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Regulating Transformational Branchless Banking: *Mobile Phones and Other Technology to Increase Access to Finance*

When a cover story last year in *The Economist* forecast provocatively the "end of the cash era," some in developing and transition countries were thinking "not yet, for us at least." Surely the high-tech electronic substitutes for cash described in the issue as taking Japan by storm would take quite a while to reach poorer countries.

And yet, the transformation from cash to electronic value, stored and conveyed by mobile phones, is hitting developing countries, too.[1] In Kenya, the M-PESA mobile wallet service offered by Safaricom attracted 1 million registered users in 10 months (in a country where fewer than 4 million people have bank accounts). And in the Philippines, the country's two mobile network operators offer the functional equivalent of small-scale transaction banking to an estimated 5.5 million customers.

In a fast increasing number, policy makers and regulators in other developing and transition countries are embracing "transformational branchless banking"[2]—the use of information and communication technologies (ICTs) and nonbank retail channels to reduce costs of delivering financial services to clients beyond the reach of traditional banking.

Much of the current buzz is around mobile phones. But other branchless banking approaches are gaining traction as well. In Brazil, banks have established more than 95,000 banking "correspondents"—local merchants, post offices, and lottery dealers equipped with card-swipe and barcode-reading point-of-sale (POS) terminals. These correspondents provide access to financial services in the 1,600 Brazilian municipalities (one quarter) that lacked any financial service outlets seven years ago.

From Afghanistan to Zambia, policy makers and regulators find themselves facing the question of how to approach regulating this new and fast-developing space at the convergence of technology and financial services. Regulation will go far in determining not only whether branchless banking is legally permitted, but also which models of branchless banking are economically feasible and how far they will go in reaching previously unserved or underserved poor people.[3]

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The questions surrounding regulation of branchless banking specifically targeting the unbanked poor have only recently begun to receive comprehensive and systematic attention.[4] The research on which this Focus Note is based sought to expand our evidentiary base. To this end, during the first half of 2007, we visited seven countries where policy makers and regulators find themselves on the frontlines of policy making about regulation of branchless banking targeted at the

1 As early as next year, the Republic of Maldives, made up of 200 inhabited islands scattered across a wide swath of the Indian Ocean—a country as distinct from Japan in terms of its economy and population size as any two Asian island nations could be—stands poised to begin a transformational process aimed at becoming the first country in the world to provide universal financial access, even for the poorest villager on the most remote island, using mobile phone networks that already reach close to 100 percent of the population.

2 The term "banking" is used in this Focus Note in the sense of the full range of financial services that customers typically get from a banking relationship, even though, in many cases, the financial services in question do not directly involve a bank or constitute "banking activity" under domestic regulation.

3 In addition to regulation, two other interrelated issues will determine how rapidly branchless banking scales up and pushes the frontier of financial access in a significant way: (i) development of successful business models that show how to serve low-income people with financial services profitably using technology and (ii) understanding of factors that affect customer adoption among the unbanked poor. This Focus Note is about regulation, although the impact of regulation on business models and customer adoption is also part of this picture.

4 DFID's "The Enabling Environment for Mobile Banking in Africa" (Porteous 2006) (hereafter DFID 2006) and CGAP's "Use of Agents in Branchless Banking for the Poor: Rewards, Risks, and Regulation" (Lyman, Ivatury, and Staschen 2006) (hereafter CGAP 2006) each tackled, for the first time, big parts of the branchless banking regulatory landscape. More recently, several chapters in the Vodafone Policy Paper "Transformational Potential of M-Transactions" (Vodafone Group Plc. 2007) picked up and expanded on some of the same themes.

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unbanked poor: in Africa, South Africa and Kenya; in Asia, the Philippines, India, and Pakistan; in Europe/Central Asia, Russia; and in Latin America, Brazil.[5]

Despite the many obvious dissimilarities among these countries and their situations, policy makers and regulators in the countries studied share a common challenge: how to formulate **proportionate** regulatory policy that gives space for innovation and permits branchless banking to scale up safely. This Focus Note offers guidance and recommendations based on analysis of the varied experiences of policy makers and regulators in these countries.

Background

Additive versus transformational branchless banking. Branchless banking can be either additive or transformational (DFID 2006). It is additive when it merely adds to the range of choices or enhances the convenience of existing customers of mainstream financial institutions.

It is transformational when it extends to customers who would not be reached profitably with traditional branch-based financial services. By tapping into existing infrastructure that already reaches unbanked people—such as mobile phones and local retail outlets

Key Topics and Recommendations on Regulating Transformational Branchless Banking

Among the countries studied, a surprising consensus surrounds the short list of most critical topics policy makers and regulators should address to formulate proportionate regulatory policy for transformational branchless banking.

We classify two topics as "necessary but not sufficient" preconditions:

- Authorization to use retail agents equipped with ICTs as the "cash-in/cash-out" point and principal customer interface
- Development of risk-based anti-money laundering (AML) rules and rules for combating financing of terrorism (CFT), adapted to the realities of remote transactions conducted through agents.

We classify four topics as "next generation" policy and regulatory topics. Though they may not prevent branchless banking from getting a start in a given country, they will figure in its success and sustainability as a means of getting financial services to the unbanked poor:

- Appropriate regulatory space for the issuance of e-money and other stored-value instruments (particularly when issued by parties other than fully prudentially licensed and supervised banks)
- Effective consumer protection (on a variety of fronts)
- Inclusive payment system regulation and effective payment system oversight as branchless banking reaches scale
- Policies governing competition among providers (which balance incentives for pioneers to get into the branchless banking business against the risk of establishing or reinforcing customer-unfriendly monopolies and which promote interoperability)

So what are our recommendations? Despite the difficulty of making strong normative statements in such a dynamic environment, our research leads us to make both process-related recommendations (see pages 17–19) and content-related recommendations (see pages 19–20). The core content-related recommendations can be summarized as follows:

- Permit nonbank retail outlets to serve as agents—and consider carefully any restrictions on the range of permissible agents and types of relationships permitted (page 19).
- Evolve a risk-based AML/CFT approach adapted to the realities of small, remote transactions conducted through agents (page 19).
- Clarify the legal boundaries between retail payments, e-money, and other stored-value instruments and bank deposits (page 20).
- Create a regulatory category for electronically stored value that allows nonbank participation on defined terms (page 20).
- Create robust but simple mechanisms for consumer protection, covering problems with retail agents, redress of grievances, price transparency, and consumer data privacy (page 20).
- Consider the likely longer range competitive landscape today and how to reach the goal of interoperability (page 20).

Above all, our core recommendation for policy makers and regulators is to **use proportionality as a guiding principle.**

5 This includes the pioneering countries that DFID 2006 and CGAP 2006 addressed, plus Russia (a middle-income transition country where elements of branchless banking are developing fast, notwithstanding the general absence of regulatory adaptations) and Pakistan (a country distinguished by the readiness of critical policy makers to undertake reforms to enable branchless banking to develop). This Focus Note contains information on the legal and regulatory positions in these countries that we believe to be accurate as of September 2007.

that might be used as agents for the cash-in/cash-out function—delivering financial services through branchless banking can be radically cheaper than delivering such services conventionally. Transformational branchless banking moves into uncharted regulatory waters. In its application to branchless banking, existing financial system regulation is likely to be both over- and under-protective simply because it was not designed with the types of actors and relationships in mind that are critical to transformational branchless banking models.

Technologies of transformational branchless banking. In transformational branchless banking, technology plays the key role of inexpensively transmitting transaction details between the customer, the retail agent, the financial service provider, and third parties. The devices typically used are mobile phones (e.g., mobile phones are used by Globe Telecom's GCash service in the Philippines) and networks of POS devices that capture client details from plastic cards (e.g., cards used by Caixa Economica in Brazil). Sometimes providers offer both mobile phone-based and card-based services to clients (as in the case of WIZZIT and MTN Banking in South Africa and Smart Money in the Philippines). Aside from data security issues, customer identification capability, and competition policy, the technology used to transmit transaction details is of relatively low regulatory significance, though establishing a technology-neutral regulatory regime has value given how quickly technologies change.

