

The Philippines' engagement with the standard setting bodies and the implications for financial inclusion



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Disclaimer:

Suggestions made in this document do not represent the official views of any of the regulatory authorities consulted. All errors and omissions are those of the authors.



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About this case study

This case study highlights the experience of the Philippines in implementing international standards in the financial sector and the interaction, where relevant, with the topic of financial inclusion – a topic that is of particular relevance in the Philippines. It draws on a questionnaire completed by the relevant regulatory authorities, coordinated by the Bangko Sentral ng Pilipinas, as well as meetings with each regulatory authority.

The case study aims to tell the story of the Philippines engagement with each of the standard-setting bodies (SSBs) and to highlight areas where further engagement from the SSBs on the topic of financial inclusion will be welcomed. The Philippines authorities recognize the important role played by each SSB and would like to contribute to the dialogue process as each SSB engages with the topic of financial inclusion. However, the case study does not present the official position of any of the supervisory authorities consulted and should not be construed as making demands on the SSBs. Rather, suggestions made illustrate potential needs at the country level for SSB dialogue, information and guidance.

1. Financial inclusion context

As shown by its innovative policies and programs around branchless banking, e-money instruments, micro-insurance and microfinance, the Philippine government has become a world leader in its commitment to producing a strong, sustainable and equitable financial sector. The effective implementation of this commitment has allowed greater segments of the Philippine population to access financial services in a safe and sound manner.

Defining inclusive finance

The Philippine Development Plan (PDP) 2011-2016, the government's blueprint reform agenda approved by the President on 28 March 2011, explicitly promotes equitable access to financial services and financial inclusion as part of the country's strategy to enhance financial sector development. The PDP states: 'The Philippines' vision for the financial sector is a regionally-responsive, development-oriented and inclusive financial system which provides for the evolving needs of its diverse public'. Under the PDP, inclusive finance is defined as:

- the provision of a wide range of financial services (credit, savings, payments, insurance) to serve the demands of different market segments;
- the development of financial products that are appropriately designed, priced and tailored to market needs and capacities;
- the participation of a wide variety of strong, sound and duly authorized financial institutions, utilizing innovative delivery channels to provide financial services to more Filipinos; and
- the effective interface of bank and non-bank products/delivery channels, technology and innovation to reach the financially excluded¹.

Efforts to measure financial inclusion (FI)

To reach the 2016 goal, the PDP specified a variety of strategies. One of the most important is to measure more accurately the levels of financial inclusion in the country, especially in light of recent programs and policies that target unbanked Filipinos. The Philippine government has been working with International Organizations such as the Alliance for Financial Inclusion (AFI) for further technical assistance in developing a comprehensive and more effective financial inclusion data framework.

Outlining Philippine membership of International Standard Setting Bodies

In developing policies and regulations to support increased financial inclusion, the Philippine government has considered the recommendations of the following International Standard Setting Bodies (SSBs) for guidance and insights in drafting effective regulatory frameworks that conform to international standards:

- Financial Action Task Force (FATF)
- the Basel Committee on Banking Supervision (BCBS)
- the Committee on Payment and Settlement Systems (CPSS)
- the International Association of Insurance Supervisors (IAIS), and
- the International Association of Deposit Insurers (IADI).

To promote knowledge sharing, enhance learning and obtain additional technical assistance, the Philippines became a founding member of the Asia Pacific Group (APG), a FATF style regional body. In addition, the Philippines has been participating in the Basel Consultative Group, a group convened by the BCBS, which consults and updates non-BCBS member countries on recent BCBS activities.² At present, Bangko Sentral ng Pilipinas (BSP) representatives are members of the workstream that is revising the Basel Core Principles and the FATF standards. The Philippines is also a member of IAIS and IADI, although not a member of CPSS. These standards are referenced and well-utilized by the Philippine government in drafting effective regulatory frameworks for financial services, as well as during the regulatory implementation phase such as the supervision process for bank and non-bank entities.

Mapping out the case study

This brief case study of the Philippines highlights the challenges faced by national regulators in respect to the current International Standards from all five standard setting bodies, whether in respect to the underlying theory or practical implementation of the core standards. Some of the challenges faced by the Philippine government are specific to the topic area, which makes them potentially relevant to all the SSBs. Therefore, the case study also depicts cross-cutting

¹ In this context, financially excluded refers to individuals that are unable to access formal financial services due to certain barriers including but not limited to, distance to access points, cost of transactions, level of financial literacy and absence of financial institutions."

² The Philippines is not officially a member of BCBS

topical challenges and highlights potential solutions by the Philippine government to address them. Finally, the case study concludes by highlighting the major pending challenges that remain unresolved and are

informing current discussions between the Philippine government and the SSBs. In this regard, policy recommendations for the SSBs to consider moving forward are provided given the Philippine experience.³

2. Key SSB engagement stories

2.1 Financial Action Task Force

Overview

Regulators in the Philippines expressed minimal reservations to the FATF 40+9 Recommendations, and have found additional guidance from FATF to be helpful during the practical implementation phase of the standards.

Past difficulties: aligning AML requirements with financial inclusion

In the past, regulators have faced challenges on how best to implement a risk-based approach (RBA) to the FATF recommendations, particularly in respect to Recommendation 5 on Customer Due Diligence (CDD). A uniform approach was established for CDD policies based on the general AML law (The Anti-money Laundering Act, as amended), which mandated financial institutions to comply with the requirements of customer identification, verification and monitoring. This led to difficulties in aligning with the social policy objectives of the Philippines' financial inclusion agenda due to several key factors:

- Many segments of the population targeted for financial inclusion did not have the kind of ID documents required under the law;
- The access points that were able to conduct CDD correctly were hard to reach by those excluded from the financial system;
- The AML requirements were very costly for a financial institution, considering the low-value transactions of the said market;

- The higher regulatory compliance costs and other constraints hampered innovations.

To address these issues, BSP's most recent AML circular (Circular 706), Updated Anti-Money Laundering Rules and Regulations (05 January 2011)⁴ has better employed the risk-based approach. The circular greatly assists financial inclusion objectives because specific regulatory provisions were amended and/or supplemented following an appropriate and comprehensive risk assessment. Therefore, the BSP is not concerned that Circular 706 and related recent initiatives conducive to financial inclusion might be evaluated negatively during the upcoming AML evaluation process in the next three to four years, as the risk-based decisions made are documented and can be well justified.

