Centre for International Finance and Regulation

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Towards Financial System Integrity

Policy and Regulation Attuned to the Pacific

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Digital Financial Services in the Pacific: Experiences and Regulatory Issues

A collaborative effort between the Pacific Private Sector Development Initiative (PSDI) of the Asian Development Bank (ADB) and the Digital Financial Services Research Team at UNSW

Payments vs Banking – Different Worlds

- Banks like risks. Their profitability derives from managing and controlling risks – intermediating on-demand deposits into long-terms loans, for instance.
- Payments providers don't like risks. Their profitability comes from customer service and convenience.
- Payments utilise networks and are subject to strong network effects -- the more users on the network, the more valuable the service.
- Banking utilises relationships, banks seek information about customers to manage risks, network effects are minor.
- Payments providers seek to avoid risks by operating on a funded basis in as close to real time as possible.
- Payments and banking are profoundly different mindsets
- **Payments and banking require profoundly different regulatory approaches -- yet are usually regulated by the same institution**

Regulatory Mindsets

- DFS poses a massive mindset challenge to regulators
- Traditional banking is profitable -- banks profit from taking on more risk – the regulators role is to limit bank risk taking.
- So gold-plated prudential regulation is generally a social good.
- Regulators regulate to ensure systemic stability and avoid bailouts.
- Payments and DFS in developing countries are often not profitable.
- The risk of a gold-plated regulatory regime for payments is that it will be a regime to be proud of – with nothing to regulate!
- Gold plated payments regulation can be a social ill.
- Regulators need to be proactive and work with industry to ensure DFS products offered to the market address real consumer needs.
- DFS products often don't address these needs because they are traditionally designed by 'techies' -- not marketing people.
- **All this adds up to a fundamentally new, and challenging, role for regulators.**

Key challenges

- Geography of the region
- Cash is King, and the King is very much alive in the Pacific (however much financial inclusion advocates may wish the King dead).
- Need for persistent coordination among a range of regulators to create a conducive ecosystem for DFS.
- The ecosystem is not simple as DFS is primarily delivered via partnerships – banks, MNOs, and agents.
- **The ecosystem matters. Financial inclusion will only really take off when money comes into a household on a phone (thru KlickEx as a remittance, or a government payment, or a salary) and then is used digitally to pay an electricity bill, school fees, or to buy petrol. THIS IS THE LONG-TERM GOAL.**

Regulation

According to CGAP a regulatory framework for DFS needs to address:

1. **Regulation of banks or MNOs in using agents**
2. **Flexible, *risk-based* AML/CTF regime**
3. **Clear regime for non-banks issuing electronically stored value**
4. **Consumer protection tailored to DFS**
5. **Payments system regulation that in the long-term at least allows broad interoperability and interconnection**

I would add -- enhanced transaction monitoring so KYC can be simpler. It is time to also move regulation into the digital age!

Regulating Agents and AML/CTF

Regulation of banks or MNOs in using agents

Safaricom's agents in Kenya are independent contractors. Safaricom accepts no formal liability for their conduct. We argue against this approach. It is far more efficient for principals to be liable for their agents' conduct, and for the principal-agent contract to impose agent rewards and penalties.

Flexible, *risk-based* AML/CTF regime

FATF's 2013 report emphasised a risk-based approach but has seemingly had little impact. The impact of "de-risking" on remittance providers from Aust/NZ to the Pacific has been severe. Given the pressure being brought to bear on Aust and NZ banks by their US correspondent banks -- it is time for new approaches by Pacific Central Banks to remittances into the Pacific.

Protecting E-money & Consumer Protection Generally

Clear regime for non-banks issuing E-money

In common law countries, we suggest requiring e-money issuers to establish a trust account with a commercial bank. Our draft Trust Deed includes a "Protector" and mandates a 1:1 ratio between issued e-money and funds in trust. The Protector's role is to periodically audit the trust account and enforce the duties in the Trust Deed. Typically the CB will be appointed Protector.

With civil law, there is no one-size fits all approach but our detailed paper analyses various ways to achieve almost as good outcomes.

Consumer protection tailored to DFS

Lines of responsibility are less clear with DFS than banking as there are more parties – issuer, agents, bank, customer. It is thus very important that financial education support DFS, and that there are clear and effective dispute resolution recourse mechanisms.

Regulate Lightly and Latish

The lesson from Kenya is don't regulate too early or hard.

DFS is now systemically significant in Kenya so the Central Bank is regulating it rigorously as it should.

But for a long time the Central Bank largely maintained a hands-off watching brief and allowed the DFS ecosystem to develop mostly by itself.

If DFS is being provided by high quality organisations, regulators can be relaxed about it for quite a long period as it develops.

AML/CTF needs to be in place early for international reasons.

Consumer protection regulation needs to be next as consumer trust is critical.

Protecting the float and agent regulation then follows.

But overall there is no rush provided the providers are legitimate.

Consumer Demand

- **The current roadblock in the Pacific is on the consumer demand side!**

- **So the central bank needs to coordinate a range of regulators to become engaged in building consumer demand in the context of an enabling ecosystem**

- **This requires CBs to collect information about what consumers need and want, bring ALL the parties together (banks, MNOs, other regulators, etc) and drive the process forward (as one part of developing national payments systems infrastructure) .**

Data, coordination, education, resources

- Need for data - good decisions require reliable complete data
- Need to coordinate Telco regulator, market conduct regulator, MNOs, local banks, and finance dep't that makes G2P payments
- Central banks are taking the lead on initiating these regular coordinations –and they really do need to drive the process
- Financial education needed in schools AND at point of service -- in the Pacific as in Australia. Education of, and by, Agents important.
- Resources challenge – the research shows poorer countries have the greatest range of financial institutions supervised by the CB which also tends to have a greater number of responsibilities
- So the regulator's burden is heavy in poorer nations!

Two Fundamental Steps to Promote Financial Inclusion

- Distribute G2P payments electronically. This will provide people with a reason to engage with the technology – crucial! Will also reduce leakage, and increase efficiency and transparency

- Need to promote affordable, easy remittances for the same reason – to force engagement with the technology!

Conclusion

- Cultural change is never easy -- vibrant DFS requires a cultural change from (i) a nation's people and (ii) its Central Bank.

- The cultural change for Central Banks and their nation's people is the big challenge, crafting enabling regulation is easier.

- The UNSW DFS Team can assist with the shaping and drafting of regulations – after all -- what else is a bunch of lawyers good for?
- **See http://www.clmr.unsw.edu.au/domains/digital-financial-services**

- **The *real challenge* is regulators and DFS providers working together to provide products consumers need and want -- not the products the bank's or MNO's IT department thinks a customer should want.**