Bank-based versus nonbank-based models.[6] From a regulatory perspective, it is useful to think of branchless banking as consisting of two basic models (CGAP 2006). In the bank-based model, customers have a direct contractual relationship with a prudentially licensed and supervised financial institution—a transaction account, a savings account, a loan, or some combination—even though the customer may deal exclusively with the staff of one or more retail agents hired to conduct transactions on the bank's behalf.[7]

In the nonbank-based model, customers have no direct contractual relationship with a fully prudentially licensed and supervised financial institution. Instead, they exchange cash at a retail agent in return for an electronic record of value. This virtual account is stored on the server of a nonbank, such as a mobile network operator or an issuer of stored-value cards.[8] Once customers have a relationship with the nonbank provider, they can order payment of funds to anyone else participating in the system and can receive payments from them. If the system relies on a POS network and plastic cards, customers must visit a participating retail agent every time they want to conduct a transaction. If the system is mobile phone-based, customers need to visit a retail agent only to add value or to convert stored value back into cash.

The bank-based and nonbank-based models also can function in combination. For example, Globe Telecom's GCash service in the Philippines (which offers virtual stored-value accounts to cell phone customers) has teamed up with member banks of the Rural Bankers Association of the Philippines. Customers can bring cash to a GCash agent to store in their virtual account and then can use an SMS sent from their cell phones to effect loan repayments, deposits, withdrawals, or transfers from a savings account with a participating rural bank.

The regulatory significance of the distinction between the bank-based and nonbank-based models lies in the fact that behind every transaction under the bank-based model, there stands a fully prudentially licensed and supervised financial institution. This fact may give policy makers false comfort, however. Evidence from the countries studied shows that, in some cases, the bank involved in the bank-based model may have outsourced so much responsibility—and risk—to nonbank actors that it, in effect, shifted the primary focus of regulatory concern from the prudentially licensed bank to its unlicensed partner.

6 We use "bank-*based*"—rather than the phrase "bank-*led*" introduced in CGAP 2006—because, in many cases, nonbank actors take the lead in establishing and implementing the branchless banking system, even though a bank is, from a legal and regulatory perspective, the provider of the services in question.

7 With the bank-based model, even one-off transactions, such as payment services, are being offered by a prudentially licensed and supervised financial institution.

8 A more limited version of the nonbank-based model can be found in payment networks, which involve a technology provider or other nonbank institution offering a network of "payment points" (e.g., payment terminals, ATMs, or retail agents equipped with POS devices) where a customer can make payments due to third parties or a governmental entity can make payments to beneficiaries.

Beyond payment services to a full range of financial services? Payments and other money transfer services are, by far, the most significant transaction type driving volume (and hence revenues) in the branchless banking models found in most of the countries studied.[9] Remittances, in particular, both cross-border and domestic, are targeted by mobile network operators in countries, like the Philippines, that have huge foreign and domestic remittance flows.[10] However, growing numbers of providers see potential in branchless banking going well beyond simple payments and other money transfer services. They are eager to extend their reach into the business of lending and deposit taking—even insurance brokerage.

The risks vary as branchless banking providers move along a spectrum (see Table 1) from the simplest payment services (which may present little risk to cus-

Table 1. Stored-Value Accounts on the Spectrum of Branchless Banking Services

	Pure Payments	Stored-Value Account	Deposit/Account Payable at Bank
Description	Provider facilitates one-off payments due to third parties	Repayable funds are accepted by provider into a virtual account that it monitors and maintains on behalf of client	Contractual relationship with a fully prudentially regulated institution to hold repayable funds in an account on behalf of client
Financial services provided	Payments only	Transaction services for receiving and making multiple payments; may include links to other financial services, such as credit, insurance, savings	Transaction services for receiving and making multiple payments; may include overdraft or credit facility
Interest paid	No	No	Yes (sometimes)
Balance repayable?	No	Yes	Yes
Cash-in/out	Cash-in only in the case of bill payments; person-to-person transfers require cash-out mechanisms	Yes—via range of agents and devices	Yes—via bank branches, agents and devices
Time for which funds held by provider	Short-term (usually < 3 days)	Indeterminate	Indeterminate
Examples from diagnostic countries	Payment terminals (Russia); Russian Post; bill payments via Easypay (South Africa); Sokotele (Kenya)	M-PESA (Kenya), GCash (Philippines); WebMoney (Russia)	Caixa Economica, Banco Popular, Banco Postal, Lemon Bank, etc. (Brazil); WIZZIT, MTN Banking (South Africa); Equity Bank (Kenya); Smart Money, Rural banks (Philippines); ICICI, State Bank of India (India); Tavrichesky Bank/Beeline, Moscow Social Card (Russia)

9 Branchless banking has yet to launch in Pakistan, although both the industry and the key regulator, the State Bank of Pakistan, are working fast toward the necessary regulatory accommodations for the bank-based model. It remains to be seen whether bill payment and other money transfers will dominate branchless banking there. In India, microfinance loans feature prominently, in part because of the rapid growth in ICICI Bank's partnerships with microfinance institutions acting as its agents. Several more recent initiatives seek to leverage government benefit payments and/or remittances into viable models of branchless banking (e.g., that of the State Bank of India with the Andhra Pradesh Rural Employment Guarantee Scheme).

10 GSMA's Mobile Money Transfer program was launched with the aim of tapping the ubiquity and ease-of-use of mobile communications to enable the world's 200 million international migrant workers to send remittances easily and securely to their dependents, many of whom don't have bank accounts.

tomers or the financial system beyond clearing and settlement risk)[11] all the way to full retail deposit taking (which triggers the complete range of depositor and systemic protection concerns that motivate prudential regulation and supervision).[12] As the risks vary, the kind of regulation that will be proportionate does as well. E-money and similar stored-value instruments occupy a special place along this spectrum. To a policy maker or regulator, the stored-value accounts offered using the nonbank-based model by GCash in the Philippines and M-PESA in Kenya may appear like the functional equivalent of a transaction banking account, even if the individual transactions are small. Yet regulating this activity in the same manner as transaction bank accounts of a fully prudentially licensed and supervised bank may be disproportionate to the risk and may drive costs beyond the reach of the unbanked poor.

Regulatory domains and the risk of coordination failure. The concerns underlying prudential regulation and supervision constitute only a fraction of the policy and regulatory issues confronting policy makers and regulators in regulating transformational branchless banking. The diagnostic approach[13] used in the countries studied considered the impact of the following policy and regulatory domains:

- Prudential risk management: the delineation among, and regulation of, simple payments, e-money, and other stored-value instruments and deposits
- Agency: the use of retail agents for handling cash-in/cash-out functions and other customer interface functions
- AML/CFT: rules applied to low-value accounts, payments, and agents
- Payment systems: oversight and rules for access and participation, with a focus on retail payment systems
- Competition: rules around creating a level playing field for providing new services, averting undue market dominance, and striking the balance between competition and cooperation
- Consumer protection: rules governing liability and recourse, disclosure, and data privacy and security
- E-commerce and e-security: rules on the legal status of electronically authorized transactions (e-signatures) and rules that ensure adequate security for conduct of banking via electronic channels
- Foreign exchange control: rules affecting foreign remittances in or out
- Taxation: differing tax treatment of transactions depending on channels and types of entities involved
- Telecommunications regulation: rules affecting mobile phone-based financial services

Can Simple Payments and Other Money Transfers Help Lead Poor Customers to Other Financial Services?

Many branchless banking providers are hoping to build their business model around dependable revenue streams, such as remittances, government social benefits, or wage payments, that clients (particularly low-income clients) can use to fund virtual stored-value accounts or bank accounts. The Philippines, for example, attracts US$15 billion in remittances annually, part of a global flow of US$275.9 billion in cross-border remittances (World Bank 2007). In Brazil, Caixa Economica handles more than US$4.2 billion annually in grants for education, food, and income subsidies via its network of more than 19,000 points of assistance, including 13,255 agents (Caixa Economica 2007). By channeling these flows into accounts, providers hope to offer additional profitable financial services—savings and transaction bank accounts (or their virtual equivalent) initially, but ultimately also credit (as creditworthy payment histories on clients are developed).

11 Money laundering and terrorist financing risks, of course, can also arise with pure payment services (Chatain et al. forthcoming).

12 Money laundering and terrorist financing risks, too, vary according to the type of service rather than the type of institution providing it, making a service-based approach to AML/CFT risk analysis appropriate (Chatain et al. forthcoming).

13 Documents related to the diagnostic approach taken, and other resource documents, as well as a complete list of individuals consulted during the diagnostic missions are available at www.cgap.org/policy/branchlessbanking.

