Digital Financial Services for Financial Inclusion: Tools for Supervisors

Speaker(s):

Juan Carlos Izaguirre
Senior Financial Sector Specialist, Consultative Group to Assist the Poor (CGAP)

Mehmet Kerse
Senior Financial Sector Specialist, CGAP

Host:

Demet Çanakçı
Senior Program Director, Toronto Centre

Date:

Dec. 12, 2023

Transcript:

Demet Çanakçı:

Hello everyone. I'm Demet Çanakçı, a senior program director at Toronto Centre. Welcome to the Toronto Centre Podcast series on “Enhancing Digital Financial Services Supervision in an Increasingly Fragile World.” Innovations in digital technologies have shown great potential to enable digital financial service (DFS) providers to reach more female, rural, and low-income customers. However, these groups are faced with an increasingly fragile state of world affairs, arising from climate change, conflicts, and food insecurity, just to mention a few causes. Financial services regulators, and supervisors around the world face numerous challenges vis-à-vis DFS.

Hence, this series of podcasts with CGAP aims to build an understanding of the impact of digital financial services across the supervisory landscape, through various strata of society. CGAP has positioned itself as a leading institution with the vision to foster a responsible and inclusive financial ecosystem that enables a green, resilient, and equitable world for all. Toronto Centre is a leading provider of capacity building for central bankers, and financial sector regulators and supervisors. Toronto Centre and CGAP have a long history of collaboration.

This podcast is based on the CGAP Technical Guide on "Digital Financial Services for Financial Inclusion: Tools for Supervisors.” released in September 2023. My guests today are Juan Carlos Izaguirre and Mehmet Kerse, both from CGAP, who have been involved in the

preparation of this report. A warm welcome to both. Juan Carlos, let me start with you. In order to provide our audience an understanding of this guide, can you please give us a brief background on what led to the publication of this guide and your involvement in this project?

Juan Carlos Izaguirre:

Thank you very much for your invitation to this podcast. As a senior financial sector specialist at CGAP, I have been involved in this work from the outset. Actually, several years ago, CGAP had worked on identifying key regulatory enablers for digital financial services, and we saw regulators in many developing economies and emerging markets make substantial progress towards putting key regulations in place to foster responsible digital financial inclusion. However, progress was a bit slow in building effective risk-based supervision of digital finance due to reasons such as competing supervisory priorities, limited resources, and limited capacity and understanding of good supervisory practices. Actually, we also published some initial guidance on the examination of e-money issuers, and related data collection requirements back in 2017-18, but the more we were talking with supervisors, the more we identified the need for a more comprehensive and practical toolkit and the need to address key knowledge and understanding gaps by supervisors of digital financial services.

So, we embarked on a set of learning engagements with a handful of digital financial services supervisors. We wanted to better understand their challenges when trying to implement regulations in digital financial services and what practical measures they were adopting, or they could adopt, to overcome such challenges. So, based on our lessons from these engagements, we developed this technical guide to help authorities navigate through all phases of supervision of digital financial services for financial inclusion. We also put our guidance to the test before publishing it, and we did this by transforming our material into a virtual course on digital financial services supervision, which I had the pleasure and the privilege of leading the development with Toronto Centre, the Digital Frontiers Institute, and with several other colleagues involved. Through this process, we were able to incorporate invaluable feedback from supervisors who participated in this course coming from multiple countries, and we incorporated that feedback into the final version of the guide that was published just a few months ago.

Demet Çanakçı:

Thank you Juan Carlos. Interesting that the guide has three main aspects: digital financial services, financial inclusion, and tools for supervisors, which are reflective of the topical issues facing supervisors. Can you elaborate on the challenges facing regulators and supervisors at the nexus of digital financial services and financial inclusion?

Juan Carlos Izaguirre:

Sure. The landscape of digital financial services is significantly evolving nowadays, with new or more complex types of products, services, providers, and channels that bring multiple

opportunities for financial inclusion and for financial market development. But they also bring about risks for consumers and for the financial system in general. Digital financial services are thus becoming the first, or kind of gateway product for people who were previously financially excluded or financially underserved. Now, these population segments are offered more innovative products that aim to address their needs, but they may also be more complex and require a stronger digital and financial capability. Regulators and supervisors need to better understand the main characteristics, opportunities, and risks of these new types of digital financial services, and have access to a range of tools that help them take proportionate risk-based measures that enable inclusive innovation but in a responsible and safe manner.

For several years, CGAP has emphasized the importance of adopting an organized or structured approach that we call the *I-SIP* approach. This aims to balance key policy objectives of financial inclusion and stability, integrity, and consumer protection when drafting, enforcing, and reviewing regulation. This approach is becoming more useful for regulators and supervisors in the current context of digital financial services evolution to always be mindful of the interlinkages among these objectives. A key point to remember is that ultimately, supervisors have to keep in mind the effects that their actions have, not only on the financial sector as a whole, but also on the real people the financial sector serves. In the end, financial services are means to an end.

> Supervisors have to keep in mind the effects that their actions have, not only on the financial sector as a whole, but also on the real people the financial sector serves. In the end, financial services are means to an end.
>
> **Juan Carlos Izaguirre**
>
> CGAP

Demet Çanakçı:

Thank you, Juan Carlos. Let me ask this question to you, Mehmet. The Guide focuses on non-bank Digital Financial Services (DFS) providers, which will be insightful for many regulators and supervisors around the world. To what extent does this guide equip them to design and set the foundations of an effective risk-based approach to the supervision of such providers?

Mehmet Kerse:

Thanks for the invitation to the podcast, and thanks for the question. Our guide offers an orderly approach to design the supervisory framework by focusing on two key aspects. First, creating a risk-based approach, and second, defining an organizational structure. Concerning the creation of a risk-based approach, there are three key steps to follow. First of all, supervisors should clearly map their overarching policy goals with the specific objectives that supervision will pursue under each. Then, supervisors should identify the primary types of risks posed by digital financial services in achieving these objectives.

After the initial mapping to determine the level of supervisory attention required, it's beneficial to prioritize risks related to DFS activities and DFS providers. At this stage, supervisors will be using impact indicators that estimate the potential harm resulting from the materialization of a provider's risks, and these indicators will help supervisors rank DFS providers from highest to lowest impact. Naturally, higher impact providers receive more supervisory attention.

The final step in creating a risk-based approach is the development of a risk assessment methodology. This methodology will guide supervisors on how to measure each provider's net-risk, enabling them to prioritize supervisory efforts.

> The level of attention and resources for DFS supervision should be adjusted based on the importance and the sophistication of the country's DFS markets.
>
> **Mehmet Kerse**
>
> CGAP

Regarding defining the organizational structure, DFS supervision should first have a clear national-level institutional setup. So, some countries may decide to go through transition periods during which they adopt temporary institutional arrangements for DFS supervision. However, these types of transition periods should be limited, and the intended final arrangements should be communicated clearly to the DFS industry. Regarding internal organization for DFS supervision, this can vary significantly across countries. Crucially, the level of attention and resources for DFS supervision should be adjusted based on the importance and the sophistication of the country's DFS markets. This is essential for both prudential and market conduct supervision of digital financial services and digital financial services providers.

Demet Çanakçı:

Thank you very much, Mehmet. After the design phase, what does the guide recommend supervisors do for successful implementation of an effective approach to DFS supervision? Are there any specific countries that provide good examples?

Mehmet Kerse:

When a foundation for DFS supervision is in place, supervisors can put the risk-based approach into action. So, our guide recommends supervisors carefully think about the entire cycle of supervisory activities from the outset to plan their activities effectively. So, this cycle involves assessing risks, taking and monitoring supervisory measures, providing feedback to refine the supervisory approach and current regulations, and also strategic planning for the next year.

As part of the supervisory cycle, supervisors need to conduct an initial risk assessment. This assessment needs to be as comprehensive as possible for higher priority providers, identified

by the impact indicators during the design phase. After the initial assessment, supervisors should develop a supervision plan. Given the limited supervisory resources, supervisors should be able to adjust the scope of activities for each supervisory cycle in-line with the DFS provider's risk profile. Then, supervisors should use a mix of supervisory tools, including effective licensing, market focused activities, optimized off-site supervision, and inspection of individual digital financial services providers.

Also, supervisors need to assess how their safety net framework will address the consequences of potential failures of DFS providers. They should also discuss the adequacy of resolution and deposit insurance frameworks. Finally, supervisors should not only collaborate and coordinate with different departments within the financial authority, but also with other domestic and foreign authorities. Our technical guide provides several recommendations, considerations, and examples to help supervisors in each of these elements of a risk-based approach to DFS supervision.

Demet Çanakçı:

Thank you very much, Mehmet. Juan Carlos, a key aspect of effective supervision is the availability of timely and quality data to ensure that supervisors can make informed decisions. Does the guide recommend any specific approach for collecting information that depicts the state of digital financial services across their purview? More importantly, how can supervisors ensure that the data to be filled is comparable at an international level?

Juan Carlos Izaguirre:

Quality data is indeed an essential element of digital financial services supervision, and our guide provides a few recommendations on how to improve supervisory data, especially focusing on five key steps: identifying data quality shortcomings, assessing the quality of existing data collection mechanisms, assessing the level of granularity of supervisory data, improving data collection, and improving data analytics. So, we believe that first, supervisors should check whether they have the quality and quantity of data that they need for their work, and what are the main issues with data. Then, they should identify the main root causes of those issues before guessing and rushing into solutions. In many cases, the root cause is related to the mechanisms that supervisors use to collect the data. For example, and you made an important point in terms of data comparability, many times there is not adequate dialogue between the supervisor and the supervised entities regarding the design of reporting requirements.

I mean, supervisors typically use standardized reporting templates, but they may have not consulted with financial institutions to check whether the definitions and variables used in the templates are easily understandable or are already being collected or used by the financial institutions. Also, there may not be adequate guidance, such as data dictionaries or taxonomies, to help financial institutions submit data that are compatible, both at national and even

international levels. In other cases, the guidance may exist, but the supervisors may not have adequate mechanisms and resources to validate the data before and after the data is submitted, which will impact the reliance on such data. In some instances, supervisors are also considering investments in RegTech and SupTech solutions to gather more and higher quality granular data in a timely manner. It's understandable because recent advances in SupTech are allowing data collection enhancements without the need for the prohibitive, expansive, and expensive investments that were previously required. At the same time, it's quite important for supervisors to have a strategic approach to SupTech so that they are quite specific in terms of the scope of data that they need in the short, medium, and long term. A gradual transition of process may be needed actually, and the strategy will be useful to help supervisors allocate the necessary resources at the design, testing, and implementation phases. Technology can help enhance supervisor's data analytics capacity; however, it does not substitute for the need to invest in supervisory team analytical skills and expertise.

Technology can help enhance supervisor's data analytics capacity; however, it does not substitute for the need to invest in supervisory team analytical skills and expertise.

Juan Carlos Izaguirre

CGAP

Demet Çanakçı:

Thank you, Juan Carlos. Mehmet, what are some key challenges that supervisors need to be aware of when implementing effective supervision of digital financial services, and does the guide provide any suggestions on how to address those challenges?

Mehmet Kerse:

This is a very important question. Our work has revealed that supervisors in emerging markets and developing economies face some common challenges, which may be either structural or internal. Structural challenges are related to the broader environment impacting the supervisor authority, and these challenges include issues such as overlapping legal mandates, insufficient enforcement powers and tools, inadequate legal protection of supervisors, or an inappropriate regulatory perimeter. On the other hand, internal challenges may include insufficient supervisory capacity, organizational structure and culture, or interdepartmental coordination. A key approach to addressing these challenges is to maintain a continuous dialogue with key stakeholders. This facilitates an understanding of their arguments and competing priorities, driving continual alignment with them. Our technical guide offers specific suggestions in these areas with an emphasis on ways to strengthen supervisory capacity. Supervisors in emerging markets and developing economies often face these structural and internal challenges in terms of the implementation of DFS supervision.

Demet Çanakçı:

Thank you, Mehmet. Juan Carlos, how can supervisors equip themselves to deal with disruptive innovation? Also, how can they deal with outsourcing issues with so many different players?

Juan Carlos Izaguirre:

It's true, it's crucial for supervisors to deal with this, but in a very pre-emptive and forward-looking manner. They really need to keep an eye on disruptive innovations to assess which are becoming more popular or generating more risks to consumers, as well as to the stability of the financial sector. Enhanced risk-based supervision skills, expertise, training, and tools can assist supervisors in identifying and assessing new types of risks and business models. Among them, I would emphasize the need for supervisors to use stakeholder engagement tools for learning and market monitoring purposes. For example, regulators and supervisors can leverage innovation facilitating schemes to promote learning and engagement between the regulators, supervisors, and the innovators in the financial sector, and to help authorities gather unparalleled early insights into innovations that will help them better understand the characteristics and the risks of such innovations before the supervisors start with their work.

Now, on outsourcing, digital financial service providers with new business models often leverage third-party relationships to a greater degree than they did in the past. They may more heavily rely on third parties when outsourcing even core activities. These third parties may not fall within the regulatory perimeter. However, supervisors need to maintain good oversight of these third-party providers. The outsourcing regulations should ensure that supervisors have the right to access data and the facilities of third parties for conducting remote as well as physical audits. This is crucial, particularly in the case of third-party or DFS providers' failure. Also, where necessary, there might be a need for direct regulation and supervision of those third parties that play a critical role in the provision of financial services. However, criticality would have to be properly defined, specifically defined in the regulation. So, in summary, there's quite a bit to do on these fronts, but I think supervisors and regulators need to be really thinking about it, right now, to be able to cope with these issues properly and effectively.

Demet Çanakçı:

Thank you very much, Juan Carlos. Mehmet, let me ask the final question to you. Given that artificial intelligence is gaining such prominence, what is the outlook of digital financial services?

Mehmet Kerse:

Thanks for this timely question. Artificial intelligence, AI, has the potential to reshape the landscape of digital financial services. As you know, providers are increasingly employing AI to automate customer service processes, tailor products for diverse customer segments, and assess borrowers' credit risks in addition to other tasks. For example, new AI-driven credit scoring models process alternative data from different sources; like data from utility bills, mobile phones, and satellite information. These diverse data sources can help digital financial services providers estimate credit worthiness of the customer.

> Artificial intelligence models enable providers to make automated credit decisions in seconds. This is very relevant to financial inclusion because it allows low-income individuals with little or even no credit history to access loans.
>
> **Mehmet Kerse**
> CGAP

Artificial intelligence models enable providers to make automated credit decisions in seconds. This is very relevant to financial inclusion because it allows low-income individuals with little or even no credit history to access loans. The outlook is promising. However, it's important to note that there is a growing concern that the use of AI in financial services may lead to or worsen unfair discrimination against specific customer groups based on gender, ethnicity, race, sexual orientation, or other characteristics. Despite the useful role of algorithms in customizing products and services for diverse customer segments, a significant concern arises regarding whether such decisions unfairly disadvantage specific customer demographics. So, this is one of the issues that needs to be addressed as these artificial intelligence technologies continue to evolve in the financial services industry.

Demet Çanakçı:

Thank you very much, Juan Carlos and Mehmet, for such a fascinating discussion and sharing valuable insights with us. Without any doubt, this technical guide will be an essential part of the regulators and supervisors' toolkits, and I encourage our audience to read it. I'm here today with Juan Carlos Izaguirre and Mehmet Kerse, and you have been listening to the Toronto Centre podcast series on "Enhancing Digital Financial Services Supervision in an Increasingly Fragile World". Thank you for joining us today and stay tuned for the next episodes.