

USE OF AGENTS IN BRANCHLESS BANKING FOR THE POOR: REWARDS, RISKS, AND REGULATION



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Introduction

In a growing number of countries, banks and other commercial financial service providers are finding new ways to make money delivering financial services to unbanked people. Rather than using bank branches and their own field officers, they offer banking and payment services through postal and retail outlets, including grocery stores, pharmacies, seed and fertilizer retailers, and gas stations, among others. For poor people, "branchless banking" through retail agents¹ may be far more convenient and efficient than going to a bank branch. For many poor customers, it will be the first time they have access to any formal financial services—and formal services are usually significantly safer and cheaper than informal alternatives.

Two models of branchless banking through retail agents are emerging: one led by banks, the other by nonbank commercial actors. Both use information and communication technologies, such as cell phones, debit and prepaid cards, and card readers to transmit transaction details from the retail agent or customer to the bank. For example, customers of Caixa Econômica Federal, a Brazilian state-owned bank, can open and deposit money in a current account, make person-to-person transfers, and get loans—all using simple bankcards and card readers at over 12,000² lottery outlets, supermarkets, and even butcher shops.³ Customers of Globe Telecom, the second largest mobile network operator in the Philippines, can use prepaid airtime dealers to deposit cash into virtual "e-money" accounts tied to their mobile phones. Customers can use their phone to send and receive "G-Cash," make payments to other people and shops, and store money for future use.⁴

Branchless banking through retail agents appeals to policymakers and regulators because it has the potential to extend financial services to unbanked and marginalized communities. But it also challenges them to ask: What are the risks of these new approaches, and are they different from those of conventional branch-based banking? How should we respond to these risks, so as to permit branchless banking with retail agents to operate safely and expand access to finance?

¹ In this Focus Note, retail outlets are referred to as "retail agents," because although they are not always true "agents" in the legal sense, they are not licensed to perform cash-in (deposit) and/or cash-out (withdrawal) functions on their own behalf by banking regulation, and do this only on behalf of a bank or e-money issuer. Essentially, these retail agents are acting as "borrowed tellers."

² Interview with Luis Felipe Pinheiro, Jr., at Caixa Economica Federal, May 31, 2006.

³ <http://www1.caixa.gov.br/idiomas/ingles/presentation.asp>

⁴ <http://www.myglobe.com.ph/gcash>



This Focus Note offers insights on these questions by examining the experience of five pioneering countries—Brazil, India, South Africa, the Philippines, and Kenya—where agent-assisted branchless banking that targets poor customers is already a reality. This Focus Note introduces the main issues involved in regulating branchless banking, particularly regarding the use of retail agents. The authors hope these five countries' experience will be useful for financial sector policymakers and regulators in other countries and for firms interested in these new approaches. However, because branchless banking is still very new, and our sample of countries very small, we make no attempt at generalized principles that regulators should follow, much less provide definitive answers to common questions. Instead, we hope to offer a few early lessons to be tested and elaborated upon as the concept of branchless banking for the poor takes hold.

This Focus Note begins with some background on branchless banking through retail agents and its two main models: the bank-led model and the nonbank-led model. It then examines the new or enhanced risks these branchless banking models raise and explains how banking regulators have responded to these risks so far in the five countries studied. It concludes with considerations for prudent but access-oriented regulators and policymakers regarding branchless banking for the poor.

What Is Branchless Banking through Retail Agents? Who Is Using It, and Why?

Branchless banking represents a new distribution channel that allows financial institutions and other commercial actors to offer financial services outside traditional bank premises. Some models of branchless banking—for example, Internet banking and automatic teller machines (ATMs)—can be seen as modest extensions of conventional branch-based banking.⁵ Other models—such as the ones examined in this Focus Note—offer a distinct alternative to conventional branch-based banking in that customers conduct financial transactions at a whole range of retail agents instead of at bank branches or through bank employees.

Agent-assisted branchless banking is relatively new. Among the countries studied, the phenomenon ranges in age from only a few months (in the case of Kenya), to a few years (in the case of Brazil and some services in India). Outside of Brazil and the Philippines, branchless banking through retail agents reaches relatively few customers with a limited range of financial services.

What makes branchless banking work are information and communication technologies that customers, retail agents, and banks or nonbank e-money issuers use to record and communicate transaction details quickly, reliably, and cheaply over vast distances. For example, even in rural areas, many poor people have access to low-cost mobile phones and prepaid airtime dealers. Branchless banking customers use cell phones to transmit instructions to transfer money from one person's account to another. They use the airtime dealer to exchange cash for electronic value in a bank account or a virtual e-money account and to change electronic value back into cash.

But despite their importance, the technologies are just tools. Ultimately the parties to branchless banking models must see a business case for their involvement.

For banks, branchless banking through retail agents is used to reduce the cost of delivering financial services (potentially radically), relieve crowds in bank branches, and establish a presence in new areas. The setup cost of a retail agent in Brazil can be as little as 0.5 percent of the cost of setting up a bank branch (Kumar et al. 2006). In Brazil and India, banks also use retail agents to help meet political or regulatory requirements to distribute credit in low-

⁵ Internet banking, as it is known in developed countries, remains a distant dream for poor people in most developing countries. ATMs may have greater general utility as tools to serve poor customers not reached by conventional branch-based banking. However ATMs, too, have potential limitations as a means of serving new poor customers, including the relatively high costs of installation and maintenance (particularly when the ATMs are located far from bank premises). Therefore, this paper focuses on branchless banking approaches that make use of nonbank retail agents as the primary customer interface. It does not include models where the mobile phone is simply used as an access channel to a bank account and where no retail agents for cash-in/cash-out functions are involved.

income and rural areas that they could not profitably serve with conventional branch-based banking.⁶

Mobile network operators who offer basic banking and payment services using the nonbank-led model seek greater revenue per customer (through text messaging fees and transaction fees), income from interest on customers' net e-money balances held at commercial banks, and reduced customer turnover. E-money products, such as G-Cash in the Philippines, add data traffic on an installed communications network and incremental revenue per mobile subscriber. Customers with e-money accounts are less likely to switch service providers, and new customers might join to benefit from the service (InfoDev 2006). For prepaid card issuers using the nonbank-led model, the business case depends on transaction fees and perhaps also interest income on customers' net e-money balances held in the name of the card issuer.