Each domain is complex and, in many cases, the policy-making and regulatory authority for each domain operates more or less autonomously from the authorities for the other domains. Consequently, there is a significant risk the different authorities will not coordinate with each other and that they may even work at cross-purposes.

What constitutes a proportionate regulatory approach to branchless banking in this current, fast-developing context? Faced with these challenges, policy makers and regulators may be tempted to defer action until clear good practice standards for regulating transformational branchless banking have emerged. But evidence from the countries studied shows that the industry will not wait to innovate while policy makers and regulators deliberate over an ideal course of action. Moreover, existing regulation, given that it was not developed with the convergence of telecommunications and finance in mind, typically leaves many gaps and ambiguities through which innovation might pass—including innovation of a sort that should cause policy makers and regulators legitimate concern, as several examples from the studied countries illustrate.[14] The most significant risk of doing nothing may be a spectacular accident that could have been averted with appropriate regulation—an accident that causes both customers and their policy makers and regulators to sour on the whole idea of transformational branchless banking.

When Is Branchless Banking Regulation "Proportionate"?

The United Kingdom's Financial Services Authority (FSA) is required by law to use regulation efficiently to maintain confidence in the financial system, promote public understanding of the financial system, protect consumers of financial services, and reduce financial crime. This means concentrating regulatory resources in areas that face the greatest risk and where market impact would be greatest. Innovations in financial services—such as virtual stored-value accounts offered by a nonbank issuer of prepaid cards—may have a relatively higher probability of failure than established services, but the impact of failure on the market could be relatively low given the small numbers of consumers.

The U.K. FSA offers these insights on proportionality and innovation in a recently released statement of principles:

"Proportionality: The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions. In making judgments in this area, we take into account the costs to firms and consumers. One of the main techniques we use is cost benefit analysis of proposed regulatory requirements. This approach is shown, in particular, in the different regulatory requirements we apply to wholesale and retail markets.

Innovation: The desirability of facilitating innovation in connection with regulated activities. This involves, for example, allowing scope for different means of compliance so as not to unduly restrict market participants from launching new financial products and services."*

A complementary lens for looking at proportionality in regulation of branchless banking, one that factors in the possibility of competing regulatory objectives, appears in "General Principles for International Remittance Services," jointly developed by the World Bank and the Committee on Payment and Settlement Systems of the Bank for International Settlements in Basel:

"…[P]roportionate means that the legal and regulatory framework…should not be overly restrictive and burdensome relative to the possible issues it is designed to tackle or the number and value of [transactions] involved…. In considering this, it is important to realize that the public policy objectives may not always point in the same direction…. Proportionality means that any such inconsistencies are recognized and resolved in a way that, in light of the country's overall priorities, achieves an appropriate balance." (Committee on Payment and Settlement Systems and the World Bank 2007)

* FSA, "Principles of Good Regulation" accessed September 25, 2007, at http://www.fsa.gov.uk/Pages/about/aims/principles/index.shtml

14 Web-based e-money issuers are thriving in Russia. WebMoney alone has 4.3 million registered users and over 2 million transactions per month, with a value of US$132 million. Clients purchase scratch-off cards at kiosks and merchants, giving them value, in a virtual account, that can then be remitted internationally, transferred to a bank card, or used for online purchases (http://www.wmtransfer.com). WebMoney is not licensed by the Central Bank of the Russian Federation. Kenya-based start-up SmartMoney offers a reloadable virtual card that can be used to send money, pay utility bills, and pay online merchants using the Internet or mobile phones (http://www.smartmoney.co.ke). SmartMoney reports "several thousand" clients and launched operations in April 2006 without a license.

Another risk is that branchless banking will not take off because of barriers in existing regulation unnecessarily prohibiting certain approaches that are central to transformational models. Even significant uncertainty about what is permitted could have a similar effect.

If inaction in the face of innovation carries too high a potential cost, how can access-oriented policy makers and regulators respond to branchless banking **proportionately?** The answer will not be the same from one country to another, or even necessarily from one aspect of branchless banking to the next, because proportionate regulation should match the type and level of protection to differing levels and types of risk involved and the costs that regulation will entail. Moreover, the answer itself will not stay constant even within a given country, because of the varying levels, nature, and speed of market development.

Key Topics in Regulating Transformational Branchless Banking

The dissimilarities among the countries studied in terms of political systems, economy, geography, demographics, state of development and nature of their financial systems, profile of their unbanked poor, and legal and regulatory traditions all contribute to the challenge of extracting general key principles. Nonetheless, a surprising consensus surrounds the short list of most critical topics policy makers and regulators should address to formulate regulatory policy for transformational branchless banking.

"Necessary but not Sufficient" conditions. The first two key topics might be seen as "necessary but not sufficient" regulatory preconditions for transformational branchless banking to emerge in a given country. The first is authorization to use retail agents equipped with ICTs as the cash-in/cash-out point and principal customer interface. The second is a risk-based approach for combating money-laundering and terrorist financing, adapted to the realities of remote transactions conducted through agents. Without these two preconditions, transformational branchless banking will not be legally and economically feasible.

Agents. The common element across transformational branchless banking models is the use of agents to reach customers who are either unable (e.g., because of physical distance) or unwilling (e.g., because

Country-Specific Key Issues

Regulatory policy is largely determined at the national and subnational level (even when guided by international standards). There is therefore no substitute for deep country-level diagnostic analysis that brings to light issues that may not be key in other countries. Examples from Pakistan and Brazil illustrate this point.

Mobile network operators (MNOs) in Pakistan face some of the toughest competition and lowest average revenues per user in the world, sparking a race to find value-added services to boost revenues, such as mobile phone-based branchless banking. Several pioneering microfinance institutions are also pursuing plans that could include links with MNOs. Pakistan imposes VAT and excise taxes on telecommunication services totaling 26 percent. If applied to the purchase and sale of electronically stored value, it could render mobile-based branchless banking unaffordable, and it could establish an uneven playing field between branchless banking providers using mobile phones and those relying on other ICTs.

Low costs have made it possible for branchless banking to reach even the most remote Amazonian hamlet in Brazil. A significant part of these cost savings comes from the use of banking agents whose commissions are much lower than salaries and benefits paid to unionized bank employees. Recently, employees of commercial retailers acting as agents sued banks in multiple courts arguing that they should be considered bank employees for the purposes of working hours and wages. The potential impact on the agent business model is substantial. Some lawyers are advising banks to forgo investments in agent-based channels until the law suits are settled.

of the fees charged or simply negative perceptions) to take advantage of financial services delivered through traditional bank branches. The parties to whom direct customer interaction is outsourced may or may not be "agents," in the true legal sense, of the bank or nonbank on whose behalf they interact with poor customers, depending on the regulatory system and contractual arrangements made.[15] Regardless, they are indispensable for the following reasons:

- They can be outfitted with the necessary ICTs and can operate at a fraction of the cost of opening and operating conventional bank branches (making it possible to reach vast new groups of poor customers profitably).[16]
- They offer customers both convenience[17] and a milieu in which they are already comfortable transacting business.[18]

The use of retail agents introduces new or enhanced risks policy makers and regulators should consider seriously (CGAP 2006). For example, agents present a variety of operational risks to the provider and, in particular, reputational risk given that the agent is the public face of the provider. Moreover, the use of agents adds a special dimension to the challenge of satisfying AML/CFT norms and to consumer protection—two other key topics that are critical to transformational branchless banking.

In each of the countries studied, agents may be used, but there is great diversity as to which functions and services agents may perform, what types of entities are permitted to be used as agents, who is responsible for the actions of agents, how agents may be compensated, and more.

Brazil, India, and Kenya provide illustrative examples of the range of current regulatory practice with respect to the use of agents.

Regulations issued by Brazil's central bank permit a wide range of entities to serve as agents. The Central Bank of Brazil established the notion of "banking correspondents" in 1973, permitting banks to engage third parties to collect and process payments. In 1999, the National Monetary Council substantially broadened the scope of activities that could be outsourced to correspondents, including receiving documents for account opening and handling deposits and withdrawals. Use of bank correspondents began to grow rapidly with this regulatory shift, combined with demonstration of the model's viability after several banks (in particular Caixa and Bradesco) invested in establishing large agent networks. The number of correspondents grew by more than 50 percent between 2000 and 2006 to more than 95,000 (Marques Soares and Duarte de Melo Sobrinho 2007).

In Brazil, nearly any retail establishment with a cash drawer can act as a banking correspondent. But the central bank also notes some restricting conditions. Among other conditions, it requires the following:

- A bank is liable for the actions of its agent.
- Agents engaged in opening accounts or accepting deposits and withdrawals are approved by the central bank.
- Certain mandatory clauses must be included in contracts between banks and agents on such topics as, for example, enjoining agents from representing themselves as anything more than an intermediary of the bank.
- The Central Bank has access to all data relating to agents, via the bank (typically) and also directly via the agent (as the central bank deems necessary).
- All transactions must be settled between a bank and an agent within 48 hours.

By contrast, the Reserve Bank of India's "Business Correspondent and Facilitator Circular," issued in early 2006,

15 Contrast "correspondents" in Brazil, which, under Brazilian regulation, hold a relationship to the banks they serve that has many attributes of true agency in the legal sense; South African WizzKids, which are independent franchisees that purchase starter packs from WIZZIT at US$3 and sell at US$6; and M-PESA agents in Kenya, for whom Safaricom has disavowed responsibility by contract with its customers, although the function performed is similar to that performed by Brazilian "correspondents."

16 In Russia, branchless banking cuts costs even further through the use of automated payment terminals. An operational office—not even a full-scale branch—typically costs US$200,000 to establish, as compared to US$7500 for an automated payment terminal.

17 The unbanked poor live in cash economies where electronic value, whether stored in a bank or on the server of a nonbank or in a device in the customer's possession, must be steeply discounted if there is no ready way to convert it into cash and vice versa.

18 Low-income clients are often uncomfortable with banking halls, even if they are close by. However, they may be more comfortable banking through local merchants, post offices, and other outlets where they already conduct business.

permits only a narrow range of cooperatives, nonprofit entities, and the postal system to be used by banks as agents. Indian policy makers say this restriction is in place because of the generally positive reputation of community-based nongovernmental organizations and the postal system and the comparatively poor reputation of many local businesses and widespread fraud reported in the past when commercial entities were used for small-scale deposit mobilization on behalf of licensed financial institutions.

Brazil and India shed light on some potential consequences of defining the regulatory space for the use of agents more or less broadly. Although causality would be hard to establish given the range of possible contributing factors, it is striking that almost two years after the promulgation of the restrictive Reserve Bank of India Circular, India has seen only relatively modest uptake of transformational branchless banking. In Brazil, where an extremely wide array of retail establishments is permitted to serve as agents, and where parties enjoy substantial freedom to determine the commercial details of their relationship, more than 95,000 agents currently operate. They serve every municipality in the country, and an entire industry has grown around identifying and servicing agent networks.

In Kenya, the mobile phone-based M-PESA stored-value accounts are carefully structured so as not to constitute a "banking activity" under the Kenyan Banking Act. This leaves M-PESA's provider, Safaricom (jointly owned by the Government of Kenya and Vodafone, a large international mobile telecommunications firm) free to choose its agents based on its business judgment alone.

Both Safaricom and Vodafone have their own reasons to choose and manage agents carefully, given the potential reputational risk to their core telecommunications business. However, they do not stand behind their agents in the way Brazilian banks are required to do by regulation. In fact, the fine print in the M-PESA account holder agreement states specifically that Safaricom bears no responsibility or liability for any default or negligence on the part of agents providing M-PESA services.

And although the general absence of regulation in the nonbank-based model of branchless banking practiced by M-PESA leaves its sponsors free to innovate in agent selection and management, it also leaves Kenya exposed to the possible entry of new promoters of the nonbank-based model of branchless banking. Some of these entrants will be start-up issuers of electronic stores of value, accessed through prepaid cards, who may have comparatively little to lose (other than possibly their customers' funds) in the event of fraud or bad management.

AML/CFT.[19] In many countries, the next most critical regulatory prerequisite for launching transformational branchless banking is adopting a risk-based approach for combating money laundering and terrorist financing.[20] Unless the rules are adapted to the realities of low-income clients who may have limited access to formal documentation and remote transactions conducted through relatively unsophisticated retail agents, they risk preventing transformational branchless banking from getting off the ground.

The Financial Action Task Force (FATF) sets international AML/CFT standards and oversees compliance monitoring. It calls for national-level regulatory regimes to require that adequate customer due diligence (CDD) (also known as "know your customer" [KYC] rules) be undertaken on all new accounts and on one-off cash transactions over designated thresholds. FATF-compliant CDD/KYC rules require "[i]dentifying

19 Research on AML/CFT in three of the seven countries studied—Brazil, South Africa, and the Philippines—was conducted in collaboration with a team from the World Bank's Financial Markets Integrity in the context of a multi-country study it conducted looking specifically at AML/CFT issues in branchless banking using mobile phones (Chatain et al. forthcoming). The study focuses just on AML/CFT and deals only with mobile phone-based approaches to branchless banking. Nonetheless, the findings represent an important contribution to the state of knowledge on this critical subset of branchless banking policy and regulatory topics. Although differing terminology is used in the study, its findings are entirely consistent with the research supporting this Focus Note.

20 This is certainly not to say that money laundering or terrorist financing constitute the most important financial crimes made possible or potentially easier with branchless banking. From anecdotal evidence collected during the diagnostic missions, simple customer fraud and identity theft are more significant problems in the countries studied.

the customer and verifying that customer's identity using reliable, independent source documents, data or information" (FATF Recommendation 5).[21]

In addition to CDD/KYC, FATF standards require financial service providers to keep detailed transaction records (including documentation collected in identifying and verifying the identity of customers) for at least five years (FATF Recommendation 10) and that they report suspicious transactions promptly to the AML/CFT authority (FATF Recommendation 13).[22] Finally, FATF standards mandate special attention to "threats that may arise from new or developing technologies that might favor anonymity" and require policies and procedures be in place "to address any specific risks associated with non-face to face business relationships or transactions" (FATF Recommendation 8).

Depending on how these standards are implemented in national-level regulation, they pose potentially formidable challenges to serving the unbanked poor using transformational branchless banking approaches. There is a critically important distinction to be drawn between what the FATF recommendations themselves permit and how they end up getting reflected in national-level regulation. In numerous instances, national-level AML/CFT regulation fails to take advantage of important flexibility allowed for by the FATF recommendations, with an access-constraining result (Bester et al. forthcoming; Chatain et al. forthcoming).[23]

Many low-income individuals have difficulty presenting documentation required to establish their identity and other particulars. Being able to perform CDD/KYC beyond bank branches is also an important shift in the ease and cost of opening accounts, for clients and financial service providers alike. At present, national AML/CFT regimes in many countries are fashioned without space for non-face-to-face account opening, including CDD/KYC entrusted to staff of nonbank retail agents, or remote account opening, with customer data submitted electronically and verified through independent, third-party information.

These types of barriers may stop branchless banking before it starts. However, the experience of South Africa and the Philippines offers some encouragement to policy makers and regulators in other countries who want both a FATF-compliant AML/CFT regulatory regime[24] and transformational branchless banking.

In the Philippines, policy makers managed to tighten AML/CFT regulation and enforcement sufficiently to get the country removed from FATF's blacklist of noncompliant countries and regions. At the same time, they arrived at regulatory accommodations that permitted the launch of both the bank-based (Smart) and nonbank-based (Globe) models of branchless banking. This includes mechanisms that enable CDD/KYC to be conducted by agents (Circular 471), a key characteristic of both Smart's and Globe's mobile banking models. They also allow a multiplicity of formal identity documents to be presented for verification purposes (Circular 562).

In South Africa, a carefully tailored exemption to otherwise applicable CDD/KYC measures (Exemption 17) and a special allowance for remote account opening (Circular 6) permitted the launch of two different mobile phone-based branchless banking ventures (MTN Banking and WIZZIT). At roughly the same time, South Africa was meeting the stringent standards necessary to gain admission as a full member of FATF in 2003 (even holding the FATF presidency for 2005–2006).

Despite these successes, AML/CFT compliance is still viewed by providers in the branchless banking space as a factor limiting the speed at which their operations can gain scale. Rules on record keeping and agent training can be expensive, adversely affecting the business case for transformational branchless banking.

21 This recommendation also applies to remittances. In addition, FATF Special Recommendation 7 calls for countries to ensure financial institutions and other money remitters capture "meaningful originator information" (name, address, and account number) on funds transfers and related messages that are sent and that such information remain attached to the transfer from end to end.

22 FATF Special Recommendation IV calls for institutions involved in remittances to make prompt reports to the competent authorities if they suspect funds are linked to terrorism.

23 For more on the juncture between AML/CFT and access to finance, consult Isern et al. 2005; Bester et al. forthcoming; and Chatain et al. forthcoming. FATF's 40 Recommendations, nine Special Recommendations, and Guidance on Risk-based Approach to Combating Money Laundering and Terrorist Financing can be accessed at www.fatf-gafi.org.

24 Note that neither South Africa nor the Philippines has yet undergone the mutual evaluation process FATF uses to determine the level of compliance with FATF's AML/CFT recommendations.

The Philippines' Circular 471 and South Africa's Exemption 17 and Circular 6

In the Philippines, the central bank's Circular 471 opened the way for retail agents to be accredited to perform CDD/KYC checks. Although primarily aimed at foreign exchange transactions and cross-border money transfers, Circular 471 is phrased in wide enough terms to cover retail outlets acting as agents of Globe's GCash and Smart Telecom's Smart Money branchless banking services. Agents must (1) apply to the central bank for registration, which entails the submission of various legal documents; (2) send their officers and personnel directly involved in the cash operations to undergo training by the Philippine AML Council; (3) complete a CDD/KYC process for all first-time transactions by GCash or Smart Money users, which entails obtaining from the client a completed application form and establishing his or her identity with a government-issued ID; (4) maintain records of all transactions for five years; and (5) report covered and suspicious transactions.

South Africa's Exemption 17 eliminates the otherwise applicable requirement under South African regulation to verify a customer's physical address for accounts subject to a maximum balance cap of approximately US$3,868 and a daily transaction limit of approximately US$773 (South African Ministry of Finance 2004). One-third of South Africans, particularly low-income individuals, have trouble securing documents to prove their physical address, mostly because they live in informal housing (Truen et al. 2005). Exemption 17 uses the flexibility permitted by FATF Recommendation 5 to apply "reduced or simplified" CDD/KYC if risks are low, by capping balance and transaction size, and therefore account utility for criminal elements (FATF 2003).*

Circular 6 extends Exemption 17 to mobile-based services, permitting non-face-to-face account opening under certain circumstances. Clients can open mobile banking accounts by submitting data remotely via mobile phone. These data must then be verified against a third-party source, such as credit bureaus or databases containing information from the Department of Home Affairs. To limit risk, the functionality of accounts opened in this manner is more restricted than under Exemption 17, with transaction limits of US$155 (South African Reserve Bank 2006a). Reliable third-party databases in South Africa help satisfy the requirement of FATF Recommendation 5 to verify customer identity "using reliable, independent source documents, data or information." Circular 6 permits the bank to establish the identity of clients without seeing either the customers or their identity document. In South Africa, where (as in many developing and transition countries) false IDs are relatively easy and inexpensive to obtain, the face-to-face ID check may prove less effective than other procedures to verify the customer's identity, such as querying the customer to provide additional personal information to check against a credit bureau profile or database with data from the Department of Home Affairs. Proponents of Circular 6 point to this possibility as addressing the need for "policies and procedures…to address any specific risks associated with non-face-to-face" relationships, such as remote account opening, as called for in FATF Recommendation 8 (FATF 2003).

*Relevant FATF guidance refers to the Basel Committee's "Guidance Paper on Customer Due Diligence for Banks" (2001), which contains a best practice list of information, including address details, that should be obtained. The proponents of Exemption 17 argued that it does away with awkward address verification, which adds little to the crime risk management framework and does not prevent banks from asking for further information from clients that may be more relevant in the case of the unbanked poor (who often lack a fixed address).

In Kenya, for example, the draft AML Bill would require providers to collect extensive records for every transaction, including customer's name, physical and postal addresses (an impossibility in the case of many clients in a country with a lot of informal housing), and occupation, as well as the name and address of the officer, employee, or agent who prepared the record, and to retain these records for seven years (two years longer than the minimum suggested five-year record retention period of FATF Recommendation 10).

In the Philippines, merchants must complete a one-day AML/CFT training to obtain accreditation as an agent under Circular 471. The training is typically

available only in Manila. As a result, less than 1 percent of Globe airtime dealers are accredited GCash agents. This could become a bottleneck if Globe hopes eventually to make GCash available at a substantial number of the approximately 700,000 merchants selling airtime throughout the Philippines. And when the lens is widened to include the rest of the seven countries studied, a picture that is even more mixed emerges.[25]

Next generation topics to think about now. Policy makers and regulators in the countries studied have not limited their concerns to preconditions that might prevent the launch of transformational branchless banking. To varying extents, they also have given attention to regulation that might mitigate the risk of a catastrophic failure that could turn the public off to the very idea of branchless banking. Some also are looking ahead to future market development and are at least beginning to think about issues that will affect the scaling up and sustainability of branchless banking. The following next generation topics are particularly important:

- Appropriate regulatory space for the issuance of e-money and other stored-value instruments (particularly when issued by parties other than fully prudentially licensed and supervised banks)
- Effective consumer protection (on a variety of fronts)
- Inclusive payment system regulation and effective oversight as branchless banking reaches scale
- Rules governing competition among providers (which balance incentives for pioneers to get into the branchless banking business against the risk of establishing or reinforcing customer-unfriendly monopolies and which promote interoperability)

E-money and other stored-value instruments. Some of the money transfer service providers that dominate the branchless banking landscape in most of the countries studied (particularly the simple bill payment service providers)[26] have built their business around providing one-time transactions. But branchless banking innovators more typically hope to develop ongoing relationships with customers and expand the range of services they can market to increase transaction volumes. A growing number have already moved beyond pure payment services to offer a virtual transaction account where customers can "park" repayable stored value in electronic form for an indeterminate period and make payments and other money transfers when they choose to.[27] These models, to the extent that they facilitate payments via mobile phones, offer great potential for transformational branchless banking because they effectively constitute a retail payments network far beyond the current banking and POS networks.

Where the electronic stored value is issued by a bank, the funds, or float, backing the stored value will be monitored as a component of the overall prudential supervision of the bank, even if it is not considered a normal bank deposit. In some countries, such as the Philippines, a prepaid card account—such as the accounts Smart mobile customers can open with Smart's bank partners—is considered an account payable on the books of the bank, rather than a deposit. This results in the bank facing a lower cost regulatory regime and customers receiving a lower level of protection (because customers' funds are not counted for deposit insurance purposes). Nonetheless, in general, branchless banking services provided through the bank-based model offer at least some measure of regulatory oversight.

However, in the case of the nonbank-based model, where a mobile network operator or issuer of prepaid cards creates a virtual stored-value account for a customer and the customer does not have a contractual

25 Differing national-level approaches to AML/CFT on key issues affecting transformational branchless banking in the countries studied are summarized in Annex 2, available on the Web at www.cgap.org/policy/branchlessbanking.

26 As noted, Pakistan is only now embarking on branchless banking, and it remains to be seen whether payment services will dominate early use. Microfinance loans feature prominently in the earliest branchless banking program in India—ICICI's partnership with MFIs—though more recent initiatives place government benefit payments and/or remittances toward the center of the business model.

27 These electronic stored-value accounts may or may not meet one or more of the various definitions of e-money. Typically they share the attributes most commonly used in defining the concept: the virtual account represents monetary value; it is stored on an electronic device (typically the server of the issuer of the stored value, but sometimes on a card or chip in the customer's possession); and the electronic store of value has general-purpose use (i.e., it is accepted as a means of payment by entities other than the issuer and its close corporate associates).

relationship with a prudentially regulated and supervised bank, there may be little or no regulatory oversight. Even if net proceeds received by the provider from customers are deposited in a bank, the funds are pooled, often in an account in the provider's name, and a client may have a claim only against the provider and not the provider's bank.[28] Moreover, unless there is regulation in place addressing these issues, there is no guarantee the provider will have the liquidity to honor customers' claims, and customers' funds have no priority over the claims of the provider's other creditors.

