Governance and risk in banking for the unbanked

Compliance challenges of financial inclusion initiatives

RiskBusiness NEWSLETTER

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Many banks are launching financial inclusion programmes to serve unbanked populations, but this comes with its own set of governance and compliance challenges, especially in areas like KYC/AML, fraud prevention and digital literacy. In our latest free report, we take a look at some examples of initiatives already in action and discuss the potential GRC risks involved.

UNBANKED VS UNDERBANKED

It's important to understand the distinction between "unbanked" and "underbanked." Underbanked individuals may have access to some banking services such as a basic bank account (with no overdraft facility), but not additional services such as credit cards, overdrafts, mortgages and the like; whereas unbanked people have no access to traditional banking services at all. They are often paid in cash or may be paid by cheque and often have to make use of alternative financial services such as payday loans, cheque cashing services, money remitters and pawn brokers.

EXAMPLES OF INITIATIVES TARGETING THE UNBANKED:

M-PESA

Launched in 2007 by Vodafone and Safaricom, M-PESA is a mobile money service that revolutionised access to financial services in Kenya, where traditional banking penetration was low and the majority of the population was unbanked. M-PESA allows users to send and receive money, pay bills and also access credit through their mobile phones.
It has since launched into several other African countries, including Tanzania, Mozambique, Democratic Republic of Congo, Lesotho, Ghana, Egypt, South Africa, Afghanistan and Ethiopia. It is

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currently one of the largest mobile fintech companies in Africa and had 66.2 million customers as of March 2024.

KYC/AML REGULATIONS

Initially, M-PESA faced challenges with KYC (know your customer) and AML (anti-money laundering) compliance due to the informal nature of many of its users. Safaricom partnered with regulators to develop a flexible KYC framework that allowed users to register with basic identification documents. M-PESA also leverages AI technology to help account for a lack of credit history or official documentation. M-PESA's parent company, Safaricom, is able to harness data from phone usage patterns such as airtime purchase and frequency of transactions to create a basic risk score for customers. AI models can help to determine creditworthiness or likelihood of fraud based on these non-traditional data points. In areas where formal ID systems are lacking, mobile numbers and SIM registration can also act as a form of identity.

FRAUD

M-PESA's ubiquity has made it a popular target for scammers. A recurring problem has been a type of identity theft known as "SIM swap" fraud. This involves criminals convincing the victim's phone provider to change the mobile number linked to a SIM card over to a number they control. They can then make payments, request overdrafts and even take out loans using the victim's M-PESA account.

In May 2022, Safaricom introduced a new code that enabled users to block fraudulent SIM swap attempts. In March 2023, it also launched a 'SIM-Swap-Check' anti-fraud service which allows major banks to see when a customer last swapped their SIM, helping them to determine whether an M-PESA transaction is likely to be fraudulent.

Safaricom also conducts internal investigations into fraudulent activity and has fired 119 staff members since 2019 for fraud, including involvement in SIM swap scams.

GEO-BLOCKING

Businesses can also use something called an M-PESA Business Till. This is not a physical till but a virtual account which can be used by small businesses and entrepreneurs to make and collect payments from customers and other businesses; pay bills and buy goods; withdraw cash from an M-PESA agent and also sell phone airtime to customers and earn commission. There are similar fraud risks surrounding this service too, such as SIM-swap fraud and phishing fraud, so Safaricom has been working to address these risks with mitigation measures. One such measure is the introduction of a geo-blocking function, which prevents access to the account outside of a specified location. "If a till is moved to a different location, it stops working until it is returned to the authorised location. This has in turn led to a reduction in fraud cases resulting from theft of tills and increased compliance from a regulatory point of view," says M-PESA's annual sustainability report.

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> **Not being regulated in the same way as traditional banks allows the firm to adapt quickly and make changes that improve the customer experience**

BANKING LICENCE

As M-Pesa is not a traditional banking organisation, it does not hold a banking licence. This provides both benefits and disadvantages for the firm and its customers. Not being regulated in the same way as traditional banks allows the firm to adapt quickly and make changes that improve the customer experience and support its goal of providing easily accessible services to the unbanked. However, it also means the firm is not as tightly regulated and so customers are not offered the same protections as they might be with a traditional bank.



BNI (BANK NEGARA INDONESIA)

Indonesia has one of the largest unbanked populations in the world. According to 2022 data from the Asian Development Bank (ADB), 48% of the adult population of Indonesia does not have a bank account. In order to address this, BNI, which is one of the country's largest state-owned banks, has launched various digital banking initiatives, including BNI Agen46, a branchless banking project. The programme is a partnership between BNI and individuals/legal entities (or "agents) who provide banking services to members of the public.

The BNI Agen46 project offers services such as the Laku Pandai Service, which stands for Layanan Keuangan Tanpa Kantor dalam Rangka Keuangan Inklusif (Branchless Banking for Financial Inclusion) and is a service initiated by Indonesia's Financial Services Authority (OJK). BNI Agen46 agents are able to use Laku Pandai to help customers open savings accounts, transfer funds, deposit and withdraw cash, pay bills and make purchases.

