

FINANCIAL INCLUSION

The Basel Committee on regulation and supervision for financial inclusion

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Last December, the Basel Committee for the first time ever issued guidance on regulation and supervision for financial inclusion. The draft Guidance builds on the Committee's Core Principles for Effective Banking Supervision¹ and is intended to help supervisors and regulators around the world accommodate the fast-changing environment of institutions that are relevant to financial inclusion. A final version of the Guidance will be published once the Basel Committee has analysed the feedback received.

The Basel Guidance

The G20's commitment to financial inclusion is encouraging international Standard-Setting Bodies, such as the Basel Committee for Banking Supervision (BCBS), to include financial inclusion in their mandates. It has also contributed to increasing the number of countries that have made financial inclusion a policy priority. In this context, the Basel Committee has issued this Guidance with the purpose of illustrating the implementation of its Core Principles for institutions that serve customers excluded from the formal financial sector.

In the consultation, 19 of the total 29 Core Principles are identified as areas where additional guidance is needed. The guidance is extensive, but the following five cross-cutting issues can be identified: i) licensing and registration of relevant institutions, ii) cooperation and collaboration among authorities, iii) the supervisory approach, iv) management of risks and capital adequacy and v) abuse of financial services.

The Guidance revolves around the principle of proportionality, in line with the latest revision of the BCBS's Core Principles in 2012. This principle is necessary so as not to inhibit smaller institutions from facilitating access to the formal financial sector for those that are excluded. Imposing overly strict requirements on the operations conducted with these lower-risk clients can prevent unserved and underserved customers from accessing the formal financial sector. The BCBS suggests setting differentiated requirements for different types of institutions. The size of the institution seems to be a critical factor in this differentiation. However, this might end up harnessing the level playing field between institutions that engage in similar activities with similar clients. A more sensible application of the principle of proportionality might follow a risk-based approach, under which regulations affecting financial inclusion are similar for all institutions that provide similar services.

The environment of financial inclusion is constantly evolving and therefore supervisory and regulatory regimes for financial inclusion should not be static. An important effort should be made to monitor new activities, channels and players in order to avoid an excessive build-up of risks while avoiding unnecessarily stifling financial innovation. Having said this, the proposed guidance provides an uneven coverage of the products, services and players that are relevant to financial inclusion. It focuses mainly on microcredit, while it barely covers other aspects that are essential to promoting financial inclusion. For instance, new digital services, the agency model and the use of big data are barely touched upon or not mentioned at all in the Guidance. Although it might be too soon to formulate in-depth guidance on all these

1: BCBS (2012): [Core Principles for effective banking supervision](#).

emerging topics, it is important for the Committee to implement clear-cut efforts to analyse them. This requires the BCBS and other regulators to follow a more dynamic, forward-looking approach.

Finally, it is necessary to acknowledge that complying with this Guidance can be very challenging for some institutions, and also for supervisors and regulators in smaller and less developed economies.

In the end, the basis for a sound supervisory and regulatory framework is an in-depth knowledge of the business models and activities of the diverse ecosystem that caters to those outside the financial system. This demands a high level of coordination and cooperation among relevant authorities, not only those related to the financial sector, but also the telecommunications agency, the consumer protection authority or the financial intelligence unit. This understanding is a prerequisite before entering into the fine-tuning of supervisory techniques and minimum requirements.

Main issues included in the Basel Guidance

A. Licensing and registration of institutions

Increased transparency on the activities carried out by different types of institutions is essential to raise consumer awareness and confidence in the financial sector. With that aim, the Basel Committee appropriately suggests that non-financial firms that provide financial services as one of their primary sources of activity should either become registered or licensed. In some cases, this might require a non-financial firm to establish a separate legal entity.

Furthermore, according to the Guidance, the supervisor should maintain and publish a list of all registered, licensed or supervised institutions, which will include the permitted activities, the supervisory authority and whether the funds are subject to deposit insurance. This requires a significant effort on the part of supervisors to fully understand the different business models of licensed/registered institutions, and the monitoring of the emergence of new products and services to avoid an unnecessary stifling of innovation.

Finally, the establishment of a graduated set of licensing criteria for different types of institutions must be accompanied by a close monitoring of when an institution or sub-sector has evolved to the extent that the risks they pose require the fulfillment of a more stringent set of criteria.

B. Cooperation and coordination

The Basel guidance correctly signals the importance of establishing adequate cooperation and coordination mechanisms among regulators and supervisors. Coordination is especially important among authorities with responsibility over banks, nonbank financial institutions and non-financial firms involved in the delivery of such products (for instance, the telecommunications agency). Coordination is also required with the financial intelligence unit (for customer due diligence) and with the authority with consumer protection responsibilities.

A more fluid, periodic dialogue could facilitate the identification of new risks in this fast-changing environment, as well as helping to overcome the limitations of the prudential supervisor in fully understanding the business models of all the institutions that are relevant to financial inclusion. According to the Range of Practice Survey², there is significant room for improvement on this front, given that a majority of respondents stated that inter-agency coordination takes place “only when needed”. Furthermore, coordination among regulators is of the utmost importance in the drafting of reporting requirements, to avoid overlaps and unnecessary duplications that might impose an excessive burden on some institutions, especially those of a relatively smaller size that are relevant to financial inclusion.