The regulatory treatment of nonbank-issued e-money and other stored-value instruments in Russia and the Philippines illustrates two ends of a spectrum among those of the countries studied where nonbanks are not prohibited entirely from offering electronic stored-value accounts.[29] In Russia, WebMoney offers stored-value accounts in unlimited amounts that can be topped up, among other means, via electronic cash acceptance terminals or through the purchase of scratch cards. WebMoney faces no prudential oversight, and customers' funds are not protected from the firm's other creditors.

In the Philippines, the central bank used its broad regulatory powers to bring Globe Telecom's GCash subsidiary GXI under its supervision. The central bank limited the risk of GCash, by requiring, among other things, daily and monthly transaction caps, as well as a low cap on the amount customers may leave in their virtual account. Moreover, GXI submits monthly reports on its activities to the central bank, which monitors it closely.[30]

Policy makers and regulators in both Russia and the Philippines readily acknowledge the potential risks posed by nonbank issuance of stored-value instruments. In Russia, defining and appropriately regulating e-money and similar electronic stored-value accounts are high on the priority list of the central bank. In the Philippines, policy makers feel the one-of-a-kind accommodation worked out for GCash has served the country well during the period of early experimentation. But they feel the time is now right for the topic to be addressed in a comprehensive fashion in a national payment system law that is currently being prepared.

Both countries have plenty of company. Policy makers and regulators—not just in developing and transition countries, but also throughout the developed world—are searching for the optimal approach to regulating e-money and other stored-value instruments offered by nonbanks. Where the stored value can be used only to purchase goods or services offered by the issuer or closely related businesses,[31] most countries that have addressed the question have left the matter unregulated (aside from perhaps establishing transaction and balance thresholds). But where the stored value can be used as the virtual equivalent of a transaction banking account, the trend among developed countries is to impose minimum capitalization and liquidity thresholds, prudent investment standards, and possibly transaction thresholds along the lines of those agreed with Globe Telecom's GCash product in the Philippines.[32] This approach allows space for innovation among nonbank providers, and it allows their potentially lower cost approach to compete with banks and others whose monopoly position may constrain access.

28 This is the case with GCash in the Philippines. An exception is M-PESA in Kenya. Unlike Globe, Safaricom places M-PESA funds in a trust account for the benefit of its customers at Commercial Bank of Africa. It is too soon since M-PESA's March 2007 launch to know how readily clients will be able to press a claim to the funds held in trust on their behalf. The primary purpose of creating the trust for the benefit of M-PESA customers was to avoid the Kenyan Banking Act's definition of "banking business," which would have required a banking license.

29 In South Africa, for example, official guidance interpreting the Banking Act prohibits nonbanks from issuing stored-value instruments (South African Reserve Bank 2006b), forcing nonbanks interested in issuing stored-value products to form joint ventures with banks.

30 GXI holds net proceeds from the issuance of GCash in licensed Philippine banks. The central bank does not directly regulate the solvency or liquidity of GXI or its parent, Globe Telecom. However, Globe is one the country's largest publicly traded domestic corporations—more solvent and less leveraged than the country's banking sector on average.

31 These stored-value schemes are often referred to as closed systems, as distinguished from open systems, where customers can purchase from or make payments to a wide variety of parties who are separate from the stored-value issuer.

32 Under the EU E-Money Directive (2000) electronic money institutions must maintain certain minimum capital and liquid investments equal to 100 percent of the value of outstanding e-money. The Directive provides for Member States to issue waivers for institutions with outstanding e-money balances generally less than EUR 5 million or that issue e-money accepted only at one or a limited number of parties. As of 2006, nine institutions operated as full electronic money institutions and 72 operated under waiver, of which 66 were registered in countries in which the national authorities exempted institutions operating under waiver from all requirements except a maximum balance cap of EUR 150 and a requirement to report on activities and outstanding e-money liabilities (Evaluation Partnership 2006).

It also allows space to calibrate the level and type of regulation to the scale of the nonbank providers' activity, leaving room to make adjustments as the market develops and experience is gained with the new or enhanced risks involved.[33]

Consumer protection. Policy makers in the countries studied are concerned about the challenges of protecting customers of transformational branchless banking. The following aspects of branchless banking contribute to a generally held sentiment that consumer protection requires special regulatory attention:

- Potentially large distances separate customers, agents, and retail transactions from the premises (let alone head offices) of the bank or nonbank institution that is using the branchless banking model in question (and the tribunals where disputes ordinarily would be taken for redress).
- The insertion of retail agents between customers and the bank or nonbank institution providing their financial services will lead to factual (and perhaps also legal) disagreements about who is responsible to the customer in the case of fraud or other alleged misdeeds. (Moreover, certain kinds of fraud or abuse may be more prevalent—or easier to get away with—in the case of transactions undertaken through retail agents.)
- Ensuring transparency (and comprehensibility) of pricing becomes more difficult the larger the number of parties whose fees and commissions need to be factored in and the greater the number of arguably separate, yet embedded, services involved (e.g., airtime purchases, SMS fees, commissions paid to the retail agent for the cash-in/cash-out function, and so forth).
- The electronic storage and transmittal of minutely detailed electronic records about customers and their transactions as part of branchless banking increase the importance of consumer data privacy and security protection.[34]

Furthermore, many of the countries studied started out with consumer protection-related challenges not directly related to branchless banking. In Russia, for example, consumer protection for all matters, from consumer product safety complaints to credit card fraud, falls within the jurisdiction of a single, centralized, and lightly staffed body. On the other hand, in India, primary legislative jurisdiction for consumer protection lies at the state level, meaning providers face a patchwork of different requirements depending on the location of their agents. In all seven countries studied, to a greater or lesser extent, poorer and more remote clients may not know about or understand their rights even if adequate regulatory protections are in place.

The countries studied also illustrate some steps that might be taken to mitigate the new or enhanced consumer protection challenges of branchless banking. India requires banks working through agents to set up complaint-filing procedures for customers, designate a Grievance Redressal Officer within the bank, and publicize these mechanisms "widely" through electronic and print media (Reserve Bank of India 2006). Brazil's 2001 banking client protection code applies to all facilities used by banks and requires them to post the telephone number for the bank's consumer care mechanism and the central bank's ombudsman in all facilities (including agents) (National Monetary Council 2001).

Both India and Brazil have put in place banking ombudsmen as an alternative means of redress.[35] To simplify things for customers in case of alleged fraud or other misconduct by agents, both Indian and Brazilian regulations hold banks liable for the conduct of their agents (helping to shift the burden of vigilance from

33 Systemic and customer protection are not the only policy issues e-money and other electronic stored-value instruments present. Central bankers also harbor concerns about e-money's potential macroeconomic impact, including the possibility of affecting the demand for and velocity of money and central bank control over money supply, as well as possible loss of revenue from bank note issuance known as seigniorage. However, although the Bank for International Settlements underscores the need for ongoing monitoring as technology enables new forms of payment instruments and devices, it has observed that "[s]o far no central bank has indicated an adverse impact on the size of its balance sheet due to a decline in the value of banknotes in circulation as a consequence of the widespread adoption of e-money" (Committee on Payment and Settlement Systems 2004).

34 Vis-à-vis data security, it should be remembered that poor customers, too, face risk of identity theft. Vis-à-vis data privacy, this is a consumer protection issue, but it is also likely to be closely linked with customer adoption of branchless banking. For example, if customers fear their financial transaction records will find their way into the hands of tax authorities, they may well decide to stick with less transparent, informal financial services.

35 Many countries have an official body—such as an independent ombudsman or unit within the central bank—that will facilitate redress of consumer complaints with respect to financial services.

the customer to the financial service provider) (RBI 2006; National Monetary Council 2003). Brazilian regulation also requires the agent to post information that explains, in unequivocal terms, its status as simply a provider of services for the bank and enjoins agents from charging additional fees (National Monetary Council 2003).

In Brazil, the general consumer protection code, the banking client protection code, and a central bank resolution on bank fees all require transparency of pricing for services rendered. In 2001, the banking client protection code was amended to add the phrase "and in the facilities where their services are delivered." In December 2007, new regulations were issued to explicitly state that agents are also governed by price transparency requirements (National Monetary Council 2007).

On data privacy, consumers in the countries studied are likely to have some measure of regulatory protection, depending on the model of branchless banking and the country in question, under general consumer protection regulation, bank secrecy provisions, and sometimes "right to privacy" provisions of the Telecommunications Act, as well as under common law privacy doctrines, where applicable. But this patchwork of provisions often fails to address clearly some of the thornier issues and is typically untested in the branchless banking context.

