REGULATING DIGITAL FINANCIAL SERVICES AGENTS IN DEVELOPING COUNTRIES TO PROMOTE FINANCIAL INCLUSION

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Limited access to bank branches excludes over one billion people from accessing financial services in developing countries. Digital financial services offered by banks and mobile money providers through agents can solve this problem without the need for complex and costly physical banking infrastructures. Delivering digital financial services through agents requires a legal framework to regulate liability. This article analyses whether vicarious liability of the principal is a more efficient regulatory approach than personal liability of the agent. Agent liability in Kenya, Fiji, and Malawi is analysed to demonstrate that vicarious liability of the principal, coupled to an explicit agreement as to agent rewards and penalties, is the more efficient regulatory approach.

I. INTRODUCTION

Banks traditionally provide financial services through bank branch networks. In developing countries, these networks tend to be concentrated in cities. For poor people in remote regions, access to financial services through bank branches has been severely limited. To rectify this problem, governments have embraced digital financial services ("DFS") as an efficient means to promote financial inclusion. DFS can be defined as financial services provided through mobile phones, and includes e-money and mobile money delivered through bank-led and non-bank-led models.[1] Non-bank-led models include DFS provided by internet and telecommunications providers. This article will assess the most efficient regulatory approach for promoting financial inclusion in developing countries under both models.

In developing countries, DFS are providing over 2.5 billion people with access to basic fundamental financial services.[2] Governments in more than 80 countries have adopted DFS as a

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[1] Louise Malady & Ross P Buckley, *Building Consumer Demand for Digital Financial Services – The New Regulatory Frontier*, CIFR Paper No 035/2014 (25 August 2014) at 2.

[2] The World Bank, *Digital Finance: Empowering the Poor via New Technology*, online: The World Bank <http://www.worldbank.org/en/news/feature/2014/04/10/digital-finance-empowering-poor-new-technologies>.

means of extending financial services to millions of financially excluded and underserved people.[3] DFS has acted as a catalyst for economic development and growth in these countries.[4]

By offering DFS through mobile money and branchless banking services, providers can promote financial inclusion without physical access to a traditional bank branch.[5] Mobile money involves customers acquiring e-money by paying cash to an agent, or by receiving remittances, government payments, or otherwise. The e-money can then be used to pay bills, remit funds, or be saved.[6] Branchless banking is accessing a bank account and other financial services through telecommunication technologies and is usually outsourced to a third party – typically a retail agent.[7] Agents acting on behalf of a bank or Mobile Network Operator ("MNO") normally operate viable stand-alone businesses including retail shops, petrol stations, or post offices. The existing business premises and its infrastructure are used by the agent to deliver primary DFS functions such as cash-in and cash-out, thereby serving as the customer interface.[8]

Although the DFS provided by agents in developing countries are typically simple and involve small amounts of money, they are nonetheless vulnerable to fraud and other financial crimes.[9] Successful agent networks therefore require a suitably regulated and supervised legal framework.[10] Allocating the legal responsibility or liability for an agent's acts or omissions bears economic implications for a DFS network in terms of regulatory efficiency and financial inclusion. Liability rules prescribe which party in a relationship bears the economic risk and social cost of an activity.[11] From a legal perspective, agent liability is shaped by regulations and the contractual relationship between a principal and its agent.[12]

This paper will analyse agent liability from a theoretical perspective so as to determine which liability regime will best facilitate future market growth. During the early stages of a DFS market, a developing country's central bank needs to play a pivotal role in regulatory enforcement and consumer protection because it is unlikely that customers will engage in litigation to enforce their

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[3] *Ibid*; Kate Lauer & Timothy Lyman, *Digital Financial Inclusion: Implications for Customers, Regulators, Supervisors, and Standard-Setting Bodies*, (Washington, DC: CGAP, February 2015) at 1, online: CGAP <http://www.cgap.org/sites/default/files/Brief-Digital-Financial-Inclusion-Feb-2015.pdf>.

[4] Claire Alexandre & Lynn Chang Eisenhart, "Mobile Money as an Engine of Financial Inclusion and Lynchpin of Financial Integrity" (2013) 8 Washington Journal of Law, Technology and Arts 285; Michael Klein & Colin Mayer, *Mobile Banking and Financial Inclusion: The Regulatory Lessons*, World Bank Policy Research Working Paper No 5664 (1 May 2011); Clara Veniard, "How Agent Banking Changes the Economics of Small Accounts" (delivered at the Global Saving Forum, November 2010).

[5] Malady & Buckley, *supra* note 1 at 31.

[6] See CIFR Research Project, *The Regulation of Mobile Financial Services – E226*, online: CIFR <http://www.cifr.edu.au/project/The_Regulation_of_Mobile_Money.aspx>.

[7] Timothy R Lyman, Gautam Ivatury & Stefan Staschen, *Use of Agents in Branchless Banking for the Poor: Rewards, Risks, and Regulation*, *CGAP Focus Note No 38*, (Washington, DC: CGAP, October 2006) at 2, online: CGAP <https://www.cgap.org/sites/default/files/CGAP-Focus-Notes-Use-of-Agents-in-Branchless-Banking-for-the-Poor-Rewards-Risks-and-Regulation-Oct-2006.pdf> [*CGAP Focus Note No 38*]; CGAP, *Branchless Banking Policy*, online: CGAP <http://www.cgap.org/topics/branchless-banking-policy> (last accessed 14 November 2014) [*CGAP Branchless Banking Policy*].

[8] *CGAP Branchless Banking Policy*, *ibid.*

[9] Kate Lauer, Denise Dias & Michael Tarazi, *Bank Agents: Risk Management, Mitigation, and Supervision*, *CGAP Focus Note No 75*, (Washington, DC: CGAP, December 2011) at 4, 5 [*CGAP Focus Note No 75*]; Simone Di Castri, *Mobile Money: Enabling Regulatory Solutions*, (London: GSMA, February 2013) at 18-23.

[10] *CGAP Focus Note No 75*, *ibid*; Michael Tarazi & Paul Breloff, *Regulating Bank Agents*, *CGAP Focus Note No 68*, (Washington, DC: CGAP, March 2011) [*CGAP Focus Note No 68*].

[11] See Satish Kumar Jain, *Economic Analysis of Liability Rules* (New York: Springer, 2015).

[12] Alliance for Financial Inclusion, *Mobile Financial Services: Basic Terminology*, *Mobile Financial Services Working Group Guidance Note No 1*, (Bangkok: AFI, March 2013) at 1; Neil Davidson, *Mapping and Effectively Structuring Operator-Bank Relationships to Offer Mobile Money for the Unbanked*, (London: GSMA, March 2012); Janet Hernandez, Jeff Bernstein & Amy Zirkle, "The Regulatory Landscape for Mobile Banking" (Discussion Paper delivered at 11th Global Symposium for Regulators (GSR11), 21-23 September 2011).

rights; although there may be the possibility of collective or class actions as markets develop. Nonetheless the best regulatory regime is one that is right in theory as well as in practice, and this is what we are seeking to define.

This article seeks to assess whether principal vicarious liability or agent personal liability is a more efficient regulatory approach to promote financial inclusion in developing countries. In this context regulatory efficiency is the regulation of a DFS agent network that does not impose unnecessary costs and obligations on supervisors, customers, principals, or agents.[13] To explore this issue, we compare three common law jurisdictions – Kenya, Fiji, and Malawi. These case studies were selected on the basis of their level of regulatory development and financially inclusive policies.