Challenges with standards

Record keeping requirements can increase costs for MFI customers

The Philippine regulators noted that FATF could revisit its record-keeping requirement (most prominently in Recommendation 10⁵), to clarify the extent of flexibility allowed for low-risk customers. Currently, the requirement from FATF is to retain records for at least five years. Circular 706 has allowed the five years record retention to be reduced to three years for microfinance entities, provided that sufficient documents duly support the low-risk profile of the client and that the entities keep a record of the names of these low-risk clients whose records of transactions are not retained after the lapse of three years. It was found that maintaining records for five years increased compliance costs for MFIs, and that these costs may ultimately have translated into higher interest rates for low-income customers. The higher interest rates are attributed to MFIs having numerous clients

³ Given that most SSBs are currently undergoing a re-evaluation and revision of its current standards, the timing of these policy recommendations are opportune and it is hoped they will be adequately reflected in the revised standards and/or work program of the SSBs

⁴ The BSP issued Circular 706 (January 2011) which upholds the basic principle to "know sufficiently your customers at all times and ensure that the financially and socially disadvantaged are not denied access to financial services while at the same time prevent suspicious individuals or entities from opening or maintaining an account or transacting with the covered institution by himself or otherwise." Guided by this framework, the following principles have been established: 1) Risk-based, tiered customer acceptance policy (reduced customer due diligence (CDD) for low-risk clients and enhanced CDD for high risk accounts) - each covered institution shall develop a clear graduated acceptance policy to ensure that the financially and socially disadvantaged are not denied access to financial services. 2) The required face-to-face and gathering of minimum information to open new accounts can be outsourced, provided that the outsourcing arrangement is formally documented, subject to existing outsourcing rules. 3) If a third party has already conducted face-to-face proof of identification for its own customers, others can rely on this. 4) Identification can be completed on sight with only one photo bearing ID, as long as this has been issued by an official authority which may be government or duly registered private entities. 5) Financial institutions should maintain, for at least five years, all necessary records on transactions, both domestic or international, to enable them to comply swiftly with information requests from the competent authorities. (partial excerpt)

(in the hundreds of thousands), with most clients receiving short term loans (i.e. three to six month loans) almost continuously, resulting in voluminous documents stored. Limited physical infrastructure, especially in remote areas, may also have played a role⁶.

Although it was felt that the standards should better address financial inclusion challenges, relevant BSP interviewees did not necessarily believe that there ought to be a separate FATF recommendation dedicated to financial inclusion. Instead, AML assessors should be appropriately aware of country-specific financial inclusion challenges and objectives. In addition, in reviewing each FATF recommendation, the potential implications for financial inclusion should be borne in mind.

Challenges with implementation and other issues

Considerations around a risk-based approach

The Philippine regulators would welcome continued guidance on the risk-based approach – building on the progress made in the FATF-APG-World Bank Guidance Paper on Financial Inclusion. This paper provides a myriad of good practices, which are being implemented by countries involved in FI, although the practice in one country may not be the best practice for another. The key output of the paper is the implementation of a risk-based approach, which according to the FATF Paper, need not be a complicated process.

However, in practice regulators felt that this is not as simple as it may initially seem. The reason is that when providing exemptions (by applying the flexibility that the paper claims FATF Recommendations provide), the country must be able to provide strong justifications. Yet making these “strong justifications” can often be challenging and regulators are uncertain about exactly how “strong” justifications should be. Hence further guidance is requested from FATF on the kind of reduced due diligence measures that can be undertaken. It is hoped the proposed revision of the standards will include more examples of Reduced Due Diligence (RDD) measures; otherwise regulators are likely to remain more cautious and conservative than needed in their implementation of AML policies.

Additional examples of these RDD measures are particularly desired given that zero CDD is permitted by FATF only in certain occasional/limited transactions (as ascertained by proven low risk through a risk-

based assessment)⁷. Although FATF is clarifying this position in the revisions to the recommendations, regulators would welcome additional guidance and concrete examples of what these occasional/limited transactions could be.

Guidance desired on terrorist financing issues within financial inclusion context

Along the same lines, FATF could provide a guidance note or similar document on terrorist and terrorist financing issues within the greater context of financial inclusion. This document could clarify the risk-based approach specific to terrorist financing (TF). It was noted that most regulators are focused on money laundering, rather than TF when implementing current RBA approaches: however, the two are very different issues and so the respective RBAs may also be different. A customer considered low risk for money laundering may not necessarily be considered low risk for TF; similarly, small amounts of funds transfers may not pose significant money laundering risks, but could pose higher TF risks. Although transaction volumes and amounts might comparatively be smaller in the target financial inclusion demographic, the costs of terrorist acts can also be smaller relative to money laundering transactions.

Such a document is especially valuable given that the FATF-APG-World Bank Guidance Paper on Financial Inclusion did not specifically touch on TF issues. In addition, the proposed revisions to the FATF standards on Customer Due Diligence (CDD, record keeping and Suspicious Transaction Reporting (STR) may also be relevant and applicable to TF. Therefore, a guidance document that specifically clarifies how the revised standards apply to TF issues and financial inclusion would be quite valuable to regulators.

Further, this document (or a separate FATF document) could clarify supervisory requirements specific to TF issues under a risk-based approach. Although there is currently no TF law in the Philippines, the AMLC⁸ has issued red flags for TF long ago for “covered”⁹ institutions. However, bank supervisors/examiners mentioned that additional guidance from FATF, which would inform the directives received by AMLC, could help regulators understand if there are additional TF supervisory checks that should be implemented¹⁰. Banking supervisors also mentioned that there are generally fewer supervisory checks on TF¹¹ relative to the money laundering prevention programs during the ongoing supervision process for “covered” institutions.

⁶ Some of the increased compliance costs for MFIs were attributed to storage of records in paper form in remote areas where there was less electronic means of storage. This means larger storage space must be bought or rented for longer periods. Also, there were significant transportation costs incurred by providers to retain records obtained from customers in very isolated and difficult to reach areas, as well as costs to pay and train relevant staff.

⁷ As per interpretation of FATF/APG/World Bank guidance paper on Financial Inclusion

⁸ Financial Intelligence Unit (FIU), Philippines.

⁹ Legal BSP terminology that essentially means the Philippines formally regulates the institution to a minimum Level.

