

Organizing for the Supervision of Bottom of the Pyramid Product Providers

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1. Introduction: The Bangko Sentral ng Pilipinas' Approach as Supervisor and Regulator

1.1 Risk-Based Approach

The Bangko Sentral ng Pilipinas (BSP) adopts a risk-based approach to the supervision of the banking system. This approach not only provides a more efficient allocation of resources based on identified priorities but is also more adaptive to the growing complexity of the banking business. A risk-based approach allows the BSP to better channel its resources in critical areas that need more supervisory attention.

This move away from a compliance based approach, which started to take place in 1997, enables the BSP to instead focus on evaluating the banks' quality of oversight, adequacy of policies and procedures and ability to implement them, as well as the robustness and effectiveness of the risk management and internal audit functions (Espenilla, 2007). Hand in hand with this, the BSP also works toward ensuring that an enabling policy and regulatory environment is in place to allow flexibility for innovations in business models, space for the provision of a wide range of products and services, and opportunities for entry into new markets by the banks (Espenilla and Roman Tayag, 2011).

This environment thereby provides the banks with greater latitude to undertake activities and take on risks as long as they have the ability to manage said risks and absorb any resulting losses from the said activities. This arrangement builds on the basic proposition that it is in the banks' inherent interest, and therefore the onus rests on the bank's leadership, to ensure that their banking business thrives, innovates, remains competitive while continuing to operate in a safe, sound and stable manner. This approach is closely complemented by a financial stability view where the BSP monitors the market holistically to ensure that the interaction of market players, products and services do not result in market behavior that may lead to severe market disruption and even financial crisis.

1.2 Offsite Monitoring/Supervision and Data Collection and Management

Integral to this risk-based approach is the ability to balance complementation of offsite and onsite monitoring. An effective offsite monitoring mechanism that yields an updated assessment of the changing risk profile of a banking unit serves as a valuable input to the scoping and planning of an onsite examination. On the other hand, the report from an onsite examination which presents significant supervisory conclusions is integral in updating the risk profile assessment of the bank (Espenilla, 2007).

In this paper, emphasis is being made on offsite monitoring in light of the role it plays in ensuring that the BSP can assess the risk profile of a bank at any given time and its directional activities that can impact its risk profile. This enables the BSP to thoroughly understand and be updated on the business of the bank, including any new products and services that it is positioning to provide. Robust and updated data collection and management are crucial in this regard. Toward this end, the BSP has crafted a comprehensive Financial Reporting Package (FRP), fully aligned with International Accounting Standards for enhanced financial transparency. Together with the FRP, Bank Performance Reports (BPR) which monitor ongoing financial performance of banks are captured in a Data Warehouse System that can be used to perform various analyses by the supervisor.

In addition to these institutionalized data collection and management, targeted surveys are also conducted by offsite supervision to inform the BSP on certain trends, identified areas of risks as well as possible opportunities. All these form part of the supervisory information framework which aims to enhance the ability to assess the adequacy and appropriateness of the banks' risk assessment processes particularly for its products and services.

International guidance papers also provide additional information on the possible supervisory approach to particular products and services. The Basel Committee for Banking Supervision (BCBS), for instance, has published several papers on risk assessments for particular products, providing an indicative though not exhaustive list of risk areas that supervisors should be mindful of. However, these are usually for sophisticated or mainstream products that do not cover innovations currently being targeted to the bottom of the pyramid (BOP) market.

2. New Bank Products and Services for the Bottom of the Pyramid Market

Many businesses have targeted providing goods and services to the poorest people in the world. Pralahad and Hart (2002) make a case for the fastest growing new markets and entrepreneurial opportunities being found among the billions of poor people at the bottom of the (financial) pyramid. Similar interest has been burgeoning in the financial system with the reality that an estimated 2.5 billion adults do not use formal financial services to save or borrow (Financial Access Initiative, 2009). The opportunity is vast for those who are willing to develop products and services or even transform business models to serve this significantly untapped market.

In the Philippines, the figures of "unbanked" continue to present a challenge that must be addressed. While continued banking reforms and efforts at strengthening the system to allow strong banks to expand their operating networks have borne fruit, there still remains 37% of municipalities in the country that do not have a banking office. Concentration of banking services are also biased toward higher income areas, leaving much of the low income areas significantly underserved. The National Capital Region (NCR) alone accounted for 43% of the total number of deposit accounts, 68% of the total peso volume of deposits and 87% of the total outstanding loans in the

banking system (BSP, 2012). Other data indicate that almost 27% of Filipino adults have a formal savings account and only 10.5% had a loan from a formal financial institution in the last 12 months prior to the conduct of the survey (World Bank, 2012).