KYC CHALLENGES

A key area of focus for BNI's inclusive banking drive was reaching rural areas where branches are virtually non-existent. One of the problems when trying to onboard customers from these areas is a lack of official documentation, making KYC compliance difficult. BNI simplified the documentation process for onboarding customers by allowing local agents (Agen46) to verify customers' identities directly in the field, reducing the need for formal documents like ID cards. They

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utilised basic, more accessible forms of identification and digital tools to streamline the process. This approach lowered the barriers to account creation, making it easier for those without formal paperwork to access banking services.

REGULATORY COMPLIANCE CHALLENGES

As BNI expanded its digital banking services, it had to navigate Indonesia's evolving regulatory framework for fintech, including the 2022 Personal Data Protection Law, OJK Regulations (POJK) on Digital Financial Services, POJK on Cybersecurity, E-Money Regulations, Kominfo Regulation on Data Privacy and Security and others. The bank collaborated with regulators to ensure that its digital services met regulatory standards, particularly in data privacy and consumer protection.

RISK OF CYBERSECURITY AND FRAUD

The rapid shift to digital platforms naturally exposed BNI to increased cybersecurity risks. To counter this, the bank invested in IT infrastructure, fraud detection systems and employee training. Another key focus for the bank was educating customers on the types of fraud to be aware of. Head of the Risk Management Division of BNI, Rayendra Minarsa Goenawan, has said that education is the most effective measure for preventing fraud. "The end user as the owner of data is everyone who uses the product, so literacy must be increased along with the increase in inclusion" he said.

BNI has also highlighted the need for education and improving financial and digital literacy in its latest annual Sustainability Report: "Customer knowledge must be improved in the effort to prevent data leak and cyber crime," it says. "As per OJK directions, BNI educates customers on customer data protection via various channels. The Bank also conducts security awareness (customer data confidentiality) socialisation and urges customers to always protect the confidentiality of personal information, such as transaction PIN and OTP as well as immediately contact the bank's call centre in the event of the card being missing or stolen or irregularity in transaction."

"The end user as the owner of data is everyone who uses the product, so literacy must be increased along with the increase in inclusion"

RAYENDRA MINARSA GOENAWAN
Head of the Risk Management Division of BNI

BANCOSOL:

BancoSol is a microfinance provider based in Bolivia and is one of the largest microfinance providers in the world. It provides small loans and financial services for small businesses and individual entrepreneurs. Bolivia has a large unbanked population, particularly in rural areas where access to traditional financial services is limited.

Microfinance products are aimed towards customers who would likely be unable to secure a traditional bank loan due to little or no credit history and a lack of collateral – therefore a high risk of default.

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BancoSol offers flexible loan terms that are designed to suit the specific cash flow cycles of micro and small businesses

GRC CHALLENGES

BancoSol, launched in 1992, is the world's first regulated microfinance operator. This means it has to adhere to the same strict regulations as traditional banks such as capital adequacy, risk management, transparency and consumer protection, and does not benefit from the same flexibilities as other microfinance providers.

Being a regulated financial institution also gives BancoSol access to broader financial markets, including international capital and banking systems, which can provide more stability and financial resources than unregulated entities.



HOW DOES BANCOSOL MITIGATE THE HEIGHTENED RISK OF LOAN DEFAULT?

BancoSol (and other microfinance institutions) employs several strategies to manage the risk associated with servicing clients who have a higher likelihood of default. Here are the key approaches:

- **Comprehensive credit assessment**
  BancoSol conducts thorough assessments of potential borrowers' creditworthiness. This includes analysing financial statements, cash flow, credit history and business plans. The bank also uses risk scoring models to quantify the likelihood of default based on various factors, helping them categorise clients into different levels of risk.
- **Tailored loan products**
  BancoSol offers flexible loan terms that are designed to suit the specific cash flow cycles of micro and small businesses. This can include varying repayment schedules that align with the borrower's income patterns, which may not always be as predictable and consistent as larger businesses. It also offers a diverse range of loan products, including microloans and specialised loans for different sectors, allowing them to recommend the right type of loan for each individual client, reducing the risk of default.
- **Training and support**
  BancoSol provides training programmes for clients to help improve their business management knowledge and skills. It also offers financial literacy programmes to help clients understand budgeting, cash flow management and

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the implications and risks associated with taking out a loan.

- **Collateral**
  Where feasible, BancoSol may require some type of collateral for taking out a loan. This could include assets like property, inventory, or equipment, depending on the nature of the client or business.
- **Monitoring and follow-up**
  BancoSol conducts ongoing monitoring of borrowers' financial health and business performance throughout the loan period. Early detection of potential repayment issues allows the bank to intervene and provide assistance. Maintaining strong relationships with clients enables BancoSol to better understand their challenges and assist them proactively, which can help prevent defaults.
- **Diversification**
  By diversifying its loan portfolio across various sectors and client demographics, BancoSol reduces its exposure to risks associated with specific industries or economic conditions. In cases where clients face difficulties, BancoