

Digital Financial Inclusion: Implications for Customers, Regulators, Supervisors, and Standard-Setting Bodies

"Digital financial inclusion can be a game changer for unserved and under-served low-income households as well as micro- and small enterprises. The regulatory, supervisory and standard-setting challenges—and likewise the solutions—include those we currently face, and others we can only imagine as billions of new digital finance users go online. We have the opportunity—and indeed the responsibility—to prepare for both the risks and the rewards of the digitisation of financial services."—Jaime Caruana, General Manager, Bank for International Settlements, welcoming remarks to the 2nd Global Partnership for Financial Inclusion (GPFI) Conference on Standard-Setting Bodies and Financial Inclusion, 30–31 October 2014.

With the prospect of reaching billions of new customers, banks and nonbanks have begun to offer digital financial services for financially excluded and underserved populations, building on the approaches that have been used for years to improve access channels for those already served by banks and other financial institutions. Innovative digital financial services involving the use of mobile phones have been launched in more than 80 countries (GSMA 2014).¹ As a result of the significant advances in the accessibility and affordability provided by digital financial services, millions of poor customers are moving from exclusively cash-based transactions to formal financial services. The benefits of this development include economic growth and stability, both for the customers and for the economies where they and their families reside. However, the use of digital financial services by formerly excluded customers brings not only benefits but also risks, due in part to the characteristics of a typical poor customer (inexperienced with formal financial services and unfamiliar with consumer rights). Some of the risks are new while others, although well known, may take on different dimensions in the financial inclusion context.

This Brief² aims to provide national and global policy makers with a clear picture of the rapid development of digital financial services for the poor and the need for their attention and informed understanding. It proposes a concise definition of "digital financial

inclusion" and summarizes its impact on financially excluded and underserved populations; outlines the new and shifting risks of digital financial inclusion models that are significant to regulators, supervisors, and standard-setting bodies (SSBs); and concludes with observations on digital financial inclusion issues on the policy-making horizon.

Digital financial inclusion and its impact on the financially excluded and underserved

"Digital financial inclusion" can be defined as digital access to and use of formal financial services by excluded and underserved populations. Such services should be suited to the customers' needs and delivered responsibly, at a cost both affordable to customers and sustainable for providers.

Today's providers of such financial services can be divided into four broad groupings based on the party holding the contractual relationship with the customer: (i) a full-service bank offering a "basic" or "simplified" transactional account for payments, transfers, and value storage via mobile device or payment card plus point-of-sale (POS) terminal; (ii) a limited-service niche bank offering such an account via mobile device or payment card plus POS terminal; (iii) a mobile network operator (MNO) e-money issuer; and (iv) a nonbank non-MNO e-money issuer.³ All

1 There is no global data source for nonmobile digital financial services for the financially excluded and underserved.

2 This Brief is largely drawn from an Issues Paper prepared by CGAP for the 2nd GPFI Conference on Standard-Setting Bodies and Financial Inclusion (GPFI 2014).

3 The first two "bank-based" models often rely on nonbanks to provide processing or other technology. A recently issued report by the Committee on Payments and Market Infrastructures (CPMI) analyzes the increasing influence of nonbanks on retail payment systems. The report finds that improved efficiency through bank outsourcing to nonbanks has the potential to lower fees, increase the range of payment methods, and reach new markets and customers (CPMI 2014).

four models function via three components: a digital transactional platform, an agent network, and the customer's access device. (See Box 1.) With these components in place, payments and transfers, as well as credit, savings, insurance, and even securities, can be offered digitally to excluded and underserved customers.

Uptake is rapid and significant in some markets.⁴ Digital financial services can make life easier for customers by allowing them to transact locally in tiny amounts and better manage their characteristically uneven income and expenses. The payment, transfer, and value storage services of the digital transactional platform and the data generated by customer usage can enable providers to offer additional financial services tailored to customer needs. Digital financial inclusion can also reduce the risk of loss, theft, and other financial crimes posed by cash-based transactions, as well as the costs associated with transacting in cash. Ultimately, it can advance economic growth by enabling asset accumulation

Box 1. Three key components of a digital financial inclusion model

Digital transactional platform. A digital transactional platform enables a customer to make or receive payments and transfers and to store value electronically through a device that transmits and receives transaction data and connects—directly or through the use of a digital communication channel—to a bank or nonbank permitted to store electronic value.