Retail agents may have the best commercial reason to be involved. First, conducting cash transactions for banks and nonbanks earns them transaction fees, turning idle cash and underutilized staff into new revenue generators. Retail agents also gain business from the increased foot traffic of customers coming for financial services.

Overview of Branchless Banking through Retail Agents in Five Countries

Brazil

In Brazil, private and state-owned banks⁷ deliver financial services through retail agents including small supermarkets and pharmacies, post offices, and lottery kiosks (Kumar et al. 2006). These agents are called "banking correspondents." In 2000, 1,600 of Brazil's 5,800 municipalities—more than one-quarter—lacked access to formal banking services. By 2003, all municipalities had access to these services through banking correspondents. By the end of 2005, nearly 58,000 banking correspondents were operating, according to Brazil's central bank (Feltrim 2006). The banking correspondent model has been developing since 2000, when Caixa Econômica Federal gained the rights to offer bill

payment services through the large national lottery outlet network.⁸

India

In January 2006, India's central bank—the Reserve Bank of India (RBI)—issued a circular permitting banks to use post offices and specialized micro-finance institutions (MFIs), including nonprofit organizations (NGOs), cooperatives, and for-profit companies, as retail agents. The circular calls these agents "business correspondents."⁹ Although ICICI Bank (India's second largest bank)¹⁰ and several other private-sector banks had already used MFIs as retail agents for disbursing and collecting loans (Harper and Kirsten 2006), banks now may use MFIs and post offices to perform other tasks, including collecting small-value deposits. However, since the circular's issuance, there has been virtually no experience with deposit collection. Thus far, specialized MFIs claim not to see the advantage of handling deposit collection on behalf of banks.

South Africa

In South Africa, branchless banking through retail agents is permitted only for licensed financial institutions. Nonbanks are prohibited from accepting public deposits, broadly defined, so mobile operators interested in branchless banking have created joint ventures with licensed banks to offer cell phone-based banking. WIZZIT, a four-year-old technology firm, became a division of the South African Bank of Athens

⁶ In India, banks have to direct 40% or more of lending to "priority" sectors, with 18% going to rural areas. See Harper and Kirsten 2006. In Brazil, 2% of demand deposits must be directed to loans below a certain size, considered to be microloans. See Kumar et al. 2006.

⁷ The private banks are Banco Bradesco (<http://www.bradesco.com.br/ir>) and Lemon Bank (<http://www.lemon.com>). The state-owned banks are Banco do Brasil (<http://www.bb.com.br/appbb/portal/ri/eng/index.jsp>) and Caixa Econômica Federal.

⁸ Caixa has been using lottery outlets to distribute social benefits for 10 years. In 2000, formal recognition of banking correspondents by the Brazil Central Bank led Caixa to branch out into other services, including basic financial services. See Kumar et al. 2006.

⁹ The RBI circular also permits "business facilitators," which assist in various outreach-related tasks on behalf of a bank, but which could not be considered retail agents as this term is used in this Focus Note, because they are not permitted to perform the cash-in/cash-out function on the bank's behalf. See Reserve Bank of India 2006.

¹⁰ <http://www.icicibank.com>

to be able to offer cell phone- and card-based bank accounts for the unbanked.¹¹ WIZZIT offers deposit, withdrawal, payment, and airtime purchase services through a combination of the mobile phone interface, ATMs, branches of ABSA Bank (South Africa's largest), and post offices. MTN Banking, a competitor, is a joint venture of a leading mobile operator, MTN, and Standard Bank.¹² Neither WIZZIT nor MTN Banking uses retail agents (with the exception of post offices) to handle cash on its behalf. Still, South Africa is an important reference case because of network operators' interest in branchless banking and the strict regulatory interpretation that forced joint ventures with banks.

The Philippines

Mobile network operators Globe Telecom and SMART¹³ have offered branchless banking in the Philippines since 2000. Globe Telecom's G-Cash service is an e-money account tied to a mobile phone subscriber information module (SIM card). The account can be loaded and unloaded by depositing or withdrawing cash at a wide range of retail agents and the mobile operator's own dealers. Customers can store cash (in the form of e-money), send funds from person to person, pay bills and make loan repayments, and purchase goods at shops using the e-money value in their G-Cash accounts. Most of the 1.3 million users buy airtime and send money to friends and family with the service.

Kenya

Safaricom, a Vodafone affiliate and the leading mobile operator in Kenya, offers customers the M-Pesa account, which they can load and unload at retail agents in a manner similar to the G-Cash offering in the Philippines.¹⁴

Customers can use the M-Pesa account tied to the SIM in their cellphone to accomplish the same range of transactions as with G-Cash. Safaricom has partnered with the Commercial Bank of Africa (CBA) and a local MFI (Faulu) to pilot-test the product. A second branchless banking initiative in Kenya, called SmartMoney, was launched in April 2006.¹⁵ This startup firm issues customers prepaid cards they can use as e-money transaction accounts. Customers can add money to their card (and the virtual e-money account that backs it), withdraw funds from it, or make payments at a super-market chain (and soon, SmartMoney hopes, at other participating retail outlets).

The Bank-Led Model

In the most basic version of the bank-led model of branchless banking, a licensed financial institution (typically a bank) delivers financial services through a retail agent. That is, the bank develops financial products and services, but distributes them through retail agents who handle all or most customer interaction. The bank is the ultimate provider of financial services and is the institution in which customers maintain accounts. This is depicted in Figure 1.

Retail agents have face-to-face interaction with customers and perform cash-in/cash-out functions,

¹¹ <http://www.wizzit.co.za>

¹² <http://www.mtnbanking.co.za>

¹³ <http://www.smart.com.ph/SMART/Value+Added+Services/Smart+Money>

¹⁴ http://www.vodafone.com/article/0,3029,CATEGORY_ID%253D30403%2526LANGUAGE_ID%253D0%2526CONTENT_ID%253D278612,00.html

¹⁵ <http://www.smartmoney.co.ke>

Figure 1 The Bank-Led Model

CUSTOMER	RETAIL AGENT	BANK
<p>Step 1: Customer requests financial service.</p> <p>Examples of Services Offered: Deposits and withdrawals; money transfers; loan/bill/tax payments; loan application and disbursement; account opening and credit card application acceptance.</p>	<p>Step 2: Retail agent checks customer's ID and processes transaction, either directly through bank's infrastructure (POS) or through payment processing agent.</p> <p>Examples of Retail Agents: Retail outlets (grocery stores, lottery outlets, pharmacies, etc.); socially motivated organizations (NGOs, MFIs, etc.); post offices.</p>	<p>Step 3: Bank credits and debits bank accounts of customer and other party to the transaction.</p> <p>Examples of Other Parties: Includes retail agent (for deposits or withdrawals) and recipients of money transfers (other customers, utility companies, tax authorities, etc.).</p>

much as a branch-based teller would take deposits and process withdrawals. In some countries, retail agents also handle all account opening procedures and, in some cases, even identify and service loan customers. Virtually any outlet that handles cash and is located near customers could potentially serve as a retail agent. Whatever the establishment, each retail agent is outfitted to communicate electronically with the bank for which it is working. The equipment may be a mobile phone or an electronic point-of-sale (POS) terminal that reads cards.

Once an account is established or loan approved, the customer goes to the retail agent to conduct all or certain financial transactions. The retail agent checks the customer's identification documentation and processes the transaction, debiting the customer's and crediting the payee's bank account if it is a purchase or a transfer of funds between accounts. Unless the transaction is merely a transfer of funds, cash is either deposited to or withdrawn from the retail agent's cash drawer. An electronic record of the transaction is either routed directly from the retail agent to the bank or is handled by a payment processing agent that settles the transaction between the customer's account and the payee's account.

In some versions of the bank-led model, such as in Brazil, banks may contract management companies to identify, contract, equip, and monitor retail agents on the banks' behalf. In many cases, management agents assume liability for cash handled by the retail agent (although the bank is also liable to the customer in the case of fraud or negligence by the retail agent). In some cases, a payment processing agent may settle transactions among banks.

The Nonbank-led Model

In the typical nonbank-led model of branchless banking, customers do not deal with a bank, nor do they maintain a bank account. A bank may not be involved at all. Instead, customers deal with a nonbank firm—either a mobile network operator or prepaid card issuer—and retail agents serve as the point of customer contact. Rather than deposit money into and withdraw money from a

bank account, customers exchange their cash for e-money stored in a virtual e-money account on the nonbank's server, which is not linked to a bank account in the individual's name. E-money, according to the Basel Committee's definition, is "a stored value or prepaid product in which a record of the funds or value available to the consumer for multi-purpose use is stored on an electronic device in the consumer's possession." (Bank for International Settlements 2004).¹⁶ In other words, customers exchange cash for value stored in a card- or mobile phone-based virtual account. Customers can send this e-money to others, use it to make purchases, or use the e-money account to store funds for future use. They can also convert it back to cash at any participating retail agent.

Figure 2 depicts the three parties to the nonbank-led model. The nonbank performs a role similar to that of a bank in the bank-led model. It designs financial and payment products, contracts retail agents directly or through intermediaries, and maintains customer e-money accounts. Globe Telecom, Safaricom, and other nonbank e-money issuers track and maintain customer-level account balances on their own data systems. When the nonbank is a prepaid card issuer, it issues POS card readers and other equipment to retail agents. When the nonbank is a mobile operator, it generally has preexisting relationships with retail agents and many customers—it provides them with their cell phones or their cell phone service. Unlike customers that use payment cards, mobile phone banking customers can conduct transactions wherever they have cell coverage; they need to visit a retail agent only for transactions that involve depositing or withdrawing cash.¹⁷

Retail agents in the nonbank-led model also perform the same basic functions as in the bank-led model. They take in and disburse cash (i.e., they "load" and "unload" e-money, also referred to as "issuing/selling" and "buying" e-money) using mobile phones or POS card readers to record

¹⁶ In the case of mobile phones, the record of the stored funds may be on the phone itself or on a host server accessible by the customer using his or her phone, depending on the technology used.

¹⁷ See, e.g., Owens 2006.

Figure 2 The Nonbank-Led Model

CUSTOMER	RETAIL AGENT	NONBANK	BANK
<p>Step 1: Customer requests sale or financial services using either cell phone or smart card.</p> <p>Examples of Services Offered: Deposits to and withdrawals from customer's e-money account (cash-in and cash-out); item purchases*; money transfers*; loan disbursement/repayment*; bill/tax payments*.</p> <p>* These services may also be accessible directly via cell phone without visiting a retail agent.</p>	<p>Step 2: Retail agent checks customer's ID and processes transaction on behalf of nonbank, using either cell phone or smart card reader.</p> <p>Examples of Retail Agents: Airtime vendors; department stores; supermarkets; other commercial enterprises.</p>	<p>Step 3: Nonbank registers transaction, updates the (virtual) e-money accounts belonging to the customer and the other party to the transaction. Nonbank manages individual customer accounts.</p> <p>Examples of Other Parties: Includes retail agent (for deposits, withdrawals, or item purchases); recipients of money transfers (other customers, utility companies, tax authorities, etc.).</p>	<p>Step 4: Bank (generally)† holds net funds from the nonbank's issuance of e-money on behalf of nonbank. Bank does not have a relationship with customer or retail agent.</p> <p>†This is the practice of mobile phone operators in the Philippines and Kenya, as a simple matter of business prudence, although not required by regulatory authorities in either country.</p>

transactions.¹⁸ When a customer hands over cash to increase her e-money balance, the retail agent keeps the cash in exchange for some of his own e-money. Unlike in the bank-led model, the settlement takes place with e-money, not funds in bank accounts. This poses a certain risk for both customer and retail agent.

