

Supervising Nonbank E-Money Issuers

Nonbank e-money issuers (NEMIs) can play an important role in providing an array of financial services—particularly payments, transfers, and savings—for those who are currently excluded from the formal financial system. In some countries, private sector interest in establishing NEMI operations has been hindered by policy maker concerns over the lack of a clear supervisory framework for this relatively new category of financial institution. In light of this, CGAP researched the current supervisory practice in 10 countries that permit NEMIs¹ and found that while few have a clear supervisory approach, all engage in minimal post-licensing supervision.

This Brief addresses only the supervision of e-money issuing activities of a NEMI. It highlights the primary risks presented by NEMIs and concludes that the minimal supervision undertaken in the researched countries reflects two current realities: NEMIs are engaged in limited activities, and they do not present a systemic risk given the limited funds involved. The minimal approach taken by supervisors today is consistent with the proportionality principle endorsed or supported by, among others, three international standard-setting bodies (i.e., the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, and the Financial Action Task Force) relevant to the supervision of NEMIs (see Box 1).

Box 1. Proportionate supervision

A proportionate approach requires the regulator (i) to understand the risks presented by a specific type of institution, activity, product, or service, and (ii) to design regulation and supervision such that the costs to the regulator, the institutions, and the consumers are proportionate to the risks being addressed, taking into consideration as well the anticipated benefits. A proportionate approach is critical to avoiding overly burdensome regulation and supervision that may handicap or inhibit new entrants and innovations, including those that could beneficially serve people who currently do not have access to financial services.

What is e-money?

While there are slight variations across countries, e-money is typically defined as a type of “stored value” instrument or product that (i) is issued on receipt of funds, (ii) consists of electronically recorded value stored on a device (i.e., a computer system, mobile phone, prepaid card, or chip), (iii) is accepted as a means of payment by parties other than the issuer, and (iv) is convertible into cash.

In countries that explicitly regulate NEMIs, regulation clearly excludes e-money issued by NEMIs from the definition of a deposit.² This issue has presented a stumbling block for some policy makers because “[c]ollecting cash from the general public sounds like the equivalent of collecting deposits, and many countries allow deposit-taking only by prudentially regulated banks” (Ehrbeck and Tarazi 2011). However, a primary risk presented by the collection of public funds by NEMIs is the loss of such funds through intermediation and speculative investment. For this and other reasons (discussed later), countries have required that the total issued and outstanding e-money be matched by an equivalent amount of funds held either as deposits in a supervised financial institution or in another permitted liquid investment (fund safeguarding) (Tarazi and Breloff 2010).³

- 1 These are Afghanistan, France, Indonesia, Kenya, Malaysia, the Philippines, Rwanda, Sierra Leone, Sri Lanka, and the United Kingdom. All of these countries, except for Kenya and Sierra Leone, have laws or regulations specifically governing NEMIs. Although there is no public list of all countries with NEMI-specific laws/regulations, the research for this Brief identified Afghanistan, Indonesia, Malaysia, the Philippines, Rwanda, Sri Lanka, as well as 20 members of the European Union (EU). (EU Working Document on State of Transposition of 2nd E-Money Directive in Member States. http://ec.europa.eu/internal_market/payments/docs/emoney/plans_en.pdf.) Other countries may have laws that do not establish NEMIs as a separate type of institution but permit certain types of institutions to issue e-money (e.g., Nigeria).
- 2 With respect to the categorization and treatment of bank-issued e-money, there is a wide divergence in approach, with some countries explicitly stating that bank-issued e-money does *not* constitute a deposit and others providing that bank-issued e-money is eligible for deposit insurance (thereby suggesting e-money is a deposit).
- 3 Other means of safeguarding, as permitted in the United Kingdom, include an insurance policy with an authorized insurer or a guarantee from an authorized insurer or other financial institution.

What is a NEMI?

In some countries, NEMIs are permitted to engage only in e-money issuance and related activities, such as remittances (e.g., the Philippines); other countries permit nonbanks engaged in a range of permitted activities to issue e-money.⁴ Some countries require an existing financial (or other) institution to establish a subsidiary to engage solely in e-money issuance. (See Box 2 for descriptions of two prominent NEMIs.)

A NEMI is different from a money transfer or payment service provider (PSP) that serves solely as a channel to effect payments and transfers for banks (including banks acting as e-money issuers) or other financial institutions but does not itself issue e-money or offer clients funds storage services.⁵ Some regulators use the term PSP to include e-money issuers although this lack of distinction may result in regulations that are not optimally

Box 2. Safaricom and G-Exchange Inc.

Safaricom of Kenya (e-money: M-PESA) is *de facto* an e-money issuer. There is no law or regulation in Kenya establishing NEMIs as a distinct type of institution so Safaricom began operating pursuant to a letter agreement with the Kenyan central bank. Safaricom issues stored value to its M-PESA customers, who are also customers of the mobile phone company, Safaricom. In contrast, G-Exchange Inc. (GXI), a subsidiary of Globe Telecom of the Philippines (e-money: GCASH), became a licensed remittance agent and offered Globe customers stored-value accounts from which to make payments and money transfers. GXI became licensed as an e-money issuer following issuance of a 2009 central bank e-money circular.

tailored to the risks of the particular provider. For example, while it may be appropriate to place a time limit on the period that a PSP may hold customer funds,⁶ a PSP need not be subject to the fund safeguarding requirement often imposed on NEMIs, as discussed below.