Retail agents. Retail agents armed with a digital device that is connected to communications infrastructure to transmit and receive transaction details enable customers to convert cash into electronically stored value and to transform stored value back into cash. Depending on applicable regulation and the arrangement with the principal financial institution, agents may also perform other functions.

Device. The device used can be digital, such as a mobile phone that is a means of transmitting data and information or an instrument, such as a payment card that connects to a digital device (e.g., POS terminal).

and, for women in particular, increasing economic participation (World Bank Development Research Group, Better than Cash Alliance, and Bill & Melinda Gates Foundation 2014). However, access to digital financial services does not come without risks to customers as well as to providers.

New risks of digital financial inclusion

Digital financial inclusion introduces new market participants and allocates roles and risks (both new and well known) in different ways compared to traditional approaches to retail financial service delivery.⁵ The three key components of digital financial inclusion models (see Box 1) correspond to the three main triggers of new or shifting risks: (i) the new parties and arrangements involved in the management and storage of account data and the holding of customer funds; (ii) the digital technology; and (iii) the use of agents as the principal customer interface. These three components, as well as the typical profile of the financially excluded or underserved customers in question, introduce various risks, including operational risks, consumer-related risks, and risks related to financial crime.

The digital transactional platform. Innovative digital financial services typically involve at least one bank and one nonbank in both the electronic storage and management of data and the holding of customers' funds. Protecting customer funds will depend on many factors, including whether the holder participates in a deposit insurance system and whether the specific type of account in which the funds are held is insured. If the account pools multiple customers' funds, coverage limits may apply to the account as a whole or to customers' individual balances. Even if the customers' funds are insured, if they are pooled and a third party (such as an MNO) is responsible for storing and managing records of customers' account balances, then there are risks related to real-time accuracy and reconcilability of the records of the failing holder of funds with those of the entity managing the accounts.

Digital technology-related risks. The quality and reliability of the digital technology affect the risks of disrupted service and lost data, including payment

⁴ An example is bKash in Bangladesh, which reached almost a quarter of the adult population in just over two years of operation. See <http://www.cgap.org/photos-videos/benefits-challenges-digital-financial-inclusion>.

⁵ Risks presented by banks and nonbanks may be the same or similar; however, differences in regulatory and supervisory risk mitigation measures applied to banks and nonbanks will affect the risk probability. See CPMI (2014). A 2015 report by the Basel Committee on Banking Supervision (BCBS) on its 2013 survey of 59 jurisdictions and their regulatory and supervisory practices regarding institutions relevant to financial inclusion reveals significant variation both in the complexity of the surveyed financial sectors and in the survey respondents' regulatory and supervisory approaches (BCBS 2015).

instructions (e.g., due to dropped messages), as well as the risk of a privacy or security breach resulting from digital transmission and storage of data. These privacy and security risks are magnified because a large number of agents handle customers' transactional and other data and the profile of previously excluded and underserved customers.

Agent-related risks. Agents and agent networks introduce new operational, financial crime and consumer risks, many of which are due to the physical distance between agents and the provider or the agent network manager and the resulting challenges to effective training and oversight. Operational risks include fraud, agent error, poor cash management by the agent, and poor data handling. In addition to the financial crime risks of fraud and theft (including data theft), agents may fail to comply with anti-money laundering and combatting the financing of terrorism (AML/CFT) rules regarding customer due diligence, handling records, and reporting suspicious transactions. Agents may also take actions that reduce transparency (e.g., on pricing, terms, and recourse), engage in abusive treatment of customers (including overcharging), or fail to handle customer data confidentially.

Other issues on the policy-making horizon

Beyond addressing these new and shifting risks through effective regulation and supervision, policy makers will face the following additional issues as digital financial inclusion expands in reach, scope, and scale.