Commercial banks *are* typically used in the nonbank-led model, but generally only as a place for the nonbank to hold the net proceeds of issuing e-money (and as a convenient means to earn a return for the nonbank on these funds while keeping them highly liquid). For example, Globe Telecom in the Philippines pools the funds that back its e-money accounts in several wholesale deposit accounts at licensed commercial banks. In Kenya, Safaricom pools its e-money account proceeds in a wholesale deposit at the Commercial Bank of Africa (CBA). SmartMoney, too, has a practice of holding net e-money proceeds in a licensed Kenyan commercial bank. In some cases, there may be no regulatory barrier to the nonbank holding the net e-money proceeds in some other form of investment (including investments considerably less safe and less liquid than a conventional wholesale bank deposit) or even using them for lending.

What New Risks Are Involved?

As compared with conventional branch-based banking, both models of agent-assisted branchless banking

touch on issues that lie at the heart of traditional bank regulation and supervision. One set of issues, common to both models, arises from the outsourcing of substantially all direct customer contact to a potentially infinite array of different types of retail agents. We refer to these as “agent-related risks.” The second set of issues, relevant only to the nonbank-led model, revolves around the acceptance of repayable funds from retail customers by nonbank entities that are not subjected to prudential regulation and supervision. We refer to these as “e-money risks.”

For regulators, the task is not to try to eliminate these risks, but to balance them appropriately with the benefits of branchless banking—including expanded outreach of financial services.

Agent-Related Risks

From a typical banking regulator’s perspective, entrusting retail customer contact to the types of retail

¹⁸ Retail agents in the nonbank-led model are likely to have long-established ties with their nonbank partners (e.g., airtime vendors who deal in G-Cash in the Philippines have been distributing prepaid airtime for the mobile network operator directly), or at least indirect existing ties with the mobile operator, through intermediary wholesalers from whom airtime dealers often purchase airtime and e-money for resale. Mobile operators, such as Globe Telecom, sell airtime to a handful of airtime wholesalers in the country, who then wholesale it to the individual retail outlets. Distributing e-money works in much the same way. Globe Telecom offers airtime wholesalers the chance to exchange cash for G-Cash and then lets the wholesale dealer offer G-Cash to its retail distributors.

Table 1 Agent-Assisted Branchless Banking in Five Countries

Country	Types of Agents	Technology Used	Model Used and Services Offered Through Agents
Brazil	Retail outlets (grocery stores, drug stores, gas stations, other retailers) and lottery and postal outlets (all referred to as banking correspondents)	Payment cards and card readers	Bank-led model: Consumer loans, deposits, withdrawals, personal credit, account balance statements, bill payments, receipt of applications to open new accounts (savings, loans, credit cards), money transfers, insurance, and payment of government benefits and pensions
India	MFIs registered under various laws (NGOs, mutually aided cooperative societies, cooperatives, section 25 companies, nondeposit-taking NBFCs) and post offices (all referred to as business correspondents)	Web-based systems, payment cards, and card readers	Bank-led model: Small-value credit (including identification of borrowers; collection, preliminary processing, and submission of loan applications; collection of interest; and follow-up for repayment and loan recovery); small-value savings; microinsurance; small-value money transfers; account opening
South Africa	Bank branches (not regarded as agents as defined in this paper), post offices, EasyPay pay-points (supermarkets linked to the national payment system through EasyPay's infrastructure)	Mobile phones, payment cards, and card readers	Bank-led model: Account opening, bill/tax payments, payment of salaries, money transfers, airtime top-up, and basic banking services
Philippines	Mobile network operator's retail stores, other retail outlets, rural bank branches	Mobile phones	Nonbank-led model: Item purchases, loan disbursements/repayments, bill/tax payments, money transfers and remittances, airtime top-up, and small-value deposits and withdrawals
Kenya	Airtime vendors, supermarkets, and, in the future, other retail outlets	Mobile phones, prepaid payment cards and card readers attached to PCs	Nonbank-led model: Loan disbursement and repayment, bill/tax payment, money transfers, and small-value deposits and withdrawals

Notes: Brazil, South Africa, the Philippines, and Kenya are examples of countries where models are currently in operation; India is an example of a country that reflects current legal framework. Agents in India do not offer most services listed here (except the provision of small-value credit through agents, which was done even before the regulations were issued).

agents used in both the bank-led and nonbank-led models would seem riskier than these same functions in the hands of bank tellers in a conventional bank branch. These retail agents may operate in hard-to-reach or dangerous areas, and they lack physical security systems and specially trained personnel. The lack of expert training may seem a particular problem if retail agents' functions range beyond the cash-in/cash-out transactions of typical bank tellers to include a role in credit decisions.

But in general, the bank-led model adds few serious risks as compared with conventional branch-based banking.

Banking regulation typically recognizes multiple categories of risk that bank regulators and supervisors seek to mitigate.¹⁹ Five of these risk categories—credit

risk, operational risk, legal risk, liquidity risk, and reputational risk²⁰—take on special importance when customers use retail agents rather than bank branches to access banking services.²¹ The use of retail agents also potentially raises special concerns regarding consumer protection and compliance with rules for combating money laundering and financing of terrorism.

Credit risk. Credit risk, simply stated, is the risk that one party to a financial transaction will not receive the money he or she is owed when it is due. When

¹⁹ These include all the risks recognized by the Basel Committee. See, e.g., Basel Committee on Banking Supervision 2006.

²⁰ See, for example, Basel Committee on Banking Supervision 2000.