This article is in six sections. Following this Introduction, Section II examines DFS agents as a tool to promote financial inclusion. Section III analyses the risks and economic incentives of the agent and the principal that influence the level of compliance and how this relationship should be supervised. Section IV analyses the statutory and common law agent liability regimes in Kenya, Fiji, and Malawi. Section V develops this analysis by examining vicarious liability as an efficient regulatory tool and how contractual mechanisms can redress inefficient economic incentives in regulating agent liability. This section also examines how non-bank MNO principals' agent liability could be more efficiently regulated in Kenya. The article then concludes.

II. DIGITAL FINANCIAL SERVICES AGENTS AND FINANCIAL INCLUSION

Given its fundamental role as a catalyst for economic growth and financial inclusion in developing countries,[14] DFS have been embraced by a wide range of countries, and endorsed in policy formulation by international bodies including the World Bank Group, the Group of Twenty-Four, the Center for Financial Inclusion ("CFI"), and the Consultative Group to Assist the Poor ("CGAP").[15] The CFI defines financial inclusion as:

> A state in which all people who can use them have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients. Financial services are delivered by a range of providers, most of them private, and reach everyone who can use them, including disabled, poor, rural, and other excluded populations.[16]

[13] David Llewellyn, "Institutional Structure of Financial Regulation and Supervision: The Basic Issues" (Paper delivered at a World Bank seminar Aligning Supervisory Structures with Country Needs, Washington DC, 6 and 7 June 2006) at 16, online: The World Bank <http://siteresources.worldbank.org/INTTOPCONF6/Resources/2057292-1162909660809/F2FlemmingLlewellyn.pdf>.

[14] United Nations Secretary General's Special Advocate for Inclusive Finance for Development, *The Imperative of Financial Inclusion*, online: UNSGSA <http://www.unsgsa.org/about/financial-inclusion>; Nouriel Roubini & Xavier Sala-i-Martin, "Financial Repression and Economic Growth" (1992) 39 Journal of Development Economics 5.

[15] Jake Kendall, Nataliya Mylenko & Alejandro Ponce, *Measuring Financial Access Around The World, CGAP Policy Research Working Paper No 5253* (2010); The World Bank, *Finance For All? – Policies And Pitfalls In Expanding Access, A World Bank Policy Research Report*, (Washington, DC: The World Bank, 2008) at 28, online: The World Bank <http://siteresources.worldbank.org/INTFINFORALL/Resources/4099583-1194373512632/FFA_book.pdf>.

[16] Center for Financial Inclusion, *Financial Inclusion Glossary*, online: CFI <http://www.centerforfinancialinclusion.org/publications-a-resources/financial-inclusion-glossary> (last accessed 14 November 2014).

DFS improves disadvantaged peoples' lives by giving people the means to create and sustain livelihoods, smooth consumption patterns, and accumulate assets.[17] Growth in DFS and financial inclusion leads to financial deepening and tends, once initiated, to be self-reinforcing due to increased transaction volumes and the availability of wider sources of funding and risk management tools.[18]

A. *Digital Financial Services and Agent Infrastructures: Safaricom's M-Pesa Network*

With large sections of developing country populations living in remote villages, DFS agents provide a means to overcome a fundamental obstacle to financial inclusion: distance. DFS infrastructures have been developed by bank and non-bank providers to deliver cost effective financial services in underdeveloped regions.[19] This section will focus on Kenya's MNO, Safaricom, and its mobile money network, "M-Pesa", as this represents a highly successful DFS and agent infrastructure rollout in a developing country.

Kenya has seen phenomenal growth in DFS. High mobile phone penetration rates allowed Safaricom to reach over 17 million customers or two-thirds of the adult population, including the unbanked, disadvantaged, and marginalised communities.[20] Around 25% of Kenya's gross national product flows through Safaricom's M-Pesa network.[21]

The M-Pesa network operates on mobile phones and therefore does not require traditional bank accounts. To gain access to M-Pesa e-money, customers purchase SIM cards and air time through Safaricom's master agents. M-Pesa retail agents, which number over 32,000, allow customers to top-up or withdraw cash and make digital fund transfers and payments.[22] This article focuses on the use of M-Pesa retail agents and their relationship with Safaricom.

M-Pesa funds are not held, nor can they be accessed, by Safaricom. All funds are held in a trust established by Vodaphone, Safaricom's parent company, and are deposited in prudentially regulated commercial banks which are 100% backed by pooled accounts.[23] Training and monitoring of agents

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[17] Robert Cull, Tilman Ehrbeck & Nina Holle, *Financial Inclusion and Development: Recent Impact Evidence*, *CGAP Focus Note No 92*, (Washington, DC: CGAP, April 2014) at 1, online: CGAP <http://www.cgap.org/publications/financial-inclusion-and-development-recent-impact-evidence>.
For more extensive discussions on the relationship between financial inclusion and economic growth, see Franklin Allen et al, *The Foundations of Financial Inclusion: Understanding Ownership and Use of Formal Accounts*, World Bank Policy Research Working Paper No 6290 (2012).

[18] International Monetary Fund, *Enhancing Financial Sector Surveillance in Low-Income Countries: Financial Deepening and Macro-Stability*, at 4, online: IMF <https://www.imf.org/external/np/pp/eng/2012/041612.pdf>; Rishi Goyal et al, *Financial Deepening and International Monetary Stability*, *IMF Staff Discussion Note SDN/11/16*, (Washington, DC: IMF, 2011).

[19] Gautam Ivatury & Ignacio Mas, *The Early Experience with Branchless Banking*, *CGAP Focus Note No 46*, (Washington, DC: CGAP, 2008) at 2.

[20] *CGAP Focus Note No 38*, *supra* note 7 at 1; CGAP, *Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance*, *CGAP Focus Note No 43* (Washington, DC: CGAP, January 2008) at 2, online: CGAP <http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Regulating-Transformational-Branchless-Banking-Mobile-Phones-and-Other-Technology-to-Increase-Access-to-Finance-Jan-2008.pdf>; "Why does Kenya lead the world in mobile money?" *The Economist* (27 May 2013), online: The Economist Newspaper Limited <http://www.economist.com/blogs/economist-explains/2013/05/economist-explains-18?fsrc/tw/te/bl/ee/mobilemoney> [*The Economist Article*].

[21] *The Economist Article*, *ibid*.

[22] Mike McCaffrey & Doreen Ahimbisibwe, *Anchoring Agent Commissions: How Much is Enough?*, online: Helix Institute of Digital Finance <http://www.helix-institute.com/blog/anchoring-agent-commissions-how-much-is-enough> (last accessed 30 April 2015).

[23] Claudia McKay & Rafe Mazer, *10 Myths about M-PESA: 2014 update*, online: CGAP <http://www.cgap.org/blog/10-myths-about-m-pesa-2014-update>.

is outsourced to agent network managers such as Top Image, which helped design the M-Pesa training curriculum.[24]

Safaricom's M-Pesa infrastructure is also being leveraged to further promote financial inclusion by facilitating payments for basic yet essential utilities and social services such as energy, health, water, and education.[25] Agents provide financial education to enhance greater participation in traditionally underserved communities.[26] Government policy makers and regulators are drawn to DFS because it enables efficient, indiscriminate, transformative, widespread, and cost effective financial inclusion.