Dedicated consumer data privacy and protection laws and regulations are being developed in several of the countries studied. In Pakistan, provincial consumer protection laws currently present no effective barrier against consumers having their personal data released,[36] though this may be ameliorated under an Electronic Data Protection Bill that is being drafted. In South Africa, the Electronic Communications and Transaction Act provides voluntary standards for data protection, which the draft Protection of Personal Information Bill would commute to compulsory requirements.

Finally, in all the countries studied, there is strong political will to address the real challenges of consumer financial literacy. Policy makers candidly acknowledge that, without financial education and outreach, customers of transformational branchless banking are unlikely to take full advantage of the protections afforded by regulation.

Payment system regulation. Around the world, policy makers and regulators increasingly recognize that retail payment transactions, although insignificant when viewed individually relative to large-value payments, carry system-wide and possibly even systemic significance when viewed in the aggregate. Given the current predominance of payment transactions in branchless banking, as the phenomenon reaches scale in particular countries, the importance of appropriate oversight looms large.

Payments Are King in Brazil and Russia

In Brazil, bill payments and delivery of government benefits comprised 78 percent of the 1.53 billion transactions conducted through more than 95,000 agents in 2006 (and 55 percent of the US$104 billion in transactions conducted via agents) (Marques Soares and Duarte de Melo Sobrinho 2007). In Russia, more than 100,000 automated payment terminals have sprung up in the larger cities in recent years. One provider, CyberPlat, claims to have processed 1.2 billion transactions worth US$4.7 billion through the first three quarters of 2007 via its 70,000 "cash acceptance" points, mostly for prepaid airtime, television, Internet, and other utilities.*

* http://www.cyberplat.com

36 The lack of protection is evidenced by the kiosks operated by the government-owned National Database and Registration Authority, at which anyone possessing the national identity number of an individual can pay the equivalent of US$5 to receive a copy of the individual's national ID card, with approximately 30 pieces of personal data, including name, date of birth, residence, birthplace, parents names and addresses, and more.

Payment system regulation holds potential significance for transformational branchless banking beyond countries' interest in appropriate oversight of systemically significant transaction volume. The new nonbank actors that branchless banking introduces to the payments sphere—particularly mobile network operators—may enter the space and prosper only if they can link with existing payment system participants, such as banks—directly or indirectly—on an economically viable basis. Inclusive payment system regulation that promotes interoperability and therefore market development has a potential role to play.

Russia, the Philippines, and Kenya, none of which has a comprehensive national payment system legislation, are nonetheless the leaders among the countries studied in the development of alternative, nonbank, technology-based payment services platforms. They prove that national payment system legislation is not necessarily a prerequisite for launching transformational branchless banking. In the Philippines, some officials say that the flexibility afforded by the absence of specifics regarding the central bank's power to regulate the payment system proved useful in structuring a proportionate regulatory and oversight approach for Globe Telecom's GCash stored-value product.

However, perhaps because all three countries already have such vibrant activity in the micropayment services realm, top policy makers and regulators in each of the three are eager to put some legislative order to the picture. Kenya and the Philippines have already embarked on initiatives to adopt comprehensive national payment system legislation, and some policy makers in Russia are considering this step. India has also embarked on this course, and a Payment Systems and Electronic Fund Transfers Ordinance was recently passed in Pakistan. In each case, this could offer an opportunity, not only to establish a level playing field for bank and nonbank payment services providers, but also possibly to clarify other important issues, such as the boundaries between payment services, e-money and other stored-value instruments, and deposit-taking requiring a banking license.

South Africa has had a national payment system law in place long enough to give insights into how such legislation might affect payment system development. A recent review (South African Reserve Bank 2007) of the 10-year strategy to develop the national payment system concluded that substantial progress had been made toward developing a robust, wide, and deep payment system, but that further effort was necessary specifically to promote retail instruments that reach more people.[37]

Competition.[38] Concerns about market dominance and unfair competition may appear premature when numbers of customers remain low. However, in the market for payment services, which is often subject to strong positive network effects,[39] competitive dynamics need to be considered early on for the following reasons:

- The early rapid growth of one system that is not interoperable with others could have a "tipping effect" such that no other system can compete. This dominance could have negative effects on market efficiency and outreach over time, through higher pricing or lower rates of innovation.
- If there are already substantial existing retail payment systems, and if the new payment systems are foreclosed or inhibited from interconnection with older systems, the result may be substantial inefficiencies that limit growth of the new and the old.

Both points relate centrally to the question of interoperability. To what extent will customers of competing financial service providers be able to transact business with each other? And what role, if any, should regulation play—and on what timetable—in answering this vital question?[40]

37 A similar situation prevails in Brazil. While high-value payment systems are highly developed, there remain challenges in retail systems that are characterized by low levels of cooperation among financial institutions, payment service providers, and settlement system operators. Most POS and ATM are not interoperable, and financial institutions and payment service providers make overlapping investments, with negative effects for efficiency and innovation in the payments system (Central Bank of Brazil 2005).

38 The subject of competition in branchless banking is vast and complex, with many aspects that vary, depending on the models and actors in question. Even a comprehensive overview of the subject falls beyond the scope of this Focus Note. The discussion here draws heavily on Houpis and Bellis 2007.

39 A positive network effect exists where the value to each member of being in the network rises as the total number of members rises; hence, bigger networks are more valuable.

40 This is not to suggest that other issues in competition policy, such as competition with bank agent schemes, would not also warrant attention from policy makers and regulators.

Regulation mandating interoperability could be imposed *ex ante*, if policy makers convince themselves that they must intervene to avert a significant market failure (such as "tipping" the market for mobile phone-based branchless banking to a single dominant mobile network operator). Or it could be imposed *ex post*—once there is evidence that a dominant player or players (such as a clearing and settlement platform owned by a group of large banks) have begun to exploit such a market failure.

Mandating the interoperability of branchless banking systems at an early stage can reduce the incentives for firms to enter the new market and compete (see Table 2).[41]

No policy makers in the countries studied have intervened *ex ante* to mandate interoperability and avert exploitation of a dominant market position before it manifests itself clearly. South Africa is currently considering *ex post* action on interbank charges. An ongoing Competition Commission inquiry launched last year into the fees set by retail banks has focused closely on the workings of the payments systems and, in particular, the payment utility company owned mainly by major banks.[42]

Recommendations from the Branchless Banking Policy Frontlines

The field of transformational branchless banking is so new, so dynamic, so rapidly developing and changing that it is challenging to make strong normative policy recommendations. The evidence gathered from observing current regulatory practice in the countries studied reveals as much about unresolved challenges and tough trade-offs as it offers in the way of concrete ideas for proportionate regulation of branchless banking that other countries might wish to pursue. The policy makers and regulators in these countries candidly expressed their uncertainties on many relevant policy fronts, as well as their appetite for learning from their peers about what has and has not worked well in other similarly situated countries.[43]

With these qualifications duly noted, however, on many issues, the evidence—positive and negative—*does* offer a basis for some general recommendations on regulating transformational branchless banking. These recommendations can be categorized as process related and content related.

Process-Related Recommendations for Policy Makers and Regulators

Use proportionality as a guiding principle. Aim for regulatory policy that fosters, rather than inhibits, innovation in connection with regulated activities, such as by allowing scope for different means of compliance so that market participants are not unduly restricted from launching new financial products and services. Proportionality requires balance when regulatory objectives clash, as can be expected where previously autonomous regulatory domains converge. Because scale of the regulated activity is critical when determining proportionate regulation, branchless banking regulatory policy should be reviewed frequently in countries where these approaches to financial service delivery are developing fastest.

Consider gaps in regulation on an urgent basis. Industry can be expected to highlight barriers in existing regulation, but not necessarily gaps. Yet industry and policy makers alike share an interest in "preventing the preventable accident" that could undermine confidence in branchless banking across the board. This does not necessarily mean a "rush to regulate." What is required is a sober analysis of the gaps in existing regulation and careful consideration of different ways to address them. This could range from

41 Paragraph 17 of the preamble to the European Commission Directive on Payment Services (2007) supports this notion.

42 South Africa's Competition Commission was created by act of Parliament in 1998, with a mandate to investigate anti-competitive conduct, assess impact of mergers and acquisitions, monitor competition levels and transparency, review laws and regulations and otherwise identify impediments to competition, and play an advocacy role in addressing these impediments. South Africa joins a number of developed countries in launching such an inquiry. In the United Kingdom, Australia, and the European Union, authorities have recently undertaken major investigations into the workings of retail and card-based payments systems to improve competition.