¹⁰ This would be particularly valuable given that new types of entities and business models are subject to supervisory examinations as “covered” or regulated institutions of the BSP.

¹¹ Some of the TF checks supervisors mentioned include cross-checking with terrorist watch lists, ensuring there are effective transaction monitoring and pattern systems in place, and comprehensively reviewing the AML and TF prevention strategy that is required of all supervised entities.

Outside of TF issues, regulators noted that FATF has not yet addressed how financial inclusion should be integrated into the mutual evaluation methodology, nor has it devised yet a proactive and coordinated strategy to train mutual evaluation assessors and assessor bodies on financial inclusion related issues – both to the benefit of member countries.

Negotiating a pathway without FATF membership

Concerns were also raised regarding the current FATF organizational process and structure. The Philippines is currently a member of APG, not FATF, and current FATF rules do not allow the country to become a FATF member. This means the country may not be directly involved in the crux of negotiations and debates occurring within FATF itself, but rather only through its involvement via APG. Furthermore, FATF style regional bodies (FSRBs) currently cannot directly advocate on behalf of their members to FATF, but can only provide progress updates related to cited deficiencies in AML/CFT compliance. Perhaps the rules governing FSRBs could be changed, to allow for the possibility of non-FATF members to advocate for themselves in specific situations (as individual FSRB members) before FATF. At the very least, such issues should be further assessed and discussed before any decisions are made. And potential amendments to the organizational/communication structure between FATF and FSRBs for the benefit of all FATF/FATF Style Regional Body member countries could be explored.

2.2 Basel Core Principles of Banking Supervision

Overview

Philippine regulators believe that the Basel Core Principles of Banking Supervision (BCP) provide a highly effective framework for effective and sustainable delivery of bank-based financial services, and have appropriately and proportionately¹² applied these principles to ensure effective operations of microfinance services in the Philippines. Regulators expressed minimal reservations regarding the current BCP. However, there were a few aspects of the core principles that were challenging when applied to the supervision of microfinance agencies (see Challenges with Implementation section).

Challenges with Standards

Defining systemic health by linking financial inclusion opportunities and challenges

The BCP consists of 25 principles that are minimum standards for a supervisory system to be sound and effective, and ensure that any systemic risks in the financial system are mitigated. However, regulators

noted that the basis of the 25 principles is the assumption that a stable and healthy financial sector is based on the capital base level and assets within the financial system, rather than the actual number of clients served. Larger financial institutions may have high capital/asset bases, but do not necessarily serve large numbers of clients, each of whom have small individual assets/deposits. If when revised the BCPs can also link financial inclusion challenges and opportunities to overall banking level stability and performance, then the revised principles may better accommodate providers such as microfinance institutions¹³ (MFIs).

In the Philippines, these MFIs could be banks with microfinance operations, and thus, the core principles would apply to them. In addition, MFIs target large numbers of clients, so there could be a re-evaluation of consumer protection issues in reference to the core principles, and in particular to assess whether the larger numbers of clients served have any potential implications on overall systemic risk.

Regulators did not have any specific principles in mind for addition or revision, but thought that these are themes SSBs may wish to explore further.

Environmental differences and institutional size and complexity must be taken into account

In respect to Principle 7, which calls for effective and comprehensive risk management processes to be in place for banks and banking groups (as commensurate to the size and complexity of the institution), it was argued that in addition to institutional size and complexity, external but relevant environmental factors could also be considered. These include varying country contexts, rural vs. urban dynamics, regional and city differences, cultural attributes, past and present client demographics and financial habits. Clearly if these are to be added, then they should be explicitly phrased in the revised principles or interpretive notes.

Challenges with Implementation

Operating within BCP standards to deliver microfinance provision

Regulators faced a few challenges in implementing the existing BCPs during their ongoing supervision frameworks and processes, and further guidance was specifically desired around BCP Principle 2 (Permissible Activities) and Principle 7 (Risk Management Process). What exactly should be considered a ‘permissible activity’ (Principle 2) and what exactly constitutes a ‘comprehensive’ risk management process (Principle 7), especially in light of smaller and/or new financial institutions who provide basic financial activities posing lower systemic risks?

Principle 2 leaves flexibility to the country to determine what should constitute a permissible

¹² The issue of proportionality in the implementation of the BCPs and pending challenges encountered is discussed later in this case study.

¹³ MFIs in the Philippines may be banks with microfinance operations, NGOs or cooperatives

activity, but that is precisely the challenge faced by regulators; although regulators have no problems with the principle itself, more specific and detailed guidance on what is permissible would be welcome. Regulators have been on the cautious side in terms of the types of permissible activities allowed for microfinance-oriented banks (defined as primarily conducting microfinance activities). These typically smaller banks (different than larger banks which are more established and permitted to offer a wider range of services including microfinance) can perform limited activities/transactions within prescribed ceilings, as authorized by national regulations. As such, some microfinance oriented banks find it challenging to work within specified regulatory boundaries to effectively deliver microfinance services in a form that satisfies the needs of their target clients.

Developing and requiring the appropriate risk management system can be challenging to regulators and FI providers

Similarly, further guidance is sought on Principle 7, so as to provide additional clarity on what exactly could constitute comprehensive risk management. Regulators have been uncertain as to what type of risk management system they should require from smaller and/or new microfinance oriented entities. It was noted that complying with prudential regulations and standards has been quite costly for them, especially at the initial stage when these MFIs attempt to determine the appropriate solvency/liquidity/profitability mix that would also be compliant with regulator standards. These agencies tend to operate in very rural areas where it can be very difficult to put risk management systems in place due to limited technical and human resources (though such a system is essential and required by national regulations).

In addition, larger banks, for whom microfinance is only one (and not their primary) service offering, also face particular challenges in addressing credit and operational risks as they implement comprehensive and effective credit and operational risk management systems. Such systems mitigate the risks inherent in their microfinance operations, but banks have faced challenges in developing and integrating these systems into their wider organizational structure and culture, especially if two different banks are merging together or if the bank has just recently formalized/transformed themselves from their previously microfinance NGO status. NGOs are currently not regulated in the Philippines, but some aspects of their operations (i.e. governance) are subject to certain standards if they

are in partnership with a covered institution (i.e. a bank) that is acting as the principal provider.

2.3 Committee on Payment and Settlement Systems (CPSS)

Overview

The BSP has a dedicated payments systems unit that oversees the implementation of PhilPaSS (Philippine Payments and Settlements System), the country's real time gross settlement system (RTGS). Continual reforms are underway to ensure that RTGS grows and matures in accordance with global standards, and can be adapted and accommodated for financial inclusion objectives. The BSP also has a dedicated unit known as the Core Information Technology Specialist Group (CITSG), which evaluates license applications of prospective E-money, among other activities; E-money is designed to be a retail low value payment systems platform in the Philippines¹⁴.

Outlining remittance initiatives

To help Overseas Foreign Workers (OFW) reduce the cost of sending remittances to their beneficiaries safer and faster, the BSP signed an agreement with the Association of Bank Remittance Officers, Inc., and the major banking groups BAP, CTB and RBAP, to use PhilPaSS as a settlement arm for remittances that are credited in bank accounts of beneficiaries maintained in banks other than the receiving bank.

To make this possible, the BSP developed the REMIT System facility to process OFW remittance transactions sent to PhilPaSS. Banks employing RTGS are incentivized to use this system because of the large volumes of transactions they would receive from customers (albeit lower value transactions, given the target clientele¹⁵). Similarly, Affiliate Switch Networks (ASN), which is a sub-network of an ATM consortium catering to particular types of institutions, has adapted the payment systems network to deploy cardless ATMs in the rural areas.

Other payment initiatives

Ongoing initiatives include enabling non-banks that do not have a "quasi banking"¹⁶ function to access PhilPaSS and the settlement of government payments/ expenditures through RTGS. Currently, the BSP charter

¹⁴ As mentioned earlier, circular 649 of the BSP specifically states that in the Philippines, e-money is not considered a "deposit". Authorized E money issuers can be any type of entity (banks, and non-banks such as MNOs etc.), as long as certain criterion are met. But if they obtain a license to issue E-money from BSP, they are also regulated as a payment systems provider. MNOs may also issue E-money through a dedicated subsidiary. E- Money is considered simply cash stored in an electronic device, just like a surrogate for cash. Philippine regulators consciously designed e-money as a low value retail payment systems platform. As such it is non-interest bearing and the outstanding amount is subject to a monthly limit.

¹⁵ The RTGS system typically settles large value funds transfers between commercial banks on a real time basis. By real time, it is meant that final settlement of interbank funds transfers are on a continuous, transaction-by-transaction basis throughout the processing day.

¹⁶ This would include certain types of e-money issuers, such as MNOs, because they do not have a "quasi banking" function. Non-banks that have "quasi banking" function could be, for example, different type of financial cooperatives.

only allows banks and non-banks with “quasi banking” function to maintain a demand deposit account (DDA) with the BSP. The DDA is the asset used for the settlement of the PhilPaSS participant’s payment transactions.

At the moment, the draft Payment and Settlement Systems Act is still under deliberation in the Philippine congress. Once enacted, the Act will greatly enhance the legal and enforcement authority of the Monetary Board of the BSP, providing it greater flexibility to decide on the types of entities allowed to conduct payment services¹⁷ and increase consumer confidence and protection of payment instruments.

Challenges with Standards

The need to acknowledge capacity constraints in lower income countries

On a general level, regulators felt that the CPSS Core Principles are too static: each of the principles assumes that a well developed financial system is already in place in the country and makes no allowance for the emergence of new business models/technologies. CPSS principles should specifically mention or acknowledge the implications arising from new business models/technologies. In this regard, any insights from CPSS on evaluating the potential risks of non-banks accessing the RTGS network would be greatly welcomed. CPSS principles should also acknowledge capacity constraints in lower income countries, as these countries may need more time and effort to comply fully and effectively with the principles.

Soliciting specific best practice from other countries

To help address these issues, guidance notes from CPSS in reference to Principle VII¹⁸ will be very useful. Core Principle VII usually poses the greatest challenge, because the impact of new innovations needs to be continually assessed and evaluated in line with this principle to ensure there are no significant disruptions or risks to the system. Regulators felt that while the principle itself is clear, more information is required from CPSS on how to effectively assess each payment systems provider, based upon more specific evaluation criteria. Specific best practices derived from other

countries, along with more detailed instructional guidance, are greatly desired.

Recent technological developments such as cloud computing systems¹⁹ particularly highlight the need for greater guidance on Principle VII. Payment systems regulators must better understand the potential benefits and pitfalls of evaluating these new innovations, especially during their initial adoption and implementation by the payment systems provider.

Another key challenge specific to the Philippine context is Core Principle I, which stipulates that the system should have a well-founded legal basis under all relevant jurisdictions. Regulators noted that the Philippines may not fully comply with Core Principle I given that the payment and settlement systems act is not formally enacted and therefore the BSP mainly relies on its broad oversight powers for money, credit and banking. Regulators sought guidance from CPSS on alternative forms of empowerment, supervision and enforcement, which would effectively enable compliance with the principle in the absence of specific legislation. They noted that in many countries, including the Philippines, creation and/or amendments to laws might take a long time due to delayed deliberations in parliament.

2.4 International Association of Deposit Insurers (IADI)

Overview

The Philippines Deposit Insurance Corporation (PDIC) has been mandated, as part of State Policy and Objectives Section 1 of Republic Act 9576, to strengthen the mandatory deposit insurance coverage system to generate, preserve, maintain faith and confidence in the country’s banking system, and to protect it from illegal schemes and machinations. Several initiatives are underway to help address some of the constraints faced by PDIC in effectively fulfilling its mandate as a deposit insurer²⁰. This includes certain limitations arising from its current legal authority, which PDIC is addressing to solve.

¹⁷ As above, this includes e-money issuers and e-money issuance.

¹⁸ Principle VII prescribes a high degree of security and operational reliability (along with contingency arrangements) on the payment systems.

¹⁹ The Cloud Security Alliance and the US National Institute of Standards and Technology define cloud computing as a model for enabling convenient, on-demand access to a shared pool of computing resources (e.g., networks, servers, storage, applications, services) that can be rapidly established and released with minimal interaction from either the organization or the service provider. Another way to view cloud services is as a public utility. Organizations subscribe to a pay-as-you-go model for things like electricity or water, and they now have the option of paying for IT software, security and network services on a consumption basis. (@ISACA, Volume 16, article of Lisa Young, CISA, CISM).

²⁰ On mitigating moral hazard (Principle 2), PDIC has requested technical assistance from FIRST Initiative to review the insurance reserves targeting framework of PDIC and to amend the PDIC Charter to include the assessment of measures to be put in place to sustain adequacy of insurance reserves relative to Section 13 of the PDIC Charter. On early detection and timely intervention and resolution (Principle 15), as an intervention measure, PDIC established in 2009 an Investor-Investee Helpdesk: through this, investors looking for banks to acquire, merge or consolidate with, or invest in, may be introduced to banks seeking interested acquirers/investors. In August 2010, the BSP and PDIC jointly launched the Strengthening Program for Rural Banks (SPRB) to encourage mergers and consolidations among rural banks to further strengthen the rural banking system. The SPRB recognizes that the rural banking system provides essential financial services in the economy, particularly in providing adequate banking services in local communities and specialized or niche markets. On reimbursing depositors (Principle 17), to facilitate immediate access by small depositors (i.e., those with deposit balances of P10,000 and below) to their deposits in case of bank closure, PDIC waived the standard requirement for personal filing of claims as well as submission of evidence of deposit. Check payments are sent through registered mail to the addresses of depositors indicated in the closed bank’s records. On powers and effective resolution process (Principle 16), PDIC is pursuing legislative initiatives to enhance its powers and ability to resolve bank failures, either through further amending the PDIC Charter or other relevant statutes, or introducing a new law.

At the moment, PDIC insures all deposits in any bank or banking institution engaged in the business of receiving deposits, from all types of depositors, even the smallest ones. It does not have the legal authority to cover deposit insurance in non-banks, such as ODTIs (e.g. cooperatives), or non-bank providers that do not take deposits, such as Telco-led mobile money providers like GXI. However, many of these non-banks (like some cooperatives) have self-funded private insurance schemes in place.

Regulators were open to learning more, yet cautious about the possibility of expanding deposit insurance to providers other than banks/banking institutions; these deposit taking institutions such as ODTIs and non-deposit taking entities such as e-money issuers may not be supervised and regulated as tightly as the current members, i.e., banking institutions, which may ultimately result in increased moral hazard risks.

Challenges with Standards

Moving away from general statements towards specific guidance on financial inclusion

In general, the PDIC found the core principles, as currently stated, cover a wide spectrum of conditions and situations applicable to any deposit insurance system. However, at present the core principles are general statements that do not explicitly address financial inclusion. Therefore, the PDIC supports the current review of the IADI Core Principles, so that financial inclusion (among other areas) could potentially be better addressed in the revised standards ²¹.

More specifically, regulators desired more detailed guidance from IADI on the “pass through insurance” mechanism, which could theoretically be provided to Philippine non-bank financial institutions such as ODTIs and e-money issuers. This mechanism, already in practice in some IADI member countries such as the United States, allows individuals who do not have a bank account to receive deposit insurance (up to a limit) for non traditional deposits or deposit like services, such as funds on a prepaid card. This can be provided as long as:

- The customer obtains the prepaid card from a distributor that keeps pooled accounts for the “float” at an insured (and thus regulated) financial institution;
- Certain record keeping requirements are met.

Taking account of the moral hazard implications

Although Philippine regulators were keen on the possibility of implementing such mechanisms, they cautioned that any positive implementation of such steps could only come after more detailed technical guidance from IADI in this specific area. Any decisions in respect to non-bank entities will take time and will need to be very carefully made. The market is very sensitive to the actions of agencies like PDIC, as they could easily create moral hazard implications in the market: even informing the public about PDIC’s potential research into insuring non-banks may create these moral hazard implications. Therefore, any positive signals in respect to certain mechanisms and policies conducive to financial inclusion must come directly from IADI itself.

2.5 International Association of Insurance Supervisors (IAIS)

Overview

The Philippines is among the few countries in the world that remains at the forefront of micro insurance initiatives. It has developed a cohesive national strategy to explicitly promote formalized micro-insurance, as a complement to microfinance, within safe and sound regulatory frameworks. Policymakers spearheaded the push for micro-insurance provisions when it was observed that low-income populations found it difficult to recover from difficult and/or emergency situations due to their lack of sufficient education and savings. Of the 25 million Filipinos (about 26.5 percent of the population) living below the poverty threshold, only 2.9 million currently have some kind of risk protection against death, injury, illness and other contingent events. Approximately 1.2 million people (or 41 percent) of those receiving these risk protection mechanisms are obtaining them informally through various types of micro-insurance providers (MFIs, cooperatives, etc.).

The existing regulatory framework

The current regulatory Framework for Micro-insurance sets out the market conduct requirements in providing micro-insurance to the informal and low-income sector, including addressing client complaints and other consumer protection mechanisms. These provisions

²¹ In this regard, it may be mentioned that the IADI Research and Guidance Committee’s Financial Inclusion and Innovation Subcommittee is currently conducting a survey to gather information on the range of practices that relate to deposit insurance and financial inclusion as well as financial innovations designed to promote financial access. It will use this information to develop a further assessment of deposit insurance issues raised by recent developments in the area of financial inclusion. In addition, the Subcommittee is developing supplemental guidance in the areas of coverage, membership, and public awareness in relation to financial inclusion. Further, the continuing research of the Subcommittee on dealing with parties at fault in bank failures and fraud in deposit insurance schemes (which also has implications in terms of the extent and types of entities eligible for deposit insurance) will also assist in taking steps towards aligning deposit insurance more clearly towards financial inclusion objectives.

include a maximum of 10 working days and simple documentary requirements for claims settlement and stipulate that the premium for micro-insurance may not be more than 5 percent of the Filipino national minimum wage. The Philippines Insurance Commission²² (PIC) has likewise prescribed a set of Performance Standards for Micro-insurance, covering the areas of solvency and stability, efficiency, governance, understanding of the product by the client, risk-based capital and outreach. These are seen as benchmarks to determine whether the operational delivery of micro-insurance products and services is being conducted in a viable and sustainable manner. Provisions are also included to allow a proportionate and risk-based capital structure regime as based on the type, size and risk of the provider/institution.

In addition, the micro-insurance regulatory framework defines and identifies the entities that are allowed and authorized to provide micro-insurance products as well as those who are allowed to sell and distribute them. In this regard, informal providers of micro-insurance are required to formalize their micro-insurance services within a prescribed time period²³.

