countries can ignore global standards. Yet compliance with most international standards is voluntary; hence supervisors do not face much risk in interpreting them in the country context to suit financial inclusion objectives. For this reason, at the principle level, not many areas were emphasized as problematic. Nevertheless, countries are assessed for adherence to international standards as part of their Financial Sector Assessment Programme (FSAP) and in the case of FATF (refer to the discussion in Section 3.2) the mutual evaluations imply a real threat of sanction, even for non-members such as Kenya and the Philippines.
- *The threat of sanction may inadvertently trigger conservative compliance response.* The assessment process forces countries to implement standards in a manner that they are able to justify at the point of assessment. Faced with the absence of good data on the risks posed by a particular low-income financial service provider, service or product, they may opt for a conservative approach (at the cost of inclusion) rather than risk being marked down. The inherent bias is, therefore, to be more conservative than is required.

*Managing proportionality: theory versus practice.* Though the principle of proportionality is widely accepted, a third challenge arises when regulators and supervisors have to put theory into practice. Proportionality and a risk-based approach are resource-intensive processes to manage on an on-going basis and will present challenges for resource-constrained developing country regulators (we consider the capacity theme in more detail below). All of the country case studies highlight this

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<sup>26</sup> Note that the terms “proportionality” and “risk-based approach” are not necessarily interchangeable. The G20 Principles for Innovative Financial Inclusion define proportionality as “...a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation.” Proportionality therefore implies that regulation should be proportionate to the risk posed. Risk-based supervision is based on the same principle. However, in certain contexts, risk-based supervision can refer specifically to a capital and broader supervisory regime tailored to the risk profile of each specific financial institution. This can be quite resource-intensive and is not necessarily the ideal “proportional” approach in low-capacity environments, which may call for what can be termed a “risk-sensitive rules-based approach” whereby certain categories of products or institutions are defined according to their general risk characteristics, with regulation and supervision tailored to the category as a whole.



challenge in some way, as witnessed in the specific questions or issues for SSB guidance referred to in Section 4.2.

### Financial inclusion market features

All case studies highlight the need for regulation to take into account the unique market features typically related to financial inclusion in developing countries. Four typical features have proven particularly challenging for the implementation of international standards in an inclusion-friendly manner:

*New players, channels and products challenge traditional regulatory and supervisory approaches.* Innovation is required to extend the reach of the market beyond its current boundaries. The role of innovation in financial inclusion emerges as a theme across SSBs as well as across countries. The financial sector landscape is changing in all of the countries considered. In thinking about systemic risk, regulators and supervisors have to move beyond their traditional focus on established institutions to also consider the risks associated with hitherto unknown, new models. New non-bank and third party players outside the financial sector such as telecommunications or technology companies are entering the payments and deposit taking space. New channels are coming to the fore and new technologies are being deployed. Innovation continuously pushes the boundaries, challenging regulators and supervisors (and the standards governing them) to respond.

*The convergence between financial services and institutions needs to be managed.* A related topic is the increasing convergence between financial services and institutions. The division between deposits and payments, between banks and non-banks and between financial institutions and third party service providers is starting to blur. There is also channel convergence whereby one channel, for example a retailer or telecommunications network, increasingly serves as distribution platform for a range of financial services. This may cross the traditional lines of jurisdiction between authorities. Managing such convergence is an issue not yet addressed by the SSBs.

*Diversity has to be addressed at different levels.* Financial inclusion expansion scenarios are inevitably characterized by diversity. The five countries are a microcosm of the diversity found within developing country financial sectors in terms of the range of institutions, services and channels, as well as between countries:

- *Diversity “within”.* There is often a dichotomy in developing country financial sectors between: (i) sophisticated financial institutions aimed at the high-end and corporate market; and (ii) a host of small entities (sometimes informal) often operating at the financial inclusion frontier. Thus regulators must regulate markets at different levels of sophistication. This has supervisory capacity implications and creates a need for proportionality.
- *Diversity “between”.* In addition, there is significant diversity between developing countries in terms of the degree of sophistication in the financial sector and the regulatory and supervisory capacity among authorities. There are also different dynamics across countries in terms of whether government takes the lead in pushing for financial inclusion, or follows the market through a “test and learn” approach.

*The presence of informality cannot be ignored.* All of the countries are characterized by some degree of informality in their financial sectors, be it in the form of unregulated funeral cover providers, community-based savings schemes or NGOs providing credit outside of the regulatory fold. Often, informal service providers reach people who would not otherwise be financially included. In thinking about financial inclusion-sensitive regulation and supervision, dealing with informality is therefore an important cross-cutting consideration. The flipside of informality is formalization. Regulatory and supervisory approaches to formalization are intricately linked to the proportionality theme and, as discussed below, are determined by capacity consideration.