43 It is also noteworthy that, among the countries studied, only Brazil has both a long enough history of enabling transformational branchless banking and sufficient scale of operations to begin to offer insights into the important challenges of supervising transformational branchless banking.

Table 2. How Interoperable Is Branchless Banking Today?

	Smart Money	GCash	M-PESA	WIZZIT	Caixa Economica
Country	Philippines	Philippines	Kenya	South Africa	Brazil
Wide network of locations for account opening?	Open in-person at one of several hundred Smart Wireless Centers (must be a Smart-owned store)	Open account via mobile and do KYC at any of 4,900 accredited agents	Open in person at any of the 850 M-PESA agents and at Safaricom Customer Care Centres	Open in-person with one of 2,000 WizzKids or at one of more than 400 Dunn's stores	Open in-person at one of approximately 13,255 agents affiliated with Caixa, or one of 2,442 branches
Which mobile networks may be used by clients?	Smart only	Globe only	Safaricom to initiate all transactions, but transfers may be received by user of any mobile network	Any mobile network	None—card-based model
Can do account-to-account transactions to and from banks?	Only for cash into Smart Money account	No (except for clients of certain rural banks)	No	Yes	Yes
Where can users deposit cash?	At one of 12,000 participating retail outlets, using phone. Also at ATMs using card or at issuing bank branches	At one of 4,900 participating retail outlets, using phone	At one of 850 participating retail outlets, using phone	At PostBank, Absa, or Bank of Athens (gives WIZZIT largest deposit-taking footprint in South Africa)	At one of 13,255 agents in Caixa's network, or one of 2,442 Caixa bank branches
Part of card network?	Yes, Mastercard	No	No	Yes, Mastercard	Depends on type of account (some Visa/Mastercard). Many Brazilian POS are not interoperable.
Can use ATM networks?	Yes, all 3 ATM networks (6,867 points)	Cash-in via Bancnet ATM network	No	Yes, all ATMs in country via SASWITCH	Yes, own bank plus ATMs on Visa and Mastercard networks
Additional ways to withdraw funds?	Cash back at merchants or at teller windows of issuing bank	No	No	Cash back at merchants	Teller window at branch. Cash back generally not available in Brazil

Note: These examples are illustrative and not exhaustive among the seven countries studied.

a decision to simply monitor and engage in dialogue with industry, to issuing nonbinding guidance, and to possibly even binding temporary regulation.

Undertake a thorough diagnostic exercise as the first step. Neither the barriers nor the gaps in existing regulation necessarily announce themselves clearly.

Instead, they emerge from close, expert diagnostic analysis of laws, regulations, and other policy guidance; from discussion with relevant policy makers and regulators about the application of these texts to the facts of proposed branchless banking approaches; and from dialogue with industry proponents.[44]

Create a process for facilitating interauthority coordination and cooperation. Because branchless banking represents the convergence of different regulatory domains, a commonly agreed platform to bring relevant regulatory authorities together will reduce the risk of coordination failure among them that could limit growth or create loopholes that unethical players might exploit.

Plan direct engagement among policy makers, regulators, and interested industry players. Neither industry nor the policy-making and regulatory community can be expected to understand each other's objectives and concerns without substantial direct engagement. This is especially important where regulatory authorities are becoming acquainted with industry actors they do not traditionally regulate, such as banking regulators and supervisors and mobile network operators.

Implement a process to gather relevant, recent, and reliable data about the features and scale of new models and approaches. Because proportionate regulation of transformational branchless banking depends in part on the specific features and developing scale of the models emerging in a given country, policy makers and regulators need to have access to reliable data on these subjects. In some countries, a mechanism for sharing this information might develop spontaneously as part of an agreed process for engagement among policy makers, regulators, and industry players. In other countries, regulatory compulsion may be needed.

Content-Related Recommendations for Policy Makers and Regulators

Permit nonbank retail outlets to serve as agents and carefully consider any restrictions imposed on the range of permissible agents and types of relationships permitted. In many countries, a necessary first step for transformational branchless banking will be to clarify the legal power of nonbank retail outlets to perform the cash-in/cash-out and other customer interface functions that are defining features of this approach to financial service delivery. Some policy makers may feel more comfortable starting with a narrower range of permitted agents and permitted services. However, the consequence of such a decision may be slower uptake—especially if there are not adequate incentives for potential agents to participate. Overly detailed regulatory prescriptions on the contractual relations permitted with agents also may dampen appetites of potential agents and financial service providers alike.

Evolve a risk-based AML/CFT approach adapted to the realities of remote transactions conducted through agents. Transformational branchless banking has the potential to serve unreached customers because of the cost savings of using agents equipped with ICTs in lieu of costlier branch-based staff. Costs can be driven out of reach of the poor if AML/CFT rules are not adjusted to permit remote account opening with CDD/KYC checks performed by agents and do not take into account the limited formal documentation normally available to low-income clients. AML/CFT risks with subsequent transactions can be limited by using electronically enforced maximum allowable transaction, turnover, and balance thresholds. Moreover, policy makers and regulators increasingly realize that AML/CFT objectives are better served by having clients inside the net of electronic transactions that can be monitored rather than outside in the untraceable cash economy. A branchless banking-friendly AML/CFT regime therefore

44 Documents outlining the diagnostic approach used in the countries studied are available at www.cgap.org/policy/branchlessbanking.

serves both the goal of increasing financial access and improving data available for law enforcement.

Clarify the legal boundaries among retail payments, e-money, and other stored-value instruments and bank deposits. In many countries, existing regulation draws unclear lines among retail payments, e-money, and other stored-value instruments and bank deposits. Clear delineation of these concepts permits policy makers to accord differing (and proportionate) regulatory treatment based on the differing levels and types of risk (to customers and financial system) that these types of services present.

Create a regulatory category for electronically stored value that allows nonbank participation on defined terms.[45] Many countries are or will soon be confronting issuance of e-money and other stored-value instruments by nonbank entities, such as mobile network operators and issuers of prepaid cards. Although these virtual stored-value accounts may look a lot like a transaction banking account, strong arguments can be made to accord nonbank stored-value issuers lighter regulatory treatment than is applied to banks. This is not to say that they should not be regulated at all (as is the case in many countries under existing regulation). Rather, a proportionate regulatory regime can be fashioned through a combination of maximum allowable transaction, turnover, and balance thresholds and liquidity and solvency protections.

Create robust, but simple, mechanisms for consumer protection, covering problems with retail agents, redress of grievances, price transparency, and consumer data privacy. Grievance redress across great distances, particularly for less sophisticated customers, is a challenge, but it can be mitigated by requiring providers to offer a simple complaint mechanism using the same ICTs as are used to transmit transaction details and by instituting a financial services ombudsman function. Risk to customers from agent fraud or other misdeeds can be addressed through regulation establishing consumer liability limits and shifting the burden of policing agent misconduct by making financial service providers legally liable for the actions of their retail agents. Price transparency also can be regulated, including a requirement of clear notice to customers of the "all in" price of a service or transaction *before* it is consummated. The issues of consumer data privacy and security are no different in the transformational branchless banking context than with financial services in general, although concern about them both may be greater among customers who presently use only informal financial services. Meaningful protection will be a prerequisite of large-scale uptake of branchless banking for such customers.

Consider the likely longer range competitive landscape today and how to reach the goal of interoperability. Regulation mandating interoperability should not be imposed *ex ante*, unless policy makers are convinced they must intervene to avert a significant market failure. Instead, at least during the early stages of branchless banking development, policy makers should merely ensure that interoperability is technologically feasible, while also ensuring they have both the necessary information and regulatory power to intervene when a dominant position is being exploited.

A compelling argument can therefore be made during the early stages of branchless banking development that policy makers should merely ensure that interoperability is technologically feasible, while also ensuring they have both the necessary information and regulatory power to intervene when there is evidence that a dominant position is being exploited (Houpis and Bellis 2007).

45 Depending on the country, this does not necessarily require separate legislation, which may risk fragmentation of the overall financial regulatory framework.

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