The introduction of micro-insurance agents

Recent initiatives by the PIC and relevant stakeholders will greatly assist in accelerating the numbers of excluded and underserved Filipinos who are able to access formalized micro-insurance services. For example, the delivery and distribution channels of micro-insurance have expanded by creating a new category of agents – “micro-insurance agents”. Agents that only seek to provide micro-insurance services are regulated based only on the provision of a single service, and the requirements to become a micro-insurance agent are much simpler. They are only required to undertake one prescribed training program and pass one qualifying exam at the end of the training. In the past, micro-insurance agents had to provide a full range of insurance products and services, of which micro-insurance was only one component: the eligibility requirements for such insurance agents are much greater.

Regulators hope that this initiative will greatly increase the numbers and types of entities/ individuals (retailer outlets etc.) engaged in offering micro-insurance services. Further, a nationwide financial literacy campaign is currently underway, which aims amongst other things to find new providers of micro-insurance and increase awareness of rights and responsibilities among potential and existing clients.

Challenges with Standards and/or their Implementation

Regulators have greatly benefited from the comprehensive input that IAIS standards provide when developing micro-insurance regulatory frameworks and provisions. However, additional guidance from IAIS is desired on the supervisory side.

Adapting the principles to reflect resource-constrained scenarios

Due to the influx of applications from prospective “micro-insurance agents” and the large numbers of informal insurance providers becoming formalized, the PIC is currently seeking additional and more detailed guidance from IAIS on how they can transition towards a more risk-based supervisory approach. Given limited resources and capacity, specific guidance from IAIS is urgently required on how the specific risks associated with the provision of micro-insurance may be prioritized and evaluated during the supervision process. At the moment, the IAIS provides a very comprehensive set of principles in respect to the supervised entity (ICP 6-10), ongoing supervision (ICP 11-17) as well as other criteria. However, little guidance is provided in terms of how regulators can adapt these principles in more resource and capacity constrained scenarios.

Recognizing the greater costs inherent in establishing “comprehensive” risk management and assessment systems

In this regard, IAIS could provide a set of minimum requirements, along with the associated procedures and processes necessary, for prudential risk management and assessment of insurers offering micro-insurance products. From the supervisor’s perspective, such processes should be easy to comply with and monitor on an ongoing basis. Regulators noted that micro-insurance providers may also benefit from such guidance, as they usually find it costly to establish a “comprehensive” risk management and assessment system during the initial stages of operation. Could the risk management and assessment system fulfill certain minimum criterion that will also comply with IAIS standards?

Other factors to be considered

Due to the lack of such guidance, the PIC currently has very basic supervisory checks in place for providers. The capital/guaranty fund of the principal insurance provider is one of the few criteria observed before granting approval, including for previously

²² The Philippines Insurance Commission is the key regulator and supervisor of micro-insurance services in the Philippines.

²³ These informal insurance providers may enter into formal arrangements with authorized insurance providers by partnering with authorized insurance companies, having their members become members of authorized cooperative insurance societies or mutual benefit associations, or organizing themselves into a formal insurance provider.

informal entities. However, additional guidance is desired on how to determine (in a risk-based manner) the minimum level of capital/guaranty fund, including technical details on the specific methodology that should be used as well as any other factors to be considered, such as the external environment.

Considering other components of supervision

Once approval is granted, the PIC admits that minimal ongoing monitoring and supervision is conducted, through for example onsite and offsite examinations, unless they are informed of key red flags. The PIC would like to have confirmation that their supervisory approach is acceptable, and is therefore seeking detailed guidance from IAIS on whether they should consider other components of supervision via a risk based manner.

Translating complex policy documentation into simple vernacular

Outside of the risk-based supervisory approach, another suggestion to IAIS that could be of mutual benefit to countries is to specify in the standards a defined period for claim disbursement and settlement (in the Philippines, it cannot exceed ten working days). In addition, IAIS could provide “standard setting” recommendations on how best to adapt IAIS material into different languages and communicate them in a manner understood by low-income clientele. Most insurance contracts are long, complex and contain provisions that are highly legalistic and often too complicated for the target market to understand; therefore, the Philippines has implemented initiatives to translate complex policy contracts into short, simple and easily understandable policy contracts (ideally in the vernacular), so that micro-insurance clients can fully understand their rights and responsibilities.

3. Cross-cutting issues and conclusions

3.1 Proportionality

Seeking greater guidance in terms of deposit insurance

As observed earlier, elements of proportionality²⁴ have been applied in most areas of regulation in the Philippines, whether in respect to prudential risk, AML, payment and settlement systems and micro-insurance regulation. The only area where proportionality is perhaps not explicitly addressed is deposit insurance, although regulators are open to learning more from IADI on the possibility of providing deposit insurance to non-bank deposit takers (e.g. cooperatives), as commensurate to the size and risks of these institutions.

Proportionality based on rational and documented risk assessments

The Philippines is arguably among the few countries in the world that has better employed risk-based and proportionate assessments, often times through “test and learn²⁵” approaches. It has drafted regulatory provisions proportionate to the actual risks of the service or product rather than necessarily the provider type. Most recently, elements of proportionality based on rational and documented risk assessments have informed regulatory provisions (and assisted financial inclusion efforts) in Circular 694, Notes on Microfinance and Establishment of MicroBanking Offices (14 October 2010), Circular 704 (22 December 2010), Electronic

Money, Electronic Money Issuers and Electronic Money Network Service Providers, and Circular 706 (5 January 2011), Updated Anti-Money Laundering Rules and Regulations.

Using more country examples of best practice

However, despite the Philippines’ progress in employing a “test and learn” and more risk-based, proportionate approach to regulation, authorities have sought additional and specific guidance from the SSBs on how they can further enhance their risk-based approaches. Beyond recognizing the importance of a risk-based approach or the principle of proportionality, it would be useful for SSBs to provide specific guidelines on the optimum balance that needs to be achieved. By having clear and more detailed guidelines, various jurisdictions can come up with their respective policy initiatives. These guidelines might include supplemental country examples, the specific criteria involved in any risk-based decisions and other country evidence-based assertions, so that implementation of these principles becomes more consistent. Such guidance is particularly relevant in respect to BCBS, CPSS, IAIS and IADI.