Product- and model-specific issues in digital financial inclusion. In some countries, in addition to payments, transfers, and value storage, credit and insurance products are being offered to previously excluded and underserved customers via digital transactional platforms. Such products—and the often complex relationships among the banks and nonbanks combining to offer them—introduce both operational risks to the provider and customer risks. When products are bundled—such as life insurance packaged with a prepaid mobile plan—regulation and supervision becomes more complicated, requiring coordination among regulators (see below).

Consumer protection issues. New financial services and products offered digitally to excluded and underserved customers both challenge traditional

thinking about disclosure and recourse and raise other consumer protection issues.⁶ Some policy makers are leaning toward product standards and guidelines to complement digital innovations in disclosure and recourse. In addition, in the event the consumer suffers a loss, liability can be unclear due to the multiple parties involved in service delivery: both agents and third-party providers of communications and technology services.

Increased need for cross-sectoral coordination and communication. Digital financial inclusion—which involves new providers, services, and consumers—requires significant cross-sectoral coordination and communication among regulators and supervisors. This is true both at the country-level (e.g., credit, insurance, and investments offered via digital transactional platforms require the attention of multiple financial regulators and supervisors, and may call for involvement of the telecommunications regulator as well) and the global level of SSBs and other international bodies, such as the International Telecommunications Union.

Customer identity—new opportunities and challenges in the digital context. Financial identity for poor people when services are delivered digitally carries the potential for both inclusion and AML/CFT gains, but also raises privacy and fraud risks. Meaningful and manageable privacy principles—which will involve work at both the national and global levels—offer the prospect of win-win solutions.

References

- BCBS. 2015. "Range of practice in the regulation and supervision of institutions relevant to financial inclusion." January.
- Caruana, Jaime. 2014. Welcoming Remarks for 2nd GPFI Conference on Standard-Setting Bodies and Financial Inclusion: *Standard Setting in the Changing Landscape of Digital Financial Inclusion*, hosted by the Financial Stability Institute at the Bank for International Settlements, 30–31 October.
- CGAP. 2014. "Benefits & Challenges of Digital Financial Inclusion." Video. <http://www.cgap.org/photos-videos/benefits-challenges-digital-financial-inclusion>
- GPFI. 2014. "Issues Paper: Digital Financial Inclusion and the Implications for Customers, Regulators, Supervisors and Standard-Setting Bodies."

⁶ In some cases, new models may offer opportunities for improved consumer protection measures, such as real-time warnings or interfaces that are more intuitive for the customer.

February 2015

CPMI. 2014. "Non-banks in retail payments." September.

GSMA. 2014. "2013 State of the Industry Report on Mobile Financial Services for the Unbanked."

World Bank, Better than Cash Alliance, and Bill & Melinda Gates Foundation. 2014. "The Opportunities of Digitizing Payments—How Digitization of Payments, Transfers, and Remittances Contributes to the G20 Goals of Broad-Based Economic Growth, Financial Inclusion, and Women's Economic Empowerment." August.

Acknowledgments

The authors are grateful to the numerous colleagues who gave input, especially Camille Busette, Louis de

Koker, Xavier Faz, Michel Hanouch, Kathryn Imboden, Kabir Kumar, Kate McKee, and Stefan Staschen and the secretariats of the six SSBs that participated in the 2014 GPFI conference: the BCBS, the CPMI, the Financial Action Task Force, the International Association of Deposit Insurers, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions. The authors also express their appreciation for insights from the 3rd Meeting on Financial Inclusion among senior SSB leadership held at the BIS on 2 October 2014, co-chaired by HM Queen Máxima of the Netherlands, the UN Secretary General's Special Advocate for Inclusive Finance for Development and Honorary Patron of the GPFI and Stefan Ingves, chairman of the BCBS.

All CGAP publications are available on the CGAP Web site at www.cgap.org.

CGAP
1818 H Street, NW
MSN P3-300
Washington, DC
20433 USA

Tel: 202-473-9594
Fax: 202-522-3744

Email:
cgap@worldbank.org

© CGAP, 2015

AUTHORS:

Kate Lauer and Timothy Lyman