III. ALLOCATION OF RISK

A successful DFS network requires a regulatory framework that allocates agent liability and promotes financial inclusion. This section will focus on which party in the principal-agent relationship should be allocated risk and liability.

Law and economics analyse norms from an efficiency perspective.[27] When it comes to the issue of liability, the main goal is to assess how and to whom the law should attribute the legal risk of wrongdoings and their social costs so as to promote efficiency.[28] An optimal liability rule should place the risk of wrongdoing on the party that is the most efficient risk-bearer.[29] Arguments pertaining to liability rules and the allocation of risk focus on four issues: (i) economic incentives of the DFS parties, (ii) agent insolvency and liability, (iii) the supervision and regulation of agent liability, and (iv) consumer protection, and anti-money laundering and combating the financing of terrorism ("AML/CFT") regulations. We will deal with the first three issues in this article. We have dealt with AML/CFT issues elsewhere[30] and are presently undertaking work into consumer protection issues, the findings from which will be published later.

A. *Economic Incentives*

The recruitment and retention of an agent network is challenging. Profits from an agent business need to be sufficient to motivate the agent to join and remain in the DFS network. In deciding whether DFS is an attractive business proposition, the agent has to consider how associated compliance costs will affect profitability. These costs comprise of compliance with regulations, contractual obligations, and where relevant, potential litigation costs from offering DFS.[31]

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[24] Jennifer Barassa, *How Agent Network Managers Have Fuelled M-PESA's Success*, online: CGAP <http://www.cgap.org/blog/how-agent-network-managers-have-fueled-m-pesa's-success>.

[25] McKay & Mazer, *supra* note 23.

[26] Di Castri, *supra* note 9 at 20.

[27] For the concept of efficiency, see: Nicholas L Georgakopoulos, *Principles and Methods of Law and Economics: Enhancing Normative Analysis* (New York: Cambridge University Press, 2005); Wolfgang Weigel, *Economics of the Law: A Primer* (New York: Routledge, 2008); Steven Shavell, *Foundations of Economic Analysis of Law* (Cambridge: Harvard University Press, 2004).

[28] On the economics of liability, see: Robert D Cooter, "Economic Theories of Legal Liability" (1991) 5 The Journal of Economic Perspectives 11; Guido Calabresi & Douglas Melamed, "Property Rules, Liability Rules, and Inalienability: One View of the Cathedral" (1972) 85 Harvard Law Review 1089.

[29] For a good introduction to law and economics and the concept of efficiency see, Nicholas L. Georgakopoulos, *Principles and Methods of Law and Economics: Enhancing Normative Analysis* (Cambridge; Cambridge University Press, 2005); Wolfgang Weigel, *Economics of the Law : a Primer* (New York: Routledge, 2008); Steven Shavell, *Foundations of Economic Analysis of Law* (Cambridge; Harvard Univerisrty Press, 2004)

[30] Louise Malady, Ross Buckley & Douglas Arner, *Developing and Implementing AML/CFT Measures Using a Risk-Based Approach for New Payments Products and Services*, CIFR Paper No 028/2014 (19 June 2014).

[31] These costs would comprise the costs of hiring lawyers, court fees, and the cost of potential damages awarded against the agent.

Agent litigation can, at least in theory, arise from DFS customers seeking to recover damages for an agent's negligence, theft, violation of privacy laws, or other misuses of confidential customer data.[32] The party bearing the liability potentially faces high legal risks. If a prospective agent reasons that complying with their legal obligations is too burdensome or risky they may decline to become a DFS agent. Agent personal liability can thus be a disincentive for prospective agents, constraining potential DFS penetration, and inhibiting financial inclusion. Di Castri argues:

> Placing large compliance or financial constraints on agents hampers mobile money[[33]] services from reaching scale, as they rely heavily on low-cost distribution at low-overhead agent points. Agents constantly evaluate the mobile money business against other potential uses of their capital.[34]

If a jurisdiction chooses to adopt agent personal liability rules, principals wanting to establish a DFS network will, in theory, be compelled to incentivise agents by paying a higher commission to offset compliance costs, including potential damages from litigation. However, if the principal rewards the agent excessively, the principal's revenues, based on the cost advantage of delivering DFS through a network of agents rather than a system of branches, may be completely absorbed by agent remuneration.[35] Government policy needs to redress this liability and risk imbalance to facilitate an environment in which a DFS network can flourish.

B. *Agent Insolvency and Liability*

From the principal's perspective, a personal liability rule whereby the agent is fully exposed to DFS risk and liability may appear to be the optimal outcome. This is because the principal will receive the commercial benefits from the agent's activities while mitigating absolute costs – such as reduced levels of expenditure for training and monitoring, and paying compliance costs relating to fines and compensation following an adverse court order. Yet the literature in this field consistently supports the proposition that excessive profits for a principal at the expense of an agent's solvency, or the principal's evasion of liability for agent negligence or misconduct, is very inefficient.[36]

Agents bear a high risk of becoming insolvent from legal disputes because costs and/or compensation can exceed their net worth.[37] The risk of the agent becoming insolvent will affect each party's behaviour. Shavell argues that when an agent has insufficient financial resources this can result in a reduction in the level of customer care and therefore increased risks.[38] Sykes also states:

> [A]n efficient allocation of resources requires the agent to invest in loss avoidance to the point where the marginal cost of further investment (in dollars or their utility equivalent) exactly equals the marginal reduction of expected damages. Because of the potential

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[32] *CGAP Focus Note No 75, supra* note 9 at 19.

[33] Mobile money can be defined as a mobile-based transaction service that can be transferred electronically using mobile networks: see Alliance for Financial Inclusion, *supra* note 12 at 1.

[34] Di Castri, *supra* note 9 at 24, 25.

[35] Neil Davidson & Paul Leishman, *Building, Incentivizing, and Managing a Network of Mobile Money Agents: A Handbook for Mobile Network Operators*, (London: GSMA, January 2010) at 13.

[36] Alan O Sykes, "The Economics of Vicarious Liability" (1984) 93 Yale LJ 1231; Steven Shavell, *Economic Analysis of Accident Law* (Cambridge: Harvard University Press, 1987).

[37] When an agent's assets are insufficient to compensate a litigant following a court order is known as "judgement-proof", see Sykes, "The Economics of Vicarious Liability", *ibid* at 1231, 1241 and 1278. Principals usually offer agents pooled insurance.

[38] Shavell, *Economic Analysis* of *Accident Law, supra* note 36.

> insolvency of the agent, however, the expected loss to the agent in the event of a wrong is smaller than the expected damages. The agent thus has less incentive (overall and at the margin) to invest in loss avoidance than he would if he could pay damages in full.[39]

In these circumstances agents will underinvest in loss avoidance.[40] Agent personal liability is inefficient because as the agent's moral hazard increases so does the risk of insolvency and therefore the loss of customers' funds. The efficient liability rule discourages moral hazard and rebalances the duty of care by penalising the agent when taking excessive risks, or not complying with regulations or the principal-agent contract.

Archetypically, principals are well resourced large corporations. In comparison, agents are predominantly sole traders with limited financial backing. Principals are thus better placed to remain solvent while absorbing extraordinary liabilities such as costly legal disputes.[41] The purchasing power of corporations also means the cost of buying insurance is much lower for a principal than for an agent.[42] Although the principal's assets should cover judgment costs in full, the potential liability imposed encourages higher quality service delivery, training, and monitoring to ensure that agents exercise a satisfactory level of care to mitigate potential risks and protect customers' funds.

C. *Supervision of Digital Financial Services Agents*

Effective supervision is a precondition to ensure that DFS networks are efficiently regulated. Bank-led DFS are, like traditional banks, extensively supervised and regulated. ~~[43]~~ Yet potentially problematically, agents intermediate money while being detached from traditional bank supervision. Agents are exposed to higher economic and legal risks which can create frictional costs, undermining supervision and regulatory compliance. A precondition for effective agent supervision is therefore the efficient allocation of risk.

To clarify this point, assume that it is immaterial which party bears the risk and liability. The optimal liability rule attributes risk and liability on the party – agent, central bank/financial supervisor, or principal - that can achieve the maximum compliance with the minimal amount of effort. Agent self-regulation is inefficient because of the potential moral hazard risk. This leaves two options: either a financial supervisor supervises agents, or the principal assumes liability for, and supervision of, their agents.

In developing countries, financial supervisors, usually central banks, regulate DFS. When central banks supervise agents directly, their culture and mandates can be at odds with proportionate regulation to promote financial inclusion.[44] An excessive regulatory burden imposed on agents will produce a disincentive to take-up DFS business. A more efficient approach is for central banks to supervise the principal, and require the principal to supervise their agents. This has been the approach adopted in many developing countries, including Kenya, Fiji, and by default, Malawi.

When DFS includes products such as insurance, non-bank financial supervisors may impose further regulatory obligations. DFS supervision may regulate non-financial institutions, for example MNOs, which are also subject to telecommunications supervision. A DFS regulatory regime

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[39] Sykes, "The Economics of Vicarious Liability", *supra* note 36 at 1244.
[40] *Ibid* at 1268.
[41] This concept was introduced by Shavell; see Steven Shavell, "The Judgment Proof Problem" (1986) 6 Int'l Rev L & Econ 45.
[42] Sykes, "The Economics of Vicarious Liability", *supra* note 36 at 1235, 1236.

[44] *CGAP Focus Note No 68, supra* note 10 at 1.

involving multiple supervisors is inefficient because of the potential to produce regulatory overlap, gaps, and "underlap", thereby exposing the principal and agent to excessive compliance burdens.[45]

In Kenya, MNOs' telecommunications activities are supervised by the Communications Authority of Kenya ("CAK") with the Central Bank of Kenya ("CBK") supervising DFS functional responsibilities.[46] The CBK did not supervise Safaricom's use of agents, nor agent liability during the market's development phase. Technological innovations and financial inclusion were able to flourish while developments were monitored and the financial system's integrity maintained.[47] Supervising and regulating mobile money was to be undertaken once the market was established.[48] Accordingly, the National Payments Systems Regulations 2014 ("NPSR") have now brought all payment service providers, e-money issuers, and their agents within the CBK's DFS supervisory ambit.

Furthermore, the Competition Authority of Kenya ruled that Safaricom's contractual agent exclusivity clause was unenforceable, thereby allowing other MNOs to utilise its agent network.[49] With DFS institutional demarcations being eroded by MNOs, the functional approach to supervision is proving to be an efficient way to regulate the use of agents.

When agent supervision is assigned to the principal, the cost is transferred from the public to the private sector. Banks and MNOs are in a superior position to monitor agents because the DFS activities are directly connected to the principal's business. In contrast, central banks are one step removed or disconnected from the DFS activity. A direct connection with the agent facilitates the most efficient collection of agent DFS information, thereby producing information asymmetries and economies of scope. This places the principal in the ideal position to recruit, assess, and monitor agents.

Vicarious liability produces the optimal level of agent supervision as the principal will be incentivised to train and monitor agents to reduce their risk exposure. Dias and McKee argue that vicarious liability limits the principal's opportunities to circumvent regulations and compels addressing customer complaints.[50] As Di Castri observes:

> Most regulators have opted for a light touch in regulating distribution networks because they recognise that the risks posed by mobile money distribution can be effectively monitored and mitigated by the providers…[51]

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[45] Underlap is a regulatory term used to describe a supervisory or regulatory function falling between two supervisors, see Lord Adair Turner, *The Turner Review: A regulatory response to the global banking crisis*, (London: FSA, March 2009), online: FSA <http://www.fsa.gov.uk/pubs/other/turner_review.pdf>; and Paul Tucker in UK, House of Lords, Select Committee on Economic Affairs, *2nd Report of Session 2008-09 – Banking Supervision and Regulation*, vol II: Evidence (Great Britain: HL, 20 January 2009).

[46] Basic regulatory functions or functional responsibilities differ from the traditional supervisory functions, see Richard J Herring & Jacopo Carmassi, *The Structure of Cross-Sector Financial Supervision*, online: < http://fic.wharton.upenn.edu/fic/papers/07/0734.pdf> (last accessed 9 August 2015).

[47] Mwangi S Kimenyi, "Mobile Wars and Political Barriers to Entry: Safaricom vs. Equity Bank" *Brookings* (29 October 2014), online: The Brookings Institution <http://www.brookings.edu/blogs/africa-in-focus/posts/2014/10/29-mobile-wars-safaricom-equity-bank-africa-kimenyi> (last accessed 26 February 2015).

[48] *Ibid*.

[49] *The Competition Act* (No 12 of 2010), s 38; see Authority of the Republic of Kenya, *The Kenya Gazette* (3 October 2014) at 2629, Gazette Notice No 6856: online: Kenya Law <http://www.kenyalaw.org/kenya_gazette/gazette/download/Vol._CXVINo_.118_.pdf>.

[50] Denise Dias & Katherine McKee, *Protecting Branchless Banking Consumers: Policy Objectives and Regulatory Options*, *CGAP Focus Note No 64*, (Washington, DC: CGAP, September 2010) at 10, online: CGAP <http://www.cgap.org/publications/protecting-branchless-banking-consumers-policy-objectives-and-regulatory-options> [*CGAP Focus Note No 64*].

[51] Di Castri, *supra* note 9 at 24, 25.

If the DFS principal is liable for its agents, the central bank's regulatory burden is substantially reduced. A light-touch regulatory approach is feasible because the principal has an economic incentive to ensure a satisfactory standard of care to mitigate risks and enforce regulatory compliance. This approach also encourages the DFS market to develop and flourish, supporting financially inclusive policies.

D. *Regulating the Use of Digital Financial Services Agents*

A precondition for regulating the use of DFS agents is a suitable legal framework.[52] The nature of the business relationship, the supervisory and regulatory structure, the principal-agent contract, and the common law all influence the legal framework's design.

When principals use agents or agent-like entities the business relationship is known as "outsourcing". The principal is not vicariously liable for its agents as employees, because legally agents are not typically employees. Independent contractors are not employees at common law but may nonetheless be agents. In Kenya, the wording of Safaricom's M-Pesa contract does not use the term "agent" and it explicitly states that cash merchants are independent contractors. Independent contractors are contracted by Safaricom as principals in their own right, despite performing the outsourcing function of an agent. Each independent contractor buys their own float through M-Pesa and trades on their own account. The nature of the outsourced business relationship will determine the extent of the principal's vicarious liability and the agent's personal liability.