Establishing supervisory authority

Laws or regulations that establish and govern NEMIs grant supervisory authority to the financial regulator—typically, the central bank. Within the central bank, both the bank supervision and the payments departments can claim primary authority given that NEMIs introduce risks associated with both holding customer funds and making payments and transfers. Nevertheless, it is often unclear which department is responsible for NEMI supervision. Furthermore, there is often a lack of clarity regarding the relationship between the financial regulator and other potentially relevant regulators (e.g., a telecommunications regulator).⁷

Risks and supervisory tools

Currently, the two NEMI risks that are the primary focus of regulator attention are (i) significant or total loss of customer funds (including agent funds) due to a decapitalization or failure of the NEMI⁸ and (ii) unavailability of customer funds (liquidity risk).

The risk of *loss of customer and agent funds* is addressed through the licensing process as well as onsite and offsite inspection of a NEMI's operations, technologies, audits, and contingency

4 The United Kingdom distinguishes an “e-money issuer” (i.e., a financial institution, such as a bank, that is permitted to engage in e-money issuance among other things) from an “e-money institution,” which refers to an institution licensed specifically to issue e-money.

5 The risks of a PSP and of retail payment systems more generally—including clearing and settlement risk—are not addressed in this Brief.

6 EU Payment Services Directive 2007 requires that payments be subject to a maximum one-day execution time. Directive 2007/64/EC. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:319:0001:01:EN:HTML>

7 In Kenya, where there is not yet an explicit regulatory framework for NEMIs, the financial supervisor has established its authority pursuant to written agreements with the NEMI, although this can require negotiation with other relevant regulators. Ideally, these agreements will specify the supervisor's powers, including the power to require information on a regular and *ad hoc* basis, to conduct onsite inspections of the company's premises and systems and its agents and other outsourcing parties, and to apply corrective measures.

8 There is also risk of loss of funds as a result of fraud, theft, misuse, negligence, or poor administration.

planning. But the primary protection against risk of loss of customer and agent funds is provided by the regulatory requirements of fund safeguarding and fund isolation (Tarazi and Breloff 2010).⁹ For fund safeguarding, the supervisor would focus on ensuring that the total outstanding e-money issued is in fact matched by an equivalent amount in deposits in a supervised financial institution or other permitted liquid investment. This can be done via reporting¹⁰ and offsite monitoring of the NEMI's process for reconciliation between the settlement account(s) and the e-money float. In some countries, offsite monitoring and reconciliation is accomplished via the NEMI's partner bank, which monitors the NEMI's system and client account balances.¹¹ Today, it is not clear whether any supervisors of NEMIs undertake this kind of review and monitoring.

For fund isolation, the supervisor would focus on ensuring the placement of customer funds in a trust account (or otherwise similarly protected). In the United Kingdom, regulations require placement in a designated account that, pursuant to the regulations, is set apart from the NEMI's other assets.

Even with fund safeguarding and fund isolation requirements, there remains the risk of *loss of customer and agent funds* if the bank holding the funds fails and there is no insurance or other guarantee scheme in place to cover the loss.¹² This highlights the importance of the NEMI supervisor's reliance on effective prudential supervision over the subject bank and, if applicable, the insurer.

The risk of *unavailability of customer funds (liquidity risk)* is addressed through requirements that funds be set aside (i.e., fund safeguarding) or by a minimum liquidity ratio. Supervision with respect to compliance with a minimum liquidity ratio can be conducted offsite or onsite.

Other supervisory priorities include ensuring that NEMIs (i) are not used for criminal purposes (particularly money laundering and terrorist financing); (ii) have adequate systems to conduct the business and to comply with applicable laws, including those on data privacy and data security;¹³ and (iii) observe consumer protection requirements. These risks could be addressed through offsite supervision (monitoring compliance with applicable regulations and internal policies and procedures) and onsite supervision (inspecting systems and conducting simulations to determine, *inter alia*, capability to conduct the operations and protect client personal information), working in cooperation or with the assistance of other regulators with relevant knowledge and information about the NEMI and its systems.

Conclusion

Several countries have instituted regulatory schemes for NEMIs. Yet there is little active supervision over NEMIs—in both developed and developing countries—due to their small size, whether measured in terms of assets, float, or customers. This situation will likely change if the float grows to a significant size¹⁴ or if there is a failure or a significant consumer protection scare, such as wide-scale fraud. Therefore,

9 Fund isolation is the protection of customer funds from NEMI creditors. This is often accomplished through a trust account to shield the funds against creditors of the mobile network operator in the case of bankruptcy. If there is no such concept of a trust account under local law, then regulations often compensate by requiring relatively high minimum capital.

10 Periodic reports might include the number of clients; number of new accounts; total outstanding e-money; total value of remittances/transfers; number of transactions, transaction limits for customers and agents, and number of breaches of such limits; number and nature of transaction errors and failures; number of customer complaints; number and nature of fraud cases and data security breaches; number of new agents and terminated agency agreements; and number of thefts at agent points.

11 See, for example, Section 6.2 of Sri Lanka's Mobile Payment Guidelines No. 2 (2011) for Custodian Account Based Mobile Payment Services.

12 For this reason, Afghanistan requires multiple holding banks. This approach is also used in Kenya.

13 System-related risks may be a significant problem in smaller markets where providers may not be able to afford the better designed and more reliable systems. Such providers (and their supervisors) would benefit from a publicly available rating of vendors and their systems.

14 Most countries place limits on load and transaction amounts for NEMI customer accounts. Unless such limits are repealed, growth that introduces systemic risk is unlikely, although there could be a risk if an NEMI were to have a significant customer base.

the principle of proportionality supports the current supervisory approach in which regulators focus their attention on institutions presenting systemic risk and, with respect to NEMIs, focus on the key risks of loss or unavailability of customer funds, limiting supervision to licensing and light review of standard reports.

References

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