### Capacity constraints

*Developing country capacity challenges textbook compliance.* Another theme that reverberates across the five countries is the fact that, while on paper they would like to fully comply with ever more complex international standards, in practice neither the supervisors nor the financial institutions in developing countries have the capacity to do so. “Lower tier” financial institutions and new players are very relevant for financial inclusion, but often have the least capacity to meet complex international standards. Regulators and supervisors are therefore confronted with the need to take capacity constraints into account in designing a proportionate approach. Yet regulators and supervisors themselves do not necessarily have sufficient capacity to oversee the changing landscape. Financial inclusion, through the innovation, diversity and informality that it often entails, places a wider set of demands on existing capacity.

The capacity challenge cuts across the regulatory spheres: it is relevant for microinsurance, new payments providers, and in the treatment of microfinance, credit cooperatives and others in banking regulation. Regulatory and supervisory capacity may vary between countries and between regulators and supervisors in a country. Time and again, the case studies highlight the practical challenge facing regulators and supervisors of how to effectively apply a risk-based approach in the way that they regulate and supervise a sector if they are limited in their ability to design, enforce and monitor.

*Formalization requires capacity.* Another salient feature across the country case studies is that the pursuit of inclusion often requires formalization of existing informal financial services. Country evidence suggests that capacity constraints play an important role in the formalization process, as formalization can

only be achieved through effective enforcement and on-going monitoring.

## Consumer protection

*Consumer protection is not clearly addressed as a cross-cutting issue.* Placed alongside the other issues, consumer protection was largely not elaborated upon by the regulators. This may reflect the fact that supervisors consider their focus on stability as ultimately aimed at protecting consumers. It is also clear that there is some uncertainty amongst supervisors around the mandate for consumer protection. Ultimately, however, it reflects the fact that the objectives of inclusion and stability have not yet been fully reconciled.

*Stability focuses on systemic risk.* The case studies have shown that the regulatory standards are still primarily focused on large-value and systemically important entities and systems. In such a system, consumer protection is, in the first instance, about ensuring stability and limited attention is afforded to the client and transaction level.

*Consumer protection is a major consideration in financial inclusion.* In contrast, financial inclusion is focused on systems that serve many (often vulnerable) consumers with small value products and may or may not be systemically important. Unlike the focus on stability, the FI focus requires consideration of small transactions and client-level issues and, as result, consumer protection is a prominent consideration. Consumer protection could be pursued in various ways by touching on all aspects of the value chain including: ensuring the stability of the institution, ensuring appropriate market conduct by intermediaries and fair treatment of consumers and ensuring appropriate and good value products. This approach would suggest that consumer protection could, therefore, be integrated into the overall regulatory approach.

Bringing new and vulnerable consumers into the formal sector will without doubt raise a discussion on the issue of consumer protection. Further deliberation amongst supervisors and the SSBs would be required to consider whether and how this fits within traditional supervisory approaches and mandates or how these need to be amended to accommodate the financial inclusion objective.

## 4.2. Implications for SSBs

This document provided a high level synthesis of the insights regarding the impact of the five SSBs on financial inclusion in the cases of Brazil, Kenya, Mexico, Philippines and South Africa. The overarching message is that the regulatory authorities in the five case study countries do not feel that any of the SSBs impact negatively on financial inclusion. However, a lack of specific impact thus far does not mean that guidance from the SSBs will not be needed going forward to ensure a financial inclusion friendly

regulatory and supervisory approach. There was a unanimous request from the case study regulators and supervisors for more clarity and more practical guidance to assist them in their day-to-day regulatory and supervisory challenges in the face of innovation, diversity, informality and capacity constraints.

Section 3 gave an overview of the areas in which guidance is needed from each individual SSB. Here we conclude by summarizing the main practices across SSBs that will be needed in response to the cross-cutting themes highlighted above. The implications will be stated in terms of further guidance required to ensure financial inclusion-sensitive, international standard-compliant regulation and supervision, or will point out areas where the sharing of experiences and approaches amongst countries is needed before guidance can be developed.

### Extending risk concepts

*Clarify definitions.* As emphasized in the SSB-specific implications in Section 3, countries call for clearer definitions of risk, clearer criteria for risk assessment and specificity on what will be an acceptable approach. The more real the threat of sanction, the more important it is for definitions to be precise. The definitions of various risk concepts (such as “low-risk”, “high-risk” or “comprehensive risk management”) should be clarified and extended to accommodate issues relevant to financial inclusion.

*Disseminate best-practice.* Regulators and supervisors are also in need of more developing country examples of acceptable practices in terms of defining and implementing a risk-based approach to guide them through the assessment process and to ensure that they will follow an acceptable methodology for justifying what they consider to be low risk.

*Acknowledge the risk implications of financial inclusion.* It will be important for each SSB to recognize the implications of financial inclusion for risk. One of the outcomes of such explicit recognition will be to recognize the “risk of the many”, namely the risk implications of financial inclusion in instances of low-value accounts or products across many different entities and clients. This stands in contrast to value (total volumes or assets) as the main determinant of risk under the current standards. As long as value remains the only focus, the standards will continue to bias regulatory responses towards large institutions and will continue to place a lower priority on institutions that serve many clients but are not large in terms of value. Under such circumstances, it will remain a practical challenge for supervisors to prioritize inclusion.