Notwithstanding DFS intermediated through agents are simple and involve small amounts of money, the market is susceptible to regulatory challenges because of the reliance on non-financial businesses and outsourcing. Yet for the market to flourish DFS businesses must comply with technically complex regulations, such as know-your-customer ("KYC") and AML/CFT. A sustainable DFS network is therefore contingent on the ability of agents to efficiently meet their regulatory compliance obligations. Inefficiently designed regulatory architecture imposes onerous compliance burdens on principals and their agents which can impede participation, profitability, and financial inclusion, while exposing the network to the risk of financial crime.[53]

The Basel Committee on Banking Supervision ("BCBS") international policy "Outsourcing in Financial Services" recommends two guiding principles. First, supervisors should be assured that outsourcing does not hamper the regulated entity's ability to meet its compliance obligations, and secondly, supervisors should be aware of the potential risks posed where the outsourcing activities of multiple regulated entities are concentrated within a limited number of service providers.[54] In practice, these principles have been applied by developing countries that regulate the use of DFS agents.

E. *Agent Legal Liability*

The principal's liability for their agent's conduct can be determined by statute, other regulations, or the principal-agent contract.[55] Under the contract, an agent typically provides DFS on behalf of the principal in exchange for: being paid a commission; possibly an interest-free overdraft; marketing;

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[52] *CGAP Branchless Banking Policy*, *supra* note 7.
[53] *CGAP Focus Note No 75*, *supra* note 9; *CGAP Focus Note No 64*, *supra* note 50.
[54] Basel Committee on Banking Supervision, *The Joint Forum – Outsourcing in Financial Services*, at 3, online: Bank for International Settlements <http://www.bis.org/publ/joint12.htm>.
[55] Di Castri, *supra* note 9 at 56.

covering communication and back-office costs; and providing technological and business infrastructure.[56]

Deciding which party is legally liable for the agent bears economic implications in terms of efficiency and financial development. Liability rules can be broadly divided into two types:[57] either (i) agent is liable when performing undertakings on the principal's behalf – agent personal liability; or (ii) the principal is liable for agent's conduct – principal vicarious liability.[58]

Negotiations are the primary means of allocating risk and liability under a contract. Coase established the principle that in a world with no transaction costs, agents are able to negotiate the most efficient bargain.[59] In an ideal world, if the agent is personally liable but not at fault, then the contract would obligate the principal to reimburse the agent. Conversely, if the principal is vicariously liable when the agent is at fault, the contract should obligate the agent to reimburse the principal.[60] In practice transaction costs are present in all contracts which include the costs of negotiating in the presence of information asymmetries, monitoring counter-party behaviour, and enforcing contractual obligations.[61] Enforcement costs are typically higher in developing countries because judicial systems are less efficient and transparent than those in developed countries.[62]

Principals also have more expansive financial and business resources, compliance experience, and legal proficiency than that of agents. This places an agent at a disadvantage when negotiating contractual terms with a principal, thereby tending to undermine the efficient allocation of DFS risk and liability.

A regulatory framework that predetermines risk and liability is required to redress this bargaining inefficiency. In Kenya and Fiji, the scope of vicarious liability is determined by the agent banking guidelines and/or the principal-agent contract.[63] How efficiently risk and liability is allocated will depend on the judicial system to interpret the liability clauses in the regulations or principal-agent contract.

IV. DIGITAL FINANCIAL SERVICES AGENT REGULATION AND THE COMMON LAW

A. *Financial Legal Infrastructure*

The use of mobile phone technology and DFS agents is quickly becoming the primary mode of financial service delivery in developing countries.[64] Building an inclusive financial system relies on

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[56] Ignacio Mas & Hannah Siedek, *Banking through Networks of Retail Agents, CGAP Focus Note No 47*, (Washington, DC: CGAP, May 2008) at 11, 17.

[57] For an overview of liability rules in agency contract in common law, see Ronal C Wyse, "A Framework of Analysis for the Law of Agency" (1979) 40 Mont L Rev 31; Christopher D Stone, "The Place of Enterprise Liability in the Control of Corporate Conduct" (1980) 90 Yale LJ 1.

[58] Sykes defines vicarious liability as the imposition of liability upon one party for a wrong committed by another party.

[59] Ronald Coase, "The Problem of Social Cost" (1960) 3 JL & Econ 1.

[60] Alan O Sykes, "The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment and Related Legal Doctrines" (1988) 101 Harv L Rev 563 at 566.

[61] See Oliver E Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 JL & Econ 233.

[62] The World Bank is actively engaged in monitoring court performance in developing countries. See online: The World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTINST/0,,menuPK:1990161~pagePK:149018~piPK:149093~theSitePK:1974062,00.html>.

[63] Reserve Bank of Fiji, *Agent Banking Guideline, Banking Supervisory Policy Statement No 18*, (Fiji: RBF, 2013) at Part II, arts 4.2d, 4.2e [*RBF Agent Banking Guideline*]; Central Bank of Kenya, *Guideline on Agent Banking, CBK/PG/15*, (Nairobi: CBK, 2010) at Part IV, art 4.5.1(i) [*CBK Guideline on Agent Banking*].

[64] See Sankar Krishnan, *The Power of Mobile Banking: How to Profit From the Revolution in Retail Financial Services* (New Jersey: Wiley, 2014).

a broad set of technical, economic, and social policies.[65] Calomiris and Haber have demonstrated how credible financial governance systems influence financial stability and determine the aggregate supply of credit in an economy.[66] Effective laws are critical in strengthening the function of finance, managing risk, and building customer trust in an inclusive financial system. Arner argues persuasively that economic growth and financial deepening depend on strong legal institutions.[67]

The financial legal infrastructure necessary to promote financial inclusion requires laws that permit financial institutions to engage efficiently with customers in transparent financial transactions.[68] Independent courts and a reliable body of law governing commercial transactions are thus prerequisites for successful and sustainable financial intermediation.[69] Regulatory design – how liability is allocated within a DFS network under regulatory guidelines and the common law – will influence the growth and development of financial systems, financial deepening, and therefore financial inclusion in developing countries.

B. *The Scope of Vicarious Liability under Guidelines, Contracts, and the Common Law*

Supervisors need to decide whether risk and liability should be allocated through a formal regulatory framework – typically either by statute, regulation, or binding guidelines. For example, Kenya and Fiji have issued agent liability guidelines for the development of agent banking.[70] By contrast, Malawi has not issued any such guidelines and the Reserve Bank (E-Money) Regulations 2014 draft (E-Money Regulations) is silent on agent liability. Di Castri has observed:

> In order to ease restrictions on how a third party can be used, regulators are increasingly relying on provider liability for the provision of third party financial services. Some jurisdictions require this liability to be expressly stated in the agreement between the provider and the third party.[71]

In practice, Fiji's Agent Banking Guideline state that a commercial bank shall:

> Be liable for the actions and omissions of its Agent relating to Agent Banking services or matters connected therewith, as agreed to in their contracts with Agents.[72]

On its face, this guideline can be interpreted two ways: either as meaning that commercial banks should always be primarily liable for their agent's conduct, but the precise extent of this liability can be determined in each case by the terms of their contract; or that commercial banks are primarily liable, but the terms of the contract can heavily modify and even exclude that liability.

In the absence of judicial authority, it is difficult to know what interpretation the Fijian central bank puts on the guideline, but no doubt there is a settled practice that will be determinative. If the

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[65] Mandira Sarma & Jesim Pais, "Financial Inclusion and Development" (2011) 23 Journal of International Development 613.