Some headway has been made in reaching out to these unbanked areas and population, particularly through the development of microfinance, and more recently through technology driven delivery channels. These are welcome developments in making the system more inclusive. Yet, while these present a vast array of social and economic opportunities, they also present some risks that need to be addressed.

3. BSP Approach to Assessing Risks in BOP Products and Services

Making the system more inclusive, where there is effective access to financial services for all, is held to be a worthy policy objective and one that is complementary if not mutually reinforcing with the BSP's more traditional objective of maintaining financial stability. Financial exclusion causes adverse effects in the economy and especially makes people more vulnerable to financial distress, debt and poverty. Mobilizing broad based savings also allows greater depth and diversity in the financial system that can contribute to its overall resiliency. In addition, sound and stable financial systems are necessary for long-term, balanced and inclusive growth as it directly contributes to social cohesion and shared economic development.

Consistent with these principles, the BSP strives to maintain the delicate balance of creating an environment flexible to innovation while managing the attendant shifts in the magnitude of risks or the changing nature of the said risks. New products and services may also bring to fore changes in the interaction with existing risks faced by the bank. It must be ensured that useful innovations are not stifled, but instead be allowed to operate in an environment where the risks associated with such innovations are adequately understood and addressed, and where there is a judicious and proportionate application of sound prudential supervision principles.

At the end of the day, the BSP looks at the ability of the banks to deliver these new products with the appropriate risk management processes. Banks will still need to demonstrate the ability to assess, control and monitor the risks as well as the agility to adjust to new risks. While this is the focus of the supervisor, it is incumbent that the supervisor is also aware of market developments to make informed assessments of banks' individual risk management processes for particular products. Since the market for BOP financial products is a relative greenfield for banks and the technology positioned to reach this market is dynamic, it is important that supervisors develop a sufficiently deep appreciation of how to balance the risks to banking operations with the benefits that can be derived for further innovations.

Aside from informing its possible supervisory and regulatory approach, the bank supervisor also needs to be abreast with market developments as a consideration for broader concerns such as financial system stability, integrity and consumer protection.

In addition to the institutionalized manner in gathering information as discussed above, the BSP also recognizes the importance of appropriate market surveillance on issues that may present risks and opportunities or the use of other mechanisms to gather useful information.

In early 2013, the BSP developed and launched a high level product catalogue to provide a snapshot of available products and services that have novel features tailored to cater to markets that are not traditionally served by the formal financial system (i.e., youth, microenterprises, low income salaried workers). A carefully selected sample of banks was asked to discuss such products and services designed to serve such niche markets. This tool, in addition to our other data gathering and offsite initiatives, could be seen as institutionalized market surveillance to enable us to know the developments in the market. There are still limited product catalogues in other jurisdictions yet they have proven to be useful to identify policy opportunities, barriers or gaps; validate effectiveness of policies; and determine whether there are risks (i.e., financial stability, Anti-Money Laundering (AML), consumer protection) inherent in the products.

This general approach of fully understanding and knowing relatively new products and services before developing a definite supervisory and regulatory approach can be described as a “test and learn” approach or a “learn then do” approach. The proportionate and judicious application of existing standards and regulations cannot be determined without the supervisor’s understanding of the product/service or business model.

The BSP can offer two tangible examples of this approach to emerging products and channels positioned to serve the BOP market: microfinance and mobile financial services.

3.1 Microfinance

The General Banking Law of 2000 mandated the BSP to recognize microfinance as a legitimate banking activity and to set the rules and regulations for its practice within the banking sector. At that time, microfinance was mainly provided by civic-oriented institutions or by for-profit institutions mainly for corporate social responsibility purposes. The “traditional” bankers tend to shun providing services to clients with no track record, no collateral and informal documentation of their cash flows. Yet, globally, microfinance was proving to be an excellent double bottom line proposition of profitability and social development. Thousands of entrepreneurial poor were being provided much needed access to financial services that enabled them to grow their businesses and improve the quality of their lives.