²¹ Three other commonly cited types of risks—country and transfer risk, market risk, and interest rate risk—play out largely the same whether or not retail agents are the primary customer interface.

banking transactions do not settle immediately, and when additional parties are interposed between the customer and the bank, opportunities for credit risk multiply. For example, when a customer makes a deposit at a bank branch, she receives a deposit receipt immediately and can be fairly certain that the funds will be credited to her account and will be available for withdrawal when desired (assuming the bank is solvent and liquid). But when a customer makes a deposit into her bank account through a retail agent, even if she receives a receipt immediately, she bears the risk that the transaction is not communicated to the bank. Her account may not be credited. On the other hand, when the retail agent processes a cash withdrawal for a customer, it is the retail agent who takes credit risk—the risk that the bank won't reimburse him the cash he disbursed from his till.

Institutions face credit risk with agent-assisted branchless banking whenever they must collect customer deposits or payments from their retail agents. Obviously, they also face credit risk whenever they decide to grant a customer a loan, and this latter form of credit risk may be enhanced in the agent-assisted branchless banking context if the bank has outsourced some or all aspects of loan underwriting or collection to its retail agents.

Operational risk. Operational risk refers to potential losses resulting from “inadequate or failed internal processes, people and systems or from external events.”²² For banks and nonbanks that use retail agents and rely on electronic communications to settle transactions, a variety of potential operational risks arise. For example, customers or retail agents could commit fraud, or a bank's equipment or other property could be stolen from a retail agent's premises. Financial loss for banks or nonbanks (and also potentially for customers) can also occur from data leaks or data loss from hacker attacks, inadequate physical or electronic security, or poor backup systems. Anecdotal evidence from Brazil, which has the longest track record with agent-assisted branchless banking, suggests that operational risk is significant. Banks in Brazil have reported losses because of retail agent fraud and robberies, which reportedly occur with great pre-

dictability when word gets around that a particular agent is handling an increased volume of cash.

Legal risk. Financial service providers will invest in a new delivery model only if they can predict and manage how relevant laws, regulations, and legal agreements will be applied and enforced, and how these things may change over time. In the countries studied, the banks and nonbanks involved undoubtedly devoted significant effort to researching the relevant laws and regulations before investing in agent-assisted branchless banking approaches, and in most cases, they also consulted with regulatory authorities to understand better how authorities were likely to apply existing rules to the new model. But because regulators have had little experience with both models and are still adjusting existing rules to address them (or have yet to begin this process), some level of legal and regulatory uncertainty and ambiguity for both the banks and nonbanks (and to a lesser extent also for retail agents) remains. Once a model becomes widely used in a country, these uncertainties and ambiguities could take on a systemic dimension if, for example, several banks with significant operations conducted through retail agents suddenly face an unfavorable interpretation that challenges their authority to transact business through retail agents or the enforceability of related legal agreements.

Liquidity risk. Retail agents, especially those that are relatively small, unsophisticated, and remote, may not have enough cash to meet customers' requests for withdrawals and may lack experience in the more complex liquidity management required for offering financial services. To manage liquidity effectively, retail agents must balance several variables, including turnover of cash, ease of access to the retail agent's bank account, and processing time of transactions, among others.

Reputational risk. When retail agents underperform or are robbed, banks' public image may suffer.²³ Many operational risks mentioned (such as the loss of customer records or the leakage of confidential customer data) also can cause reputational risk, as can liquidity shortfalls in the retail agent's cash drawer. The prospects for damage to the financial

²² See Basel Committee on Banking Supervision 2003.

²³ Likewise, there is the risk that a retail agent's reputation will suffer if a bank becomes insolvent and customers cannot access their accounts through the agent any longer.

institution's reputation from problems of this sort should not be underestimated, because many retail agents may be inexperienced in providing financial services, may not be accustomed to maintaining adequate cash to settle customer withdrawals, and may lack the physical security to protect the increased levels of cash they will have on hand if things are going well. Moreover, reputational risk can spread from one bank or nonbank to another and take on systemic dimensions. In South Africa, mobile phone banking providers expressed concern that if even one young initiative failed, it could jeopardize customers' trust in the entire mobile phone banking business.²⁴

Consumer protection, including resolution of consumer grievances. Obviously, any of the foregoing categories of risk triggers consumer protection concerns if the resulting loss falls on customers. Use of retail agents may also increase the risk that customers will be unable to understand their rights and press claims when aggrieved. Customers are protected against fraud by laws and regulations in the countries studied. But it is not always clear to customers how they will be protected against fraud when they use retail agents to conduct financial transactions. For instance, it might not be obvious whether customers should hold the bank or its retail agents liable if they suffer a loss. Poor, remote, or marginalized people may find it particularly difficult to understand their rights and to press a claim through a court or through the bank's own claims resolution mechanisms.

Anti-money laundering and combating financing of terrorism (AML/CFT). Whenever account opening and transaction processing is outsourced to retail agents, AML/CFT regulations generally require agents to conduct some aspects of customer due diligence and suspicious transaction reporting. The bank bears the risk that customers are improperly identified and that they use the retail agent to launder money or channel funding to terrorists (with or without the retail agent's knowledge or complicity). Outsourcing account opening and retail transaction processing to what may be unsophisticated retail agents also may make it difficult for the bank to observe and report suspicious transactions.²⁵

E-Money Risks of the Nonbank-Led Model

The greatest risk in the case of the nonbank-led model has little to do with the use of agents. Instead, the risk is that an unlicensed, unsupervised nonbank will collect repayable funds from the public in exchange for e-money and will either steal these funds or will use them imprudently, resulting in insolvency and the inability to honor customers' claims.

The likelihood of a nonbank becoming insolvent depends on the financial strength of the nonbank and how it maintains liquidity to back its aggregate e-money in circulation. Storing net proceeds earned from issuing e-money in licensed and prudentially supervised banks can ensure that there's adequate liquidity in the ordinary course to honor customer claims. But it will not protect customers from imprudent management of the nonbank e-money issuer's business generally nor from the claims of the nonbank's other creditors.

Developing country regulators are not alone in facing the challenge of how to deal with e-money issuance by parties that are not prudentially licensed. Much of the developed world is grappling with the same dilemma: how to unleash the vast potential of this mode of financial service delivery without undue risk, given that e-money issuers often may be parties, such as mobile operators, who are not otherwise subject to prudential regulation and supervision.

Five Countries' Approach to Regulation

In all five countries studied, regulators have had to consider the agent-related risks presented by the two models of agent-assisted branchless banking. Regulators in Kenya, the Philippines, and South Africa also have had to consider the e-money-related risks presented by the nonbank-led model. All of these regulators appear to have recognized the potential of agent-assisted branchless banking

²⁴ On operational and reputational risk for banks, see Basel Committee on Banking Supervision 1998.

²⁵ The Financial Action Task Force recommendation on outsourcing to third parties of duties associated with AML/CFT compliance calls for such third parties to be "regulated and supervised." See FATF 2003.

Box 1 Balancing AML/CFT Customer Identification Requirements and Access to Financial Services for the Poor

In many cases, poor customers lack certain documentation—such as identification cards or proof of residence—that is necessary to comply with AML/CFT customer identification requirements. AML/CFT precautions increase costs and, thus, may discourage providers from serving smaller clients. There is a compelling argument that, below certain thresholds, risks for low-value transactions and accounts aren't serious enough to require full-scale AML/CFT measures. Some of the countries studied have amended the rules for low-value transactions or accounts, to strike a balance between the need for effective AML/CFT regulation and the need to ensure poor customers are not excluded from access to financial services as a result.

In **South Africa**, banks and money transfer companies are not required to obtain and verify a customer's income tax registration number and residential address, provided that certain requirements are met (transactions limited to approximately US\$800 per day and approximately US\$4,000 per month; maximum account balance of approximately US\$4,000 at any time; no international transfers, with limited exceptions). However, institutions must still obtain and verify a customer's full name, date of birth, and identity number, using an official identity document for verification. Because approximately 1.5 million eligible South Africans lack such an identity document, the rules still exclude many low-income people from financial services.

In **India**, the central bank has emphasized that AML/CFT requirements should not limit poor customers' access to financial services. For all accounts, identity and address requirements can be met through documentation such as ration cards or letters from public authorities or employers. In addition, for certain low-value accounts (maximum account balance of approximately US\$1,100; maximum total annual credit of approximately US\$2,300), prospective customers lacking necessary documentation can be introduced by another customer in good standing who was subjected to full "know your customer" procedures and who can confirm the prospective customer's address. Alternatively, for these low-value accounts, banks can accept any form of documentation that satisfies them as to the identity and address of the customer.

In **Brazil**, poor customers must meet the same identification requirements as any other customers. However, customers may open low-value accounts (generally, maximum balance of approximately US\$500) using records provided by the National Social Security Institute, as long as all of the necessary identification information is contained in these documents. In addition, customers may temporarily open a low-value account using only their Social Identity Number, but full documentation must be provided within six months, or the account will be closed. This gives agents operating in remote areas more time to submit the required information.

Sources: Amended Exemption 17 to the Financial Intelligence Centre Act (November 1, 2004), <http://www.fic.gov.za/info/Revised%20exemption%2017%20+%202nd%20reporting%20exemption.pdf>; Genesis Analytics Ltd., *Legislative and Regulatory Obstacles to Mass Banking*, p. 54, <http://www.finmark.org.za/documents/2003/SEPTEMBER/MassBanking.pdf>; Circular RBI/2004-05/284, "Know Your Customer" (KYC) Guidelines—Anti Money Laundering Standards, pp. 6 and 15 (November 29, 2004), http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=2039; Resolution 3,211, <http://www.bcb.gov.br/?BUSCANORMA> (in Portuguese; English copy on file with authors).

to expand access to financial services. Each country has struck its own balance between mitigating risk and encouraging these new models.

Brazil

Brazilian regulation first permitted banks to outsource to agents the processing of payment orders and collection services in 1973. But it is only in the past four to five years that policy-makers in Brazil have begun allowing banks to outsource the cash-in/cash-out functions of a bank teller that are intrinsic to retail financial services. Successive amendments to the regulatory provisions on banking correspondents have gradually opened the door to the most complete outsourcing of a bank's retail functions and the widest array of different possible retail agents found in any of the countries studied. Retail agents can extend credit and accept deposits on behalf of banks and can

even make the credit decision themselves, although in practice, banks tend to retain the credit underwriting responsibility.

Brazilian regulation mitigates agent-related risks by making banks fully liable for their agents' acts²⁶ and by allowing bank supervisors to review agents' transactions and records, exactly as if they had been undertaken in a bank branch by bank employees. The central bank can examine the process a bank uses to select its retail agents. Although banks are required to develop internal controls over their retail agents, the details are left to their business judgment.

Brazilian regulators have not directly addressed the risk that individual retail agents will not have sufficient liquidity for customers who want to withdraw

²⁶ Banks typically will be able to proceed against their agent if they suffer a loss that is because of the agent's misconduct, either as a matter of law or under the terms of their contract with the agent in question.

Box 2 The European Commission's E-Money Directive

Developed countries have not yet figured out how best to regulate nonbank e-money issuers. A European Directive applying to “Electronic Money Institutions” was passed on September 18, 2000, to give nonbank e-money issuers lighter prudential requirements than banks.* The applicable requirements include the following:

- At least EUR 1000 000 in capital, or 2 percent of the “financial liabilities related to outstanding electronic money,” whichever is higher.
- Funds received in exchange for e-money may be invested only in certain low-risk asset categories (mostly liquid assets).
- Electronic money must be redeemable at par value (that is, when converted into cash, the full value should be given).
- A separate dedicated legal entity must be established (meaning a mobile operator cannot offer e-money alongside its airtime sales without a separate corporate structure for this purpose).
- Electronic Money Institutions are permitted to issue and administer only electronic money or other related forms of payment and store related data. Electronic Money Institutions are specifically prohibited from offering credit.