[66] Charles Calomiris & Stephen H Haber, *Fragile by Design: The Political Economy of Banking Crises and Scarce Credit* (Princeton: Princeton University Press, 2014).

[67] Douglas Arner, *Financial Stability*, *Economic Growth and the Role of Law* (New York: Cambridge University Press, 2007).

[68] The World Bank, *Financial Inclusion, Global Financial Development Report 2014*, (Washington, DC: The World Bank, 2014) at 86-96.

[69] Arner, *Financial Stability*, *Economic Growth and the Role of Law*, *supra* note 67 at 93-103.

[70] *CBK Guideline on Agent Banking*, *supra* note 63 at arts 4.5.1(i)(iii), 5.1.1.

[71] Di Castri, *supra* note 9 at 25, 26.

[72] *RBF Agent Banking Guideline*, *supra* note 63 at art 4.1.

latter interpretation is preferred, the agent's limited bargaining power may result in an inefficient allocation of liability.

Private regulation of agent liability under an outsourcing contract is common in non-bank led DFS models. In comparison, agent banking guidelines tend to place liability on the bank principals. Kenya's Guideline on Agent Banking states:

> The institution is wholly responsible and liable for all actions or omissions of its agents and this responsibility shall extend to actions of the agents even if not authorised in the contract as long as they relate to agent banking services or matters connected therewith.[73]

A bank principal's liability is traced from agent banking services or matters connected to a valid contract. Agents are typically defined broadly as an "entity that has been contracted by an institution and approved by the Central Bank" so as to capture all DFS outsourced entities.[74] Problematically non-bank principals, such as MNOs, are not typically captured by such regulations. Strict institutional demarcations pertaining to principals under Kenya's Agent Banking Guidelines produce a large regulatory gap and supervisory underlap by failing to capture all DFS principals. For example, because Safaricom is a MNO, its agents fall outside the CBK's Agent Banking Guidelines and their liability is therefore determined by the M-Pesa contract, which states:

> You acknowledge that M-Pesa cash merchants are independent contractors and Safaricom shall not be liable for the acts or omissions of M-Pesa cash merchants.[75]

This clause limits customer recourse solely to the cash merchant. Safaricom's M-Pesa contract is an inefficient allocation of (personal) liability and risk. Although the CBK is promoting financial inclusion with a light-touch regulatory regime, personal liability may undermine customer confidence and trust if the cash merchant is unable to fully compensate customers. A DFS market characterised by an absence of substantive competition, uncertainty, and diminished trust could trigger a feedback loop whereby customers tend to disengage from the DFS network, resulting in DFS agents being a less viable business. If the trend is not reversed, retail agents will leave the DFS network, adversely affecting the network's development and financially inclusive policies. Agent guidelines that do not regulate all DFS principals undermine the efficient allocation of liability, the DFS network, and financial inclusion.

In practice, we suspect in Kenya that Safaricom often accepts liability in situations of agent misconduct so as to preserve the value of its brand and reputation; but under the contractual regime Safaricom has in force this is a discretionary call by Safaricom on a case-by-case basis.

In Malawi, there are no agent banking guidelines and the E-Money Regulations do not explicitly allocate agent liability. Where the law is silent on agent liability, the courts determine the scope of principal and agent liability. Malawi, Kenya, and Fiji are former British colonies operating with English common law. This law holds that a valid contract between the customer and agent, within the scope of the agent's actual authority, will render a disclosed principal vicariously liable for the agent's acts or omissions.[76] When an agent acts beyond this authority, although appearing to a customer to be acting with authority, and the customer honestly and reasonably believes that the agent has authority, the principal is bound by the agent's acts or omissions due to the agent's

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[73] *CBK Guideline on Agent Banking, supra* note 63 at art 5.1.1.
[74] *Ibid* at art 1.4.
[75] Safaricom, "M-Pesa Contract," *Kenya*, 18.11 (copy on file with authors).
[76] Peter Watts & F M B Reynolds, *Bowstead and Reynolds on Agency*, 20th ed (London: Sweet & Maxwell, 2014) at para 8-001.

ostensible authority.[77] However, the agent will in this instance be personally liable to the principal for damages.[78] Conversely, if the customer is aware that the agent lacked actual authority or if the principal has provided sufficient notice such that it would be reasonable for the customer to be aware the agent lacked actual authority, then the principal will not be vicariously liable.[79]

Generally, when an agent acts within their authority a principal has an incentive to ensure that their agent meets their compliance obligations because under the common law the signing of any document by the agent, within its actual authority, is effectively the bank principal signing that document.[80] Under these circumstances, the common law in Kenya, Malawi, and Fiji incentivises the principal to mitigate all potential agent liability risks.

Prior to the introduction of the NPSR in 2014, Kenyan non-bank principals could draft the principal-agent contract so that independent contractors were personally liable.[81] This position has now changed. The NPSR states:

> A payment systems provider is liable to its customers for the conduct of its agents, performed within the scope of the agency agreement.[82]
>
> An agency agreement… shall not exclude a payment service provider from liability.[83]

The scope of principal vicarious liability under the NPSR is set by the agency agreement, with any liability exclusion clauses being invalid. An agent is defined as: "a person who for a fee, provides limited payment services on behalf of a payment service provider".[84]

This broad definition of an "agent" captures all outsourced persons, including independent contractors. The NPSR inhibits Safaricom's ability to contractually exclude liability for their agents' actions when offering payment services.

Paragraph 14(2) of the NPSR allows an agent to provide certain services under the agency agreement. An agent may provide payment services, cash services, other services that the principal may specify, or services related to payment services.[85] From such a broad definition and by including the words "other services in relation to payments", all services offered by a payment system provider under the agency agreement are captured. Therefore, the NPSR creates an incentive for Safaricom to monitor carefully the conduct of its agents.

Under the common law of tort, a principal is vicariously liable for an agent's fraud when money is received within the agent's actual authority that is connected to a contract.[86] Vicarious liability may extend to negligent misstatements which induce unsophisticated customers to contract with an agent.[87] The principal will be vicariously liable if the agent acted with authority.[88] If an agent's tort is a deliberate deceit or negligent misstatement and connected to a contract, the agent may be

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[77] *Ibid* at paras 8-010, 8-048; *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (CA).
[78] *Ibid* at para 9-002.
[79] *Ibid* at para 8-218.
[80] *Ibid* at para 9-002; *Montgomerie v United Kingdom Mutual Steamship Association* [1891] 1 QB 370 (Wright J).
[81] For example, see Safaricom, *supra* note 75.
[82] *National Payments System Regulations, 2014*, reg 14(4), online: CBK <https://www.centralbank.go.ke/images/docs/legislation/NPSRegulations2014.pdf>.
[83] *Ibid*, reg 14(5).
[84] *Ibid*, reg 2.
[85] *Ibid*, reg 14(3): Payments provided by an agent can be sent, received, stored, processed, or include other services in relation to payment services; public switch networks can be possessed, operated, managed, or controlled by the agent; data that is collected or processed can be done so on behalf of either the payment system provider or the user of payment system services.
[86] Watts & Reynolds, *supra* note 76 at para 8-198.
[87] For an example of creditworthiness, see *ibid* at para 9-118.
[88] *Ibid* at para 9-116.

personally liable.[89] Liability in fraud and for negligent misstatement provides further incentives for a principal to ensure their agents perform to high standards.