2: BCBS (2015): [Range of practice in the regulation and supervision of institutions that are relevant to financial inclusion](#).

The Peruvian initiative, or “Modelo Peru”, to foster financial inclusion might be a useful example of the benefits of this kind of collaboration. The collaboration between the public and private sectors (including commercial banks, other financial institutions and telecommunications companies) has led to the recent launch of a common mobile-payment platform (BIM), with great potential for expanding financial inclusion in Peru. This move has been made possible by close cooperation between the relevant authorities, mainly the prudential banking authority and the telecommunications agency.

C. Supervisory approach

The BCBS proposes that supervisors might substitute individual supervision by monitoring at sector or market level, primarily off-site. Supervisors face resource constraints when dealing with numerous small and more diverse financial institutions and third parties that are relevant to financial inclusion. This significantly hinders the conducting of on-site individual supervision on the same frequency as for banks. **However, placing supervision at the market level might mask the build-up of great risks at the institutional level.** It is likely that within the same market or sector, different players have different risk appetites and therefore undertake a more or less aggressive strategy in the conduct of their operations. Therefore, supervision should be conducted on an individual basis whenever it is possible, especially in the case of deposit-taking institutions.

Furthermore, the Basel Guidance states that supervision should be at the consolidated level, in order to identify and act upon risks posed to the regulated entity or to financial stability by unregulated activities within the group. For an appropriate implementation, consolidated supervision also demands supervisors to raise concerns at an early stage and communicate them to other supervisors or relevant authorities as soon as they are identified.

The Range of Practice shows that a large number of respondents, especially among low-income countries, replace differentiated supervision by a differentiated approach to licensing. Due to the fast-changing nature of risks in this context, we would recommend that an effort be made to tackle this issue, which is not touched upon in the Basel Guidance. Ideally, the supervisory approach would not differentiate on the basis of the license/category of each institution but instead be based on the risks posed by each institution and its target customers.

D. Risk management

The establishment of an appropriate risk-management framework and setting up minimum requirements for capital, liquidity or operational risks require a deep understanding of the business models and the specific dynamics of assets and liabilities in institutions targeting unserved and underserved customers.

In this area, a careful application of the principle of proportionality is needed. The document suggests setting differentiated requirements for different types of institutions. The size of an institution seems to be a critical element in determining the regulatory burden that they should bear. However, this issue would be better addressed from the point of view of the business activities of the institutions and the risks of the clients they target. Otherwise, proportionality is likely to create an unlevel playing field between institutions that engage in similar activities with similar customers, giving rise to regulatory arbitrage. This could ultimately jeopardize financial stability as well as consumer confidence in the financial system, ultimately undermining the objective of enhancing financial inclusion.

A correctly noted issue is the additional difficulty created for the risk management process by the intensive use of third parties (agents and partners) by institutions relevant to financial inclusion. It must be made clear to financial institutions that they hold the ultimate responsibility to supervisors and

customers. Further clarification would be needed on how to put in place appropriate mechanisms to ensure the transmission of the culture, values, risk appetite and risk management processes and tools.

This being said, institutions that are relevant to financial inclusion do not operate in most cases in foreign markets. They do not directly put at risk global financial stability, which is the basis on which minimum requirements for different types of risks are set for globally active banks under Basel standards. The trade-off between the aforementioned risks of setting differentiated requirements (in terms of potential arbitrage opportunities) and the potential benefits arising from having minimum standards at global level might need to be reconsidered.

E. Abuse of financial services (AML/CFT)

The Guidance proposes a risk-based approach to AML/CFT rules, consistent with the standards of the Financial Action Task Force (FATF). Where clients have a low-risk profile, the regulator should have the option of permitting the application of simplified CDD measures and should do so where appropriate. This is important as overly-strict CDD rules can prevent unserved and underserved customers from accessing formal financial services and products and potentially increase the risk of money laundering and terrorist financing by shifting transactions to the informal economy. As stated by the Basel Committee, this should be matched with appropriate operational restrictions, such as low-value limits or geographic restrictions.

Assessment

The Basel Committee is taking an important step forward with this Guidance, as it contributes to placing financial inclusion among the top policy priorities at the global level. Work by internal Standard-Setting Bodies under the auspices of the G20 can help national supervisors and regulators to respond to the changes and innovations in products, services and business models of institutions that are trying to reach those excluded from the formal financial sector. As such, this Guidance can be useful in the promotion of best practices in regulation and supervision.

However, the approach taken by the Basel Committee might have limited outreach. The Basel Committee has traditionally focused on ensuring a level playing field for internationally active banks, while preventing national supervisors from engaging in a race to the bottom that might ultimately undermine financial stability. Institutions that are relevant to financial inclusion, on the other hand, are often small and purely local.

Going forward, the G20 and international standard-setting bodies should attempt to provide a more comprehensive coverage of the fast-changing landscape of financial inclusion. The principle of proportionality, necessary not to inhibit financial innovation and financial inclusion, must be balanced against the potential risks to financial stability and the transfer of well-known risks to new players operating under less stringent rules.

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