Money laundering issues are not specifically covered by the e-money directive. However, Electronic Money Institutions are subject to customer due diligence requirements, and there is some evidence that this has been burdensome in the past. As a result, a recent Directive exempted Electronic Money Institutions from these requirements for e-money accounts below EUR 150 (nonrechargeable device) or EUR 2,500 in transactions per calendar year (rechargeable device).

Unfortunately, even these lighter prudential requirements have proven to be too heavy. As of early 2006, waivers have been granted to 72 institutions that could not comply with the prudential requirements. Only nine Electronic Money Institutions are operating subject to the Directive. Currently, the European Commission is conducting a fundamental review of the Directive.

*The Directive exempts nonbanks issuing electronic money from coverage under Article 3 of the Credit Institutions (Banking) Directive, which contains prudential requirements that would generally be too heavy for nonbank financial institutions to meet. Banks offering e-money services are exempted from the E-money Directive because such institutions are already sufficiently regulated under the Credit Institutions (Banking) Directive.

Sources: Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of, and prudential regulation of the business of electronic money institutions, http://europa.eu.int/eur-lex/pri/en/oj/dat/2000/L_275/L_27520001027en00390043.pdf; The Evaluation Partnership Limited, *Evaluation of the E-Money Directive (2000/46/EC)* (Feb. 2006), http://ec.europa.eu/internal_market/bank/docs/e-money/evaluation_en.pdf.

money—even though such a liquidity shortfall in the branch-based banking context might conceivably have a systemic impact. Perhaps regulators have concluded that the systemic implications of such liquidity shortfalls are remote, because in most cases, customers that deal with retail agents know the agents personally, particularly in rural areas. These customers may not lose confidence in the banking system as a whole even if they cannot withdraw funds on a particular day because of a particular agent’s lack of cash on hand. Still, it is not difficult to imagine circumstances under which customers could lose confidence in the system, and widespread liquidity shortfalls among retail agents could well contribute to such a problem.

India

In India, regulators have, for some time, interpreted existing regulations to permit banks to use agents for lending, including credit decisions. But only since the adoption of a new central bank circular in January 2006 have they permitted these agents to handle a broader range of services for banks, including small-

scale deposit taking. The nonbank model of agent-assisted branchless banking is not yet permitted.

As in Brazil, agency-related risks have been handled by giving the regulator power to review agents’ records²⁷ and by making banks liable for the actions of their agents. Additionally, agents must disclose that they are working on behalf of a bank, and contracts and other documents with retail-agent customers must disclose clearly that the customer can collect against the bank. Unlike Brazil, India permits only a narrow range of retail agents: specialized MFIs and post offices. This restriction could be seen as an (perhaps overzealous) attempt to protect consumers, but also as a means of mitigating participating banks’ reputational risk.²⁸

²⁷ This is the most recent RBI opinion on this topic, as per its Draft Guidelines on Outsourcing of Financial Services by Banks. See Reserve Bank of India 2005.

²⁸ Given reputation problems currently plaguing several prominent MFIs in Andhra Pradesh, the Indian state with the largest concentration of MFIs, it could be argued that restricting banks to working through MFIs is not a particularly effective means of mitigating the banks’ reputational risk. See The Hindu Business Line 2006.

Regulations also specify due diligence requirements for banks to follow in assessing potential agents.

Banks using retail agents must develop “grievance redressal machinery,” including designating a “grievance redressal officer” to deal with customer complaints about retail agents. Customers who do not receive a satisfactory response through this channel may approach the Office of the Banking Ombudsman (Reserve Bank of India 2006).

South Africa

The bank-led model in South Africa today is subject to common-law principles of agency. In addition, there are specific requirements for banks’ outsourcing arrangements (South African Reserve Bank 2004). Deposit taking by agents on behalf of a bank is permitted, but the bank is held entirely responsible (as principal) for the actions of its agents.

Banking regulation in South Africa allows only institutions with a banking license to accept repayable funds, such as e-money proceeds, from retail customers. Nonbanks have therefore not been allowed to issue e-money, a position recently reiterated in a position paper on e-money issued by the South African Reserve Bank, the country’s central bank (South African Reserve Bank 2006). Technology firms and mobile operators that want to develop e-money-based branchless banking have to partner with a licensed bank, thus increasing their costs and delaying time to market. The result is technically a bank-led model that is only marginally “branchless,” in that the bank’s infrastructure and personnel are used for all cash transactions except where services are rendered through post offices.²⁹

The Philippines

When Globe Telecom approached the central bank with the proposal for its G-Cash mobile phone-based e-money product, the parties were able to agree on an approach that would accord Globe the rather loosely defined regulatory status of remittance agent (Bangko Sentral ng Pilipinas 2004). This saved Globe from being classified as a deposit taker, which would have necessitated a banking license. However, remittance agents are subject to

the Philippine Anti-Money-Laundering Act, and the central bank imposed limitations on the use of G-Cash. Customers cannot hold e-money balances above P10,000 (approximately US\$195) at any time, or transact more than P40,000 per day and P100,000 per month (approximately US\$780 and US\$1,950).

These limits have two important policy implications. First, they help to ensure that customers use G-Cash primarily for payments rather than as a virtual deposit account (although the US\$195 cap is high enough for many poor customers to use G-Cash as a virtual current account). Second, the limits put a ceiling on the amount of money that any individual G-Cash customer could lose in the unlikely event that Globe were to go bankrupt. (Globe Telecom deposits its net e-money issuance in pooled demand deposit accounts at several prudentially regulated banks. This isn’t required by regulators, but mitigates the risk that Globe won’t have the liquidity needed to meet customer demands.)

Several additional regulatory requirements help to mitigate operational and reputational risks of the nonbank-led model. For example, the Philippine central bank has issued regulations prescribing record-keeping and reporting requirements (as well as sanctions for noncompliance). In general, however, nonbanks are left to manage the risks of using retail agents themselves, mainly through contractual arrangements. Globe Telecom, for example, requires all retail agents to go through an accreditation process led by a committee composed of representatives from its Finance, Legal, Business Operations, and Information Technology departments.³⁰

²⁹ Although permitted under law, to our knowledge, there are no current examples of issuance of e-money by banks. WIZZIT and MTN offer access to individual bank accounts (not e-money accounts) using technology, such as mobile phones and debit cards.