Cognizant of the above, the BSP’s policy and regulatory approach is to enable the delivery of commercially sustainable microfinance products by the banking sector. The BSP defines microfinance as a wide range of financial services that banks may deliver under various permitted modalities – credit, savings, insurance and fund transfers or remittances for the low-income population. This definition acknowledges that the

BOP market, like mainstream financial consumers, require a variety of appropriately designed products that can address their need for enterprise financing; savings and fund transfers for household emergency and liquidity management; and insurance protection from contingent events and economic shocks.

Regulations clearly define the features of each of the above products, and provide guidance to banks on how these can be safely and sustainably delivered. For example, a microdeposit, which is a “no-frills” small savings account targeted for the poor, must have a minimum maintaining balance not exceeding PhP100 (approximately US\$2), an average daily balance of PhP40,000 (approximately US\$900) and not be subject to dormancy charges. Another example is a microenterprise loan, which must be below PhP150,000 (approximately US\$3,000), used to finance a micro or small entrepreneurial activity, and frequently amortized as befits a client’s cash flow.

Also worth noting is how microfinance regulations are complemented by consumer protection rules, specifically those on transparency and disclosure. Like all regular loans, interest on microenterprise loans must be computed using the declining balance method, and disclosed using a standard format prescribed by regulations. This is to ensure that low-income clients are not unduly disadvantaged by misleading disclosures of interest rates and other fees associated with the loan transaction.

BSP regulations not only focus on product definitions and consumer protection but also on duly authorized providers, in recognition that the delivery of microfinance services requires providers to possess specialized capacities and an appreciation that serving the BOP is viable business. To support the entry of new providers, the BSP provided a mechanism wherein unregulated microfinance institutions can transform or formalize into regulated institutions. This allowed pioneer microfinance non-government organizations (NGOs) to establish banks that are covered by BSP supervision. Regulations were also set in place to guide existing banks that wanted to provide microfinance services. While rural banks (or village banks) and thrift banks (or savings banks) were expected to be well-positioned to cater to microfinance needs in the countryside, the regulations provide them with flexibility to make their own business decisions about entering the microfinance market.

In crafting policies and regulations, the BSP learned from successful microfinance lending practices around the world, recognizing and accepting best practices such as using group support or liability arrangements, cash flow based lending, and high frequency amortizations that match a client’s cash flow. The BSP also maintained open communication with pioneers in microfinance within the banking sector, to stay informed of market developments but more importantly to fully understand the risks associated with the business to be able to develop a proportionate policy and regulatory response.

It is in fully understanding the products that the BSP was able to map its main risk areas and determine the minimum requirements to ensure commensurate management of the identified risks. As an example, BSP regulations ensure adequate

credit risk management of the microloan portfolio of banks. The measure of Portfolio-at-Risk (PAR) and strict provisioning requirements address the greater risk of default if a microfinance client misses even one amortization to pay a relatively short-term and small value loan. This is a tangible illustration of how the objectives of financial inclusion can be proportionately balanced with the prudential considerations that underpin financial stability.

In the table below, some of the BCBS' "Core Principles of Effective Banking Supervision" are mapped against the requirements we have set in place to ensure risk management while recognizing the peculiar characteristics of microfinance.

Table 1. BSP Approach to Regulating Microfinance Services

Core Principles of Effective Banking Supervision	BSP Regulations
Definition of Microfinance	Clearly define microfinance as a provision of a range of financial services to low income clients/ entrepreneurial poor – credit, savings, insurance, and fund transfers. Microfinance loans have specific characteristics (i.e., cash flow based, frequent amortization, etc.)
Capital Requirements/ Adequacy, Licensing Requirements	Banks comply with same standards and requirements for capital adequacy and licensing.
Credit Risk	Require banks to have clear underwriting standards and practices for cash flow based lending.
Risk Management/ Problem Assets/ Provisioning	Require high frequency monitoring of portfolio-at-risk and corresponding provisioning requirements reflecting peculiar risks of microfinance.
Governance	Specify necessary experience and track record in microfinance in the board and management. Impose clear and comprehensive governance standards.

As a supervisor, the BSP has been guided by this informed assessment of the product, which then also informed the appropriate supervisory approach. Internal capacity was also developed through the creation of a specialist examination group focused on the micro and SME finance business model. Developing deeper understanding of the business model informs the conduct of proportionate, risk-based supervision. In our CAMELS (bank performance and condition) assessment, we consider for example, that small loans to microenterprises may seem like a concentration of credit in an industry, but the loan books may actually be well diversified due to the large number of individual customers. A manual of examination procedures for microfinance consistent with the broader examination framework was also developed.