Increasing coordination among SSBs

In the area of AML/CFT, regulators noted the recent APG/FATF/World Bank Financial Inclusion paper is a major step forward. However, at the moment, it is a non-binding document and zero CDD is permitted by FATF only in certain occasional/limited transactions

²⁴ Proportionality kicks in after determination or assessment of risks because in its simplest form, proportionality means applying resources to the highest risks, especially for countries of low capacity, i.e. limited resources. This means a risk based assessment must be conducted to come up with a risk matrix or matrices- which will then provide the guidance for all Financial Inclusion stakeholders. This could be, for example, in the area of CDD – in particular, identification, verification and monitoring, which are different steps of the CDD process.

²⁵ The regulations on e-money is a clear example of a “test and see” approach. When the two major telecommunication providers presented the product to the BSP for approval, the response of the BSP was to clearly understand the products rather than prohibiting it. Once fully understood and risks properly identified, they were approved on a product basis. It was only after four years that regulations creating the complete framework for e-money were issued.

(as ascertained by proven low risk through a risk based assessment)²⁶. As such, the revised FATF standards ought to have specified factors outlined for simplified (as well as enhanced) due diligence. Also, as proportionality is an area of joint relevance for all SSBs, there should be coordination among all SSBs when providing additional guidance in respect to the proportionality principle.

3.2 Formalization

Mapping a pathway to formalize informal entities

Initiatives continue in the Philippines to officially formalize entities and bring them under the regulatory umbrella, while still allowing them to conduct financial activities and target lower income clientele. For example, the BSP provided a mechanism through which unregulated institutions can transform to become microfinance-oriented banks (Circular 273), allowing some of their pioneer microfinance NGOs to establish banks that now offer savings products to their microfinance clients. Circular 471 paved the way for formal recognition of remittance agents, which previously were conducting their activities informally; also as mentioned earlier, circulars have been devised to chart a path to formalize informal micro-insurance providers within prescribed time periods. In addition, banks are now allowed to become distribution channels for authorized insurance providers of authorized micro-insurance products.

Maintaining healthy entities in the formal system

In creating and implementing these formalization strategies, the micro-insurance regulators have faced certain challenges. Therefore, more specific and detailed guidance from IAIS is desired on the balance that must be continuously monitored between allowing more institutions to enter the formal financial channels and contribute to the vision for financial inclusion, vis-à-vis the need to ensure that only “fit” entities are allowed to provide the service.

Guidance notes from IAIS would be appreciated on how best to structure a regulatory framework that will further motivate the informal providers to formalize their provision of micro-insurance products and services, as well as identifying specific corporate governance standards applicable to informal micro-insurance providers, which regulators should evaluate during the formalization appraisal. As mentioned earlier, guidance is also desired on establishing the minimum level of capital/guaranty fund that informal providers of micro-insurance products and services must possess to convert to a licensed insurance provider.

3.3 Financial Consumer Protection

Expanding consumer protection initiatives

An essential component of successful financial inclusion initiatives is to protect consumers through mandating adequate disclosure of customer rights and responsibilities, putting in place redress mechanisms, ensuring transparent and publicly available pricing, and setting up specific frameworks to prevent or solve the potential over indebtedness of clients.

Regulators have noted that the risks related to consumer protection may increase over time as there is now greater access to financial services by those that were previously excluded. Recent consumer protection initiatives in the Philippines include a “roadshow” to remote rural areas for further training and empowerment of customers, mandating minimum information to be disclosed by providers in a format and language understood by target clientele, and requiring all banks (including banks engaged in microfinance) and other MFIs to disclose effective interest rates to their clients. Some MFIs previously were only relaying the nominal interest rate (which may have hid fundamental deficiencies within the MFI and the true interest rate clients received).

Devising long-term strategies around consumer protection

Regulators felt that all the SSBs adequately address consumer protection mechanisms, and implementation of such principles/standards has not posed any specific challenges for which further assistance from SSBs is currently required. One suggestion for SSBs is to provide guidance on devising long-term strategies, through assistance on quantitatively and qualitatively deducting higher trends and patterns from consumer protection related issues such as customer complaints. The analysis of these trends and patterns, and ultimately development of associated typologies, may be the most effective way to inform future regulations and supervisory strategies.

3.4 Regulation and Supervision of E-money, and similar “deposit-like” stored value services²⁷

Regulation and issuance of e-money entities

The Philippines is a pioneer in developing well-contemplated regulatory frameworks for e-money issuers and e-money issuance. This has helped ensure

²⁶ As per interpretation of FATF/APG/World Bank guidance paper on Financial Inclusion, the FATF may permit zero CDD only if there is proven low risk and there are occasional/limited transactions.

²⁷ Please see Note 14.

the safety and soundness of the service/product, while enabling financial sector innovation by providers and expanding financial access to new population segments. The BSP has issued specific regulations (Circular 649) that govern the issuance of e-money and the regulation of activities of e-money issuers, grouping them into three categories: EMI-Banks, EMI-NBFI (Non-bank Financial Institution) and EMI-Others. This regulation has allowed EMI-NBFIs, such as investment houses, savings and loans associations, pawn shops, and EMI-others, such as Mobile Network Operators (MNO) through a dedicated subsidiary, to issue e-money as long as certain practical and feasible criterion are met. However, key regulatory areas such as risk management practices, consumer protection and system reliability, also apply to all three categories of EMIs. In order to develop the appropriate regulatory frameworks for these instruments, pilots and the “test and see” approaches (as mentioned earlier) were utilized.

Addressing e-money challenges

Some initial challenges that hindered the effective deployment, sustainability and uptake of e-money services were in the areas of AML/CFT, and the capacity of supervisors to effectively supervise new e-money issuers. However, these challenges have been addressed by the BSP, including with Circular 706 on the AML/CFT side. To address the issue of the “e-money float”, which is more of a liquidity challenge, the BSP has introduced guidelines that require the float to be equal to the amount of e-money issued. For e-money issuers engaged in other activities other than e-money issuance, “ring fencing” the liquidity cover is also required.

Encouraging a “test and learn” strategy

At the moment, regulators stated there are no challenges in this area that might merit additional assistance from the SSBs: existing guidance from the SSBs consists of general principles, but these are adequate to use as a basic framework. Given the usefulness of “test and learn” approaches in this field, however, SSBs may be advised to explicitly reference and elaborate on this process in the international standards. In addition, regulators noted that some SSBs may be in a position to provide further guidance as they continue to expand their knowledge of new payment methods.