Beyond fraud or negligent misstatement the principal is generally not vicariously liable for an agent's tortious acts and omissions. Where a customer's loss, damage, or injury is caused by an agent's tort while acting on behalf of the principal, the agent is personally liable, whether acting with authority or not.[90] By contrast, principals in Malawi and MNOs in Kenya are vicariously liable for the torts of their "agents", even when these are formally recruited as independent contractors. For instance, Kenya's Guideline on Agent Banking holds the bank principal liable for an agent's tort if it is related to banking services.[91] This probably explains why Safaricom inserted in the original contract with its M-Pesa cash merchants a provision that explicitly excluded the liability of Safaricom for the agent's tort. The scope of vicarious liability beyond fraud and negligent misstatement in Fiji is unclear when liability is determined by the principal-agent contract.

C. *Implementing a Functional Approach*

Financial regulation is required to fill the legal vacuum outlined above, and to incentivise the principal to mitigate agent liability and risk. The problem faced by many countries is that financial regulatory regimes have traditionally taken an institutional approach that did not contemplate the emergence of non-bank DFS providers.[92] One way to overcome regulatory underlap within existing supervisory frameworks is to adopt a functional approach. [93]

When an institutional approach is employed, regulatory underlap can develop. For example, the central banks examined in this article can be described as: Kenya – sectoral (banking), Malawi - partially integrated (banking and insurance), and Fiji – integrated (banking, insurance, and securities).[94] Yet none of these central banks regulate MNO DFS providers because all follow an institutional approach. Kenya's central bank is the only supervisor that has applied functional regulation to MNO DFS providers. A functional approach captures all DFS providers because it focuses on a functional responsibility.[95] This enables a central bank to supervise different DFS institutions, maintain a regulatory focus on DFS market functions as they develop, and provide a level playing field for all providers of DFS

To overcome the legal deficiencies outlined in this part, a functional approach should be supported by a broad definition of DFS agents, that mirrors the NPSR, and statutory vicarious liability regulations to capture all DFS principals, agents (whether agents properly so-called or putative independent contractors), and DFS offered, to ensure that the DFS principal is incentivized to mitigate risks and maximise regulatory compliance.

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[89] *Ibid* at para 9-117.
[90] *Ibid* at para 9-115.
[91] *CBK Guideline on Agent Banking*, *supra* note 63 at art 5.1.1.
[92] For example, e-commerce companies and mobile phone manufacturers.
[93] Herring & Carmassi, *supra* note 46 at 4; Charles Goodhart, *The Organizational Structure of Banking Supervision, Financial Stability Institute, Bank of International Settlements, FSI Occasional Papers No 1*, (Switzerland: BIS, November 2000); Michael Taylor, *'Twin Peaks': A Regulatory Structure for the New Century* (London: Centre for the Study of Financial Innovation, December 1995) at 20.
[94] Erlend W Nier, *Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis*, IMF Working Paper WP/09/70 (2009) at 40, online: IMF <http://www.imf.org/external/pubs/ft/wp/2009/wp0970.pdf> (last accessed 29 April 2015).
[95] For lists of the functional responsibilities or basic functions, see Llewellyn, "Institutional Structure of Financial Regulation and Supervision: The Basic Issues", *supra* note 13; Jeffrey Carmichael, Alexander Fleming & David T Llewellyn, eds, *Aligning Financial Supervisory Structures with Country Needs* (Washington, DC: The World Bank, 2004); Bank for International Settlements, *Range of practice in the regulation and supervision of institutions relevant to financial inclusion*, online: BIS <http://www.bis.org/bcbs/publ/d310.pdf> (last accessed 28 April 2015).

IV. REBALANCING ECONOMIC INCENTIVES WITH THE ALLOCATION OF LIABILITY

A. *Economic Incentive Mechanisms*

Placing liability and the cost of compliance on the principal creates an incentive to monitor agents' behaviour. However, allocating these costs to the principal can have adverse consequences when effective agent monitoring is not possible. When agent monitoring is weak or absent, agents may reduce their level of care by overcharging customers, ignoring risk mitigation practices, or avoiding compliance with consumer protection, KYC or AML/CTF rules.[96]

To overcome this regulatory inefficiency, incentives between the principal and agent need to be rebalanced. Vicarious liability rules coupled with an internal incentive mechanisms is one way to achieve this balance.

B. *Rebalancing Vicarious Liability with an Agent's Economic Incentives*

If the principal is vicariously liable but cannot effectively monitor an agent's behaviour, then the agent's level of care will depend on its compliance costs. When the behaviour of an agent is unobservable by the principal:

> [T]he agent's incentives for loss avoidance clearly depend upon the difference between the agent's wealth in the absence of a loss and the agent's wealth in the event of a loss (after payment of any judgment). The greater the difference, the more the agent has to gain from avoidance of the loss, and the more money or effort he will invest to that end.[97]

If the agent's compliance costs are higher than the costs of non-compliance, the agent will most likely act in his or her own self-interest by avoiding onerous compliance obligations. A pure vicarious liability rule is therefore not an effective loss-avoidance tool because the agent has an incentive to act in a more risky manner.

The agent's economic and compliance incentives should therefore be rebalanced by drafting a principal-agent agreement that supplements vicarious liability regulations. Sykes argues that when monitoring agent compliance is not possible, the principal-agent contract should adopt a combination of rewards and penalties that increase the agent's wealth in the absence of a loss and decrease wealth when a loss transpires.[98] In multi-period agency contracts – where agents accept periodic commissions for DFS, with a portion being performance based – the principal can influence the agent's behaviour by the use of rewards or penalties. Such a mechanism links the agent's remuneration to the level of compliance with the relevant laws, regulations, and the principal-agent contract. The most efficient economic mechanism is to pay a higher fee or bonus when the agent is compliant and impose a penalty when it is not.

C. *Efficiently Regulating Non-bank Principals' Agent Liability in Kenya*

To demonstrate how non-bank DFS principals' liability can be more efficiently regulated, we will explore the example of Kenya. DFS regulation is in keeping with the Kenyan Government's policy of financial inclusion through technological innovation, as the market for mobile money is well developed.

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[96] Sykes, "The Economics of Vicarious Liability", *supra* note 36 at 1237.
[97] *Ibid* at 1248.
[98] *Ibid* at 1254.

The CBK should have the power to supervise and regulate all MNO DFS activities by introducing a functional approach, akin to the NPSR, to capture all DFS providers.[99] There are, however, a number of disadvantages with the NPSR's functional approach that need to be addressed: principal vicarious liability under the Agent Banking Guidelines is wider than under the NPSR, and the regulations are unclear as to whether principals are vicariously liable for all their agent's conduct within the scope of the agent's authority or whether the scope of liability arises solely from the terms of the principal-agent contract. The NPSR is also unclear as to whether principal liability applies to all outsourced entities, such as independent contractors, and does not direct the CBK to coordinate with other supervisors such as the telecommunications supervisor, the CAK. Nonetheless, the NPSR's functional approach could be modified and applied to the Agent Banking Guidelines to capture all DFS providers, DFS activities, and DFS providers' liability for outsourced retail agent-like businesses.[100]

To overcome the institutional regulatory underlap between banks and MNOs, the functional approach should be applied to the Agent Banking Guidelines, with the Banking Act amended to capture all DFS providers. Potential regulatory overlap, underlap, and arbitrage between the CBK, financial sector supervisors, and CAK should be redressed through drafting a memorandum of understanding ("MoU"). A supplementary provision drafted into the guidelines should clarify that independent contractors or any other outsourcing entity that provide retail DFS are deemed DFS agents. This would mitigate the risk of regulatory arbitrage, specifically contractual exclusions.