### Implementation-oriented proportionality

*Offer detailed, practical guidance on implementing proportionality.* Stating that proportionality or a risk-based approach is allowed or desired at the principles level is not sufficient: more detailed guidance on the parameters thereof, given the



financial inclusion market realities and capacity constraints facing developing country regulators and supervisors, is needed in order to make proportionality operational:

- Explicit recognition is required of the complementarity of financial inclusion and adherence to international standards, the balancing act needed in order to achieve such complementarity, and how to tailor the regulatory and supervisory approach accordingly.
- The SSBs should more explicitly address the developing country formalization challenge and the implications of capacity constraints in guidance relating to proportionality across the various principles.
- In the face of diversity a “one size fits all” solution does not work. As discussed above, SSBs can play an important role in offering a dialogue platform for diverse country participation. In doing so, they need to consider the differences in sophistication between developing countries and within the financial sector in each country. The need for proportionality also requires them to keep abreast of the pace of innovation in developing countries, guiding regulators and supervisors on an appropriate proportionate or risk-based response.
- SSBs could consider guidance on how to design a “**test and learn**” approach for capacity constrained regulators and supervisors that allows innovation and accounts for diversity while adequately managing risk.

#### *Translate guidance into assessment criteria.*

Implementation-orientated guidance on proportionality will not be meaningful unless it is mirrored in evaluation or assessment criteria. Evaluation or assessments should explicitly recognize the financial inclusion objective and the risk implications thereof. Countries should know upfront how their proportionality framework will be assessed and what will constitute an acceptable risk-based approach. This links closely to the need for clearer definitions of risk concepts.

### **Coordination**

*Coordinate responses to innovations that cut across different areas.* Innovation means that the financial sector landscape in developing countries is continually changing. Topics such as prudential supervision, payment system oversight, consumer protection, formalization, and agency and intermediation regulation no longer fit in neat silos, but increasingly converge between regulatory authorities, asking for coordination and dialogue across regulatory authorities. Specifically, guidance is needed on the treatment of new channels and players, including the considerations to take into account in deciding whether to implement a bank-

based versus a telco-led approach (noting that the ultimate decision on which route to go will be country-specific). Specific consideration is also needed on multi-function channels (e.g. third parties such as retailers or telecommunication companies intermediating services of insurers, banks and other payment providers) and coordination across different regulatory and supervisory spheres in regulating such multi-function channels. Developing country authorities will look to the SSBs to chart the way.

*Establish a platform for SSBs to provide global coordination.* None of the SSBs can by themselves sufficiently deal with the financial inclusion-related market and capacity features that drive the impact of standards in the developing country context. This asks for coordination across SSBs leading, in some instances, to cross-cutting guidance.

### **Inclusive forums for mutual learning**

*Create a space for sharing developing country compliance approaches and experiences.* As standard setting bodies broaden their engagement on the financial inclusion topic, it is important to give developing countries a voice in the debate. SSBs should (and in some cases already do) use their convening power to serve as a broad forum for dialogue and exchange of learning. Given the number of unknowns and experiments in business models and regulatory approaches, SSBs need to find a way of accommodating the sharing of approaches and experiences even before they can judge success. This may include consideration of how to involve non-members and non-compliant countries in the conversation without risk of penalty. Different communication and membership structures, including a focus on the potential role of regional bodies, can be considered to accommodate financial inclusion.

*Mainstream financial inclusion.* More broadly, the imperative for inclusive forums implies the need for financial inclusion (and proportionality more broadly in the developing country context) to be integrated fully into the mainstream agenda of the SSBs, rather than as side topic. It is important that financial inclusion is not relegated to a “micro” topic, but is recognized as core to financial sector development in the developing country context.

### **In conclusion**

The five country case studies highlight the day-to-day challenges that financial sector regulators and supervisors grapple with. Each country recognizes the important role played by international standard setting bodies in guiding them through these challenges. It is hoped that the various issues identified in this document will set the stage for further debate at the global level on how to tackle the financial inclusion opportunity through practical and sufficiently specific guidance.



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# GPFI

Global Partnership  
for Financial Inclusion

## Global Partnership for Financial Inclusion

[www.gpfi.org](http://www.gpfi.org)

The Global Partnership for Financial Inclusion (GPFI) is the main platform for implementation of the G20 Financial Inclusion Action Plan. The group engages partners from G20 and non-G20 countries, private sector, civil society, and others. It is chaired by the G20 troika countries, currently Korea, France, and Mexico. The GPFI is supported by three implementing partners: the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), and the International Finance Corporation (IFC).



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Financial Inclusion  
Bringing smart policies to life

## Alliance for Financial Inclusion (AFI)

[www.afi-global.org](http://www.afi-global.org)

AFI is a global network of central banks and other financial inclusion policymaking bodies in developing countries. AFI has been given the mandate to foster the participation of non-G20 developing countries in the G20's Global Partnership for Financial Inclusion as an implementing partner.

### Alliance for Financial Inclusion

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AFI is funded by the Bill & Melinda Gates Foundation and administered by GIZ (German International Cooperation)