3.2 Mobile Banking through Electronic Money

Considering the foregoing discussions on the current demand for access to financial services in the country, it is worth noting that a study (Beshouri and Gravrak, 2010) showed that a large percentage of the country's unbanked has a mobile phone, nearly 60% of these unbanked mobile customers keep some form of savings, and 13% borrow from various informal sources. From a financial inclusion standpoint, these facts present an enormous and possibly even transformational opportunity. The depth and breadth of the reach of mobile phones as innovative service channels can be massively leveraged as possible access points for basic fund transfer activities, and with the appropriate linkages, for financial services.

The BSP recognizes that indeed technological innovations present a significant potential for increasing access to financial services. When the electronic money (e-money) product was presented to the BSP by the two leading telecommunication companies in the Philippines (one being presented as a product of a bank), the BSP endeavored to fully understand the product and its underlying technology and systems to appropriately identify the risks, the possible ways to address them, as well as other issues surrounding this novel application.

There was an understanding that aside from the risks associated with e-money, there is also a great degree of a changing nature of risks. In the table below, some of these changing risks were articulated by the BSP, side by side its potential benefits.

Table 2. BSP Approach to Regulating E-Money

	Changing Risks	Potential Benefits	BSP Approach
Customer/ User	<ul style="list-style-type: none"> • Limited information or misinformation • Lack of trust and capacity • Different customer experiences 	<ul style="list-style-type: none"> • Potential of reaching the currently unserved 	<ul style="list-style-type: none"> • Require consumer protection in the e-money regulations • Financial education
Issuer	<ul style="list-style-type: none"> • Entrance of new players, non-traditional providers (i.e., Telcos) 	<ul style="list-style-type: none"> • Greater innovation • Wider reach • Higher efficiency 	<ul style="list-style-type: none"> • Proportionate requirements for non-bank providers (i.e., risk management, capital, liquidity) • Ring fencing e-money operations • Transaction limits • Clear delineation between e-money and deposits
Agents	<ul style="list-style-type: none"> • AML issues • Agent fraud • Business case challenges 	<ul style="list-style-type: none"> • Wider reach • Serving unserved areas • Broader ecosystem 	<ul style="list-style-type: none"> • Regulation through the entity maintaining the agent networks

Consistent with the “test and learn approach,” the BSP approved the e-money products in 2004 and 2005 using existing applicable regulations. It was only in 2009, after fully understanding the risk areas, that the BSP issued the regulation on e-money. E-money was clearly defined as a surrogate for cash – an electronic stored value that does not bear interest, is not covered by deposit insurance, is prepaid and fully re-convertible to cash. It was clearly distinguished from deposit accounts and positioned to support retail fund transfers. The regulation further provided qualifications of e-money issuers particularly the non-banks (i.e., capital requirements, fit and proper standards); set clear rules in the issuance of e-money (i.e., transaction limits, anti-money laundering compliance, security features, and consumer protection); and identified parameters in the development of e-money agent networks (i.e., accountability of e-money issuers to accredit their agents).

Although e-money is primarily intended as an innovative, technology based payment channel for low value transactions, international standards on customer due diligence (CDD) and know-your-client (KYC) requirements are not foregone. E-money wallets can only be created when clients comply with mobile-based instructions to provide identity details. CDD is also repeatedly conducted every time a client transacts with a cash-in/cash-out agent. Regulations mandate e-money issuers to report suspicious transactions beyond the anti-money laundering threshold of PHP500,000 (approximately US\$11,000); and to establish an accessible consumer redress mechanism for concerns on e-money products.

The overall objective of the BSP policy approach is to create the environment that enables the creation of a broad, sound and proportionately regulated e-money ecosystem comprised of ubiquitous agent networks that can have a massive reach as potential outlets. Financial service providers can therefore build and leverage on this infrastructure to deliver their financial services.

By allowing banks to become e-money issuers or to outsource their e-money activities to technology providers or existing agent ecosystems, there is an opportunity to create linkages as well as broaden their reach and operating networks. The BSP will then ensure that such banks have the necessary risk management processes in place. To ably supervise and regulate these activities, we built up our own capacity by creating a Core Information Technology Specialist Group.

This approach is consistent with the BCBS study on risk management implications of electronic banking and e-money activities, which states that “a premature regulatory approach would run the risk of stifling innovation and creativity in these areas. Therefore, supervisors should encourage banks to develop risk management processes that are rigorous and comprehensive enough to deal with known material risks and flexible enough to accommodate changes in the types and intensity of such material risks associated with the electronic banking and electronic money initiatives” (BCBS, 1998, page 2).

3.3 Some Results

The discussions will be incomplete without the presentation of some of the results that have been brought about by the proportionate approach in assessing and controlling risks associated with new bank products and services for the BOP market.

For microfinance, positive results can be seen. From a handful of banks before 2000, there are now nearly 200 banks that provide microfinance services. This figure may only be about 29% of the total number of banks (nearly 700 banks which include commercial banks, thrift banks, and rural and cooperative banks) in the country, but these microfinance-engaged banks have become a consistent and stable source of financial services for more than a million microfinance clients. Worth pointing out is that microfinance has diversified in terms of product offerings which now include various types of microloans like housing and agriculture, and “microfinance plus” which addresses the need of growing microenterprises for loan amounts that are above the maximum threshold of a microenterprise loan.

Based on market feedback, there are indications that microdeposit clients are saving bigger amounts, which shows a greater appreciation of the value of having a deposit account. The banks are also now allowed to become distribution channels for microinsurance products, with premiums that are affordable for the BOP market, and underwritten by duly authorized insurance companies.

For e-money, there are now 24 e-money issuers that are banks, 3 are non-banks. These issuers currently have an agent network of nearly 15,000 cash in/cash-out agents and are continuously expanding. The number of e-money transactions as of year-end 2012 was over 180 million amounting to PhP613 billion. Banks have used e-money to allow their customers to transact with greater ease and lower costs. There is also the emergence of new banks whose business models rely heavily on the e-money platform and their distribution of financial services passes through the e-money ecosystem. E-money applications have also facilitated meaningful retail payments such as the delivery of the government’s conditional cash transfer pay-outs as well as person-to-government payments.

It can be said that the full understanding of the risks associated with the product by the supervisor enabled the design of a proportionate and facilitative supervisory approach that catalyzed the development and innovation in the offering of new products and services.

4. Guidance from International Standard Setters

It is said that the offering of bank products and services for the BOP may be an emerging area, yet there is an increasing global recognition of its significance in the development of stable and inclusive financial systems. Such recognition is made

in bodies like the G20 through the creation of the Global Partnership for Financial Inclusion. Standard setting bodies have also taken tangible steps that demonstrate their recognition that serving the “unbanked,” which is the essence of financial inclusion, could be complementary to their respective mandates.

The BCBS issued the guidance paper “Microfinance Activities and the Core Principles for Effective Banking Supervision” in 2010. More recently, the Basel Consultative Group has established a Financial Inclusion Workstream with the intent to update the said guidance paper to form an overall risk picture on financial inclusion. This would be of particular relevance to banking supervisors in exploring balance between financial inclusion and the broader supervisory objective of preserving the safety and soundness of the banking sector.

The BCBS likewise issued a guidance paper on “Risk Management Principles for Electronic Banking” (2003) to help develop the appropriate supervisory approaches to managing risks attendant to e-banking and e-money. The Committee on Payment and Settlement Systems (CPSS) created a Working Group on Innovative Retail Payments which intends to identify success factors of innovative retail payment instruments such as e-money, its implications to payment systems and the potential issues for central banks. This Working Group recently published its report (CPSS, 2012).

Supervisors can therefore look forward to more and clearer guidance which can help inform the crafting of appropriate and proportionate supervisory and regulatory approaches to the new bank products and services for the BOP market.

5. Concluding Remarks

In many developing countries, the banking system typically plays a very major, if not dominant role in the financial system. The role of effective banking supervision is therefore very important to promoting financial system stability and shall remain its primary focus. At the same time, the banking system cannot exist in a vacuum. There is significant scope to nurture opportunities for banks to develop appropriate financial services that are relevant and useful to BOP customers, which support virtuous inclusive growth dynamics. This presents an interesting and important challenge for bank supervisors to strike the right balance in shaping and enforcing a prudent but enabling regulatory environment.

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