³⁰ Globe Telecom and Smart are also developing partnerships with the Rural Bankers Association of the Philippines (RBAP) to provide financial services to clients who are both telecom and rural bank customers. In the case of the Globe Telecom/RBAP partnership, G-Cash customers can perform cash-in/cash-out services at rural banks, transfer funds to other rural bank customers’ accounts, pay rural bank loans, or deposit money in a rural bank account using G-Cash. This service is most similar to the nonbank-led model, with the rural bank playing the role of a payee or retail agent. No details are available on Smart’s partnership with RBAP.

Kenya

Of the countries studied, Kenya may best reflect the situation of most developing and transition countries. Policymakers and regulators have greeted branchless banking with a mixture of great enthusiasm for its potential to expand access and real concern about new risks for vulnerable customers and the financial system. Although there has been no emergence of bank-led branchless banking through retail agents, two nonbanks have begun issuing e-money.

Existing banking regulation in Kenya does not clearly define whether the issuing of e-money constitutes retail deposit taking and whether this type of business can be undertaken by anyone except for a licensed and regulated financial institution.³¹ Therefore, the mobile operator, the prepaid card issuer, and any new market entrants that use the nonbank-led model find themselves operating in an ambiguous regulatory situation. At least for the time being, it appears that they are entirely—and perhaps dangerously—unregulated.³² The central bank has recently begun consultations that should help to remove the legal uncertainty and avoid sudden market-jeopardizing changes in regulatory treatment.³³

Considerations for Regulators

In the five countries studied, branchless banking through retail agents is gaining interest. Banks, mobile network operators, and other nonbanks see the approach as a way to reach new customers and increase revenues. Policymakers recognize its potential to serve citizens who have been excluded from the formal financial system.

However, even in these five pioneering countries, the concepts are still new and the period of experimentation brief. More experience with branchless banking through retail agents is needed before we can develop general guidelines on regulating it. Nonetheless, the experience of regulators in the five countries studied offers some early insights.

- As compared with conventional branch-based banking, the bank-led model of branchless banking through retail agents may present

fewer significant new or enhanced risks than regulators might at first expect. To mitigate the increased risks that might result from the use of agents as the primary point of interaction with retail customers, the experience of the countries studied suggests it may be enough to make the banks clearly liable for the actions of their agents and for the supervisor to maintain the right to supervise agents' operations as if they were undertaken by the banks themselves.

- Systemic concerns with the bank-led model are likely to be limited for some time to come (and perhaps indefinitely). Regulators and supervisors can mitigate any system-level risks from the bank-led model in the same ways they control risk in the case of branch-based banking: by protecting retail customers and by ensuring the soundness of the banks themselves.
- To protect both the bank-led and nonbank-led models from abuse as a means of money laundering or terrorist financing, regulators should confirm the applicability of domestic AML/CFT rules to retail agents under both models. The likely utility of these rules should be weighed against their possible access-constraining effect. Small-value accounts and transactions that pose relatively little risk should have less burdensome AML/CFT treatment (Isern et al. 2005).
- Regulators should be more cautious with the nonbank-led model. Should mobile network operators and similar firms with technical and

³¹ A possible interpretation of the Kenyan Banking Act (No. 13 of 1994) is that taking retail deposits and employing depositors' funds in any way constitutes banking business, which can be undertaken only by a licensed bank. Under such an interpretation, the nonbank-led model would not be permitted.

³² As in South Africa, agency-related risks are not regulated separately. Common law principles of agency make any bank or nonbank using retail agents liable for their agents' actions. Rules on AML/CFT don't apply because existing provisions have a loophole—they apply only to banks.

³³ In the meantime, the risks presented by Safaricom's M-Pesa e-money service are, at least from a practical perspective, significantly mitigated by the involvement of the United Kingdom's Department for International Development, which co-financed the initiative's pilot phase.

financial strength, high liquidity, and a reasonable level of transparency be allowed to provide financial services, including the e-money equivalent of transaction and small-balance deposit accounts, only if they can meet all the prudential standards applicable to banks? Or should such firms be permitted to offer at least a limited range of financial services provided they meet lighter standards of transparency, financial strength, and liquidity? Whatever the answer in the case of these types of nonbanks, there is ample experience to justify treating differently poorly capitalized, illiquid, untransparent, early-stage or startup firms, such as some possible new entrants into the prepaid card issuing business. Regulators in developed countries are still struggling for the right approach at both ends of the nonbank spectrum.

- Light oversight and transaction limits may be well suited to the early days of the nonbank model, at least if the nonbank has the strength, liquidity, and reputation to protect that is characteristic of many mobile operators. So far, this approach has worked well in the Philippines.
- E-money could, in some circumstances, have massive systemic implications. Mobile network

operators already serve customers at all income levels. If their e-money products become widely used at all levels of the economy, it is not hard to imagine a severe shock if a mobile operator fell on hard times. The early experience of the few countries that we have described may not indicate what lies in store when nonbanks issue e-money at large scale.

Branchless banking through retail agents is spreading fast. Policymakers in Colombia recently made the bank-led model legal. Banks in Peru, Mexico, Chile, and elsewhere also have begun setting up retail agent channels. New mobile network operators in Central and West Africa and other developing countries are rolling out services that allow subscribers to make payments using their cell phones and are exploring developing a full range of cell phone-based banking offerings, in partnership with licensed banks or on their own.

The diversity of regulatory responses in the five countries studied highlights the challenge of extracting principles to guide regulators in other countries. Over time, as these and other initiatives emerge, the new or enhanced risks of branchless banking through retail agents—and the appropriate types of responses from regulators—will become more clear.



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