3.5 Policy considerations

Given the Philippine experience, the following policy considerations can be offered to the Standard Setting Bodies:

1. Create a guidance note (or similar document) to provide insights on terrorist financing (TF) issues within the greater context of financial inclusion. Terrorist financing has different implications than money laundering (ML), so the RBA for each may be different.
2. Clarify the supervisory requirements specific to TF issues under a RBA, as there may be additional TF supervisory checks countries could implement given new types of entities and services subject to ongoing monitoring and supervision.
3. Revisit the record-keeping requirement of a minimum of five years, as the record retention requirement may wish to be reduced in specific situations involving low-risk customers. This is provided that sufficient documents duly support the low-risk profile of the client and covered institutions keep a record of the names of these low-risk customers.
4. Devise a coordinated and proactive strategy to train all mutual evaluation assessors from all relevant institutions on financial inclusion related topics.
5. During the revision process, each recommendation should be evaluated keeping in mind its potential impact on financial inclusion objectives.
6. Offer additional guidance on how to implement the RBA, specifying additional examples of RDD measures. In respect to the possibility of zero CDD in certain occasional/limited transactions (as ascertained by proven low risk through a risk based assessment), provide additional insights and examples of what these occasional/limited transactions could be.
7. Consult with countries that are deemed to be most affected by the revisions, before a new methodology for adoption is finalized. This can be done through coordinating with partner organizations, such as the World Bank and IMF, which are familiar with the challenges faced by developing countries and also involved in the revision process.
8. Consider potential improvements in the FATF/FATF Style Regional Body organizational and communication structure, so that the involvement of countries like the Philippines is more institutionalized in representation and debates occurring within FATF itself. At the moment, institutionalized participation in FATF discussions for most countries is provided through FATF Style Regional Bodies.

Basel Core Principles of Banking Supervision (BCBS)

1. Attempt to link financial inclusion challenges and opportunities to overall banking level stability and performance. Through financial inclusion initiatives, entities can target larger numbers of customers; hence, there could be a re-evaluation of consumer protection issues underlying the core principles, and whether the larger numbers of clients served have potential implications on overall systemic risk.
2. Explore the possibility of incorporating external but relevant environment factors into Principle 7, which calls for effective and comprehensive risk management systems to be in place for banks and

banking groups (as commensurate to the size and complexity of the institution).

3. Provide additional interpretative direction on Principle 2 (Permissible Activities) and Principle 7 (Risk Management Process), including additional detail and scope on what is “permissible” and what exactly could meet the “comprehensive risk management” criteria.
4. Allow countries a smoother transition between Basel accords, with more guidance that takes into account the supervisory and market realities of the developing country context.

Committee on Payment and Settlement Systems (CPSS)

1. Incorporate in the CPSS Core Principles the potential implications arising from new business models/technologies.
2. Acknowledge in the core principles or in some form, the capacity constraints of many developing countries, which might mean they require more time to fully and effectively comply with all Core Principles.
3. Provide additional guidance on Core Principle VII, especially in light of recent technological developments such as Cloud Computing Systems.
4. In the situation of partial compliance with Core Principle I as explicitly defined, provide guidance on whether there are alternative forms of compliance that reflect the legislative dynamics in many developing countries.

International Association of Deposit Insurers (IADI)

1. Proactively offer additional guidance on financial inclusion related topics, as national deposit insurers must be very careful to avoid creating moral hazard implications in the marketplace.

International Association of Insurance Supervisors (IAIS)

1. Propose additional guidance on the risk based supervisory approach to effectively supervise micro insurance providers (whether the distributors or the actual providers) on an ongoing basis, particularly in light of resource and capacity constrained supervisors in many developing countries.
2. As part of additional guidance on the risk-based supervisory approach, create a set of minimum requirements, along with the associated procedures and processes necessary, for prudential risk management and assessment of insurers offering micro-insurance products.

3. Clarify the specific methodology and provide detail on computing the appropriate capital/guaranty fund for the principal insurance provider via a risk-based manner, which would be adequate to formally license the micro insurance provider.
4. Specify in the IAIS standards a defined period for claim disbursement and settlement, which some countries have already done in their own regulations. In addition, provide “standard setting” recommendations on how best to adapt IAIS material into different languages and communicate them in a manner understood by low-income clientele.

Proportionality

1. Beyond recognizing the importance of a risk-based approach or the principle of proportionality, SSBs should provide specific guidelines on the optimum balance that needs to be achieved. SSBs should provide clear and more detailed guidelines, which may include supplemental country examples, on the specific criteria regarding any risk-based decisions and other country evidence based assertions. This will allow these principles to be better accommodated in countries. Such guidance is particularly relevant in respect to BCBS, CPSS, IAIS and IADI.
2. In the area of AML/CFT, the recent APG/FATF/ World Bank Financial Inclusion Guidance Paper is a major step forward, but at the moment, it is a non-binding document and zero CDD is acceptable by FATF in only very limited circumstances. As such, specified factors outlined for simplified (as well as enhanced) due diligence should be explicitly specified in the revised FATF standards²⁸.

Formalization

1. Detailed guidance from SSBs is welcome on the balance that must be continuously monitored between allowing more institutions to enter the formal financial channels, vis-à-vis the need to ensure that only “fit” entities are allowed to provide the service.
2. Specific to micro-insurance, guidance notes from IAIS is desired on how best to structure regulatory frameworks that will further motivate the informal providers to formalize their provision of micro-insurance products and services.

Financial consumer protection

1. Propose guidance on devising long-term strategies, through assistance in quantitatively and qualitatively deducting higher trends and patterns from consumer protection related issues like customer complaints. The analysis of these trends and patterns, and ultimately development of associated typologies, may be the most effective way to inform future regulations and supervisory strategies.

²⁸ The Philippines has reviewed the proposed FATF recommendation revisions and acknowledges the efforts of FATF to provide more useful guidance on the matter.

Regulation and supervision of e-money, and similar “deposit-like” stored value services

1. Given the usefulness of “test and learn” approaches, explicitly reference and elaborate on this process in the international standards.
2. Future guidance in this area is certainly welcome as some SSBs are expanding their knowledge of new payment methods.



GPI

Global Partnership
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The Global Partnership for Financial Inclusion (GPI) is the main platform for implementation of the G20 Financial Inclusion Action Plan. The group engages partners from G20 and non-G20 countries, private sector, civil society, and others. It is chaired by the G20 troika countries, currently Korea, France, and Mexico. The GPI is supported by three implementing partners: the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), and the International Finance Corporation (IFC).



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