To ensure that agents do not abuse vicarious liability rules, economic incentives should be rebalanced through the principal-agent contract. A principal-agent contractual clause that calculates the agent's remuneration based on a mechanism of rewards and penalties linked with regulatory and contractual compliance should be made mandatory under the regulations. This mandatory mechanism could be included in the Agent Banking Guidelines by amending provision 4.5.1 ix – adequate oversight safeguards to address instances of non-compliance, with the mechanics left to principal-agent negotiations. Monitoring of the agent is facilitated by the current mandatory contractual provisions.[101] Finally, the Agent Banking Guidelines could be retitled 'Digital Financial Services Agent Guidelines'.

Recalibrating the DFS regulatory approach would be in keeping with the BCBS's outsourcing guiding principles. The CBK would be assured that regulating outsourcing would not hamper Safaricom's ability to meet its regulatory obligations because its mobile money market and agent network are well developed. Safaricom could comply with stronger regulatory requirements by utilising its existing DFS infrastructure, technological capabilities, information asymmetries, and economies of scale. The CBK would satisfy the BCBS's second guiding principle of being aware of the potential risks posed from the outsourcing of DFS through agents by adopting a functional

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[99] See Llewellyn, "Institutional Structure of Financial Regulation and Supervision: The Basic Issues", *supra* note 13; Carmichael, Fleming & Llewellyn, eds, *Aligning Financial Supervisory Structures with Country Needs, supra* note 95.

[100] A broad market conduct supervisory function that encapsulates a range of functional responsibilities would be the preferred approach than a financial stability supervisory function. The traditional market conduct function includes the functional responsibilities of promoting financial inclusion, enforcing consumer protections, AML/CFT, competition, dispute resolution, and financial education. It should be noted that the designation of the market conduct supervisory function is employed in a traditional application of supervisory structural design and does not precisely align with the later designated regulatory responsibilities. The responsibilities are nonetheless distinct from that of the traditional prudential function that centred on financial stability or systemic supervision. Also see Brian Muthiora, *Enabling Mobile Money Policies in Kenya: Fostering a Digital Financial Revolution*, (London: GSMA, January 2015) at 12, online: GSMA <http://www.gsma.com/mobilefordevelopment/wp-content/uploads/2015/02/2015_MMU_Enabling-Mobile-Money-Policies-in-Kenya.pdf> (last accessed 1 May 2015): Data from the Central Bank of Kenya indicates that mobile money does not introduce systemic risk to the financial system and therefore a financial stability supervisory function is not warranted at this stage of market development.

[101] *CBK Guideline on Agent Banking*, *supra* note 63 at art 4.5.1xvii.

approach to regulate all DFS providers, utilising principals' optimal information asymmetries, and through coordination and information sharing provisions in the proposed MoU.[102]

Safaricom's current market share has directly benefited from the Kenyan Government's financially inclusive policies from increased transaction volumes and financial deepening. Nonetheless, DFS financially inclusive policies require appropriate supervision and regulation to manage new functional responsibilities of competition, consumer protection, market conduct, and AML/CFT.[103] The Competition Authority of Kenya recently decided to open up Safaricom's agent network to other MNO mobile money providers. In response Safaricom lowered its M-Pesa fees for small transactions by 67%. Lowering fees so considerably will affect the profitability of other MNO DFS providers. MNO agent profitability will also come under pressure which will either result in a reduction of their level of care or the abandonment of the agent business.[104] A Kenyan 2013 agent survey suggests that abandoning their agent business would be the most likely outcome.[105] If this is the outcome, the final upshot of strengthening DFS provider competition may be reduced agent profitability and agent competition, which in turn leads to lower service quality to the detriment of customers and financially inclusive policies.[106] To better manage competition in the DFS market, the introduction of a minimum DFS fee may be necessary. This will ensure an adequate level of profitability to instil provider, agent, and customer confidence in the DFS market so that it can continue to develop while promoting financial inclusion.

V. CONCLUSION

In developing countries, DFS offered through agents has been instrumental in promoting financial inclusion. The efficient allocation of liability between the agent and the principal is fundamental to a successful and reliable DFS network. This article has assessed the economic and legal implications of agent liability to determine that vicarious liability of the principal is the more efficient regulatory approach to promote financial inclusion. At a fundamental level, vicarious liability is preferred as the principal is in a better position than the central bank to monitor agents and, in comparison to the agent, absorb any economic losses without becoming insolvent. Furthermore, vicarious liability will be preferred by the principal when monitoring of the agent is sufficient to mitigate risks.

From an economic perspective, the arguments supporting vicarious liability include financial inclusion, the central bank's inefficient monitoring of agents, mitigating the principal's ability to avoid liability under agent guidelines and the common law, and the incentives of the principal and agent to synthesise a flourishing DFS network.

Given the asymmetry of power between the parties and the cost of enforcing contracts, allocating liability solely through an explicit principal-agent agreement is not economically efficient. A legal framework that places liability on the DFS principal is both necessary and more

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[102] Basel Committee on Banking Supervision, *supra* note 54 at 3.

[103] International Monetary Fund, *supra* note 18 at 4.

[104] Shavell, *Economic Analysis* of *Accident Law*, *supra* note 36.

[105] McCaffrey & Ahimbisibwe, *supra* note 22, referring to the Agent Network Accelerator Survey: Kenya Country Report 2013 (June 2014) that represents over 2000 mobile money agent surveys.

[106] Puneet Chopra, Lokesh Kumar & Graham Wright, *So Many Steps Forward…And Now One Big Step Back…*, online: MicroSave <http://blog.microsave.net/so-many-steps-forward-and-now-one-big-step-back/> (last accessed 5 May 2015). A 2012 Survey of Business Correspondent Network Managers in India of over 860 agents across 11 states found that when agents do not earn enough they are not incentivised to offer a reasonable quality of service. Also see Graham A N Wright, Manoj K Sharma & Puneet Chopra, *MicroSave Policy Brief #9 – Behind the Big Numbers: Improving the Reach and Quality of Agent Networks in India*, online: MicroSave <http://www.microsave.net/files/pdf/1377583661_PB_9_Behind_the_Big_Numbers.pdf> (last accessed 9 August 2015).

efficient. In Kenya, because MNOs fall outside the agent banking regulatory framework, Safaricom was able, until the passage of the NPSR, to exploit contractual provisions to place personal liability on cash merchants. The introduction of the NPSR has, in part, redressed this inefficiency.

A statutory framework that places vicarious liability upon all DFS principals and recognises all outsourced entities as agents is therefore required. However, if direct monitoring by the principal is not possible, the agent may be incentivised to act in its self-interest and avoid the costs of regulatory compliance. To overcome this problem, a compliance mechanism of rewards and penalties should be made mandatory under the DFS agent regulations and drafted into the principal-agent contract. The introduction of a minimum DFS fee may also be required if competition in the DFS market is not producing adequate principal-agent profitability to support market development and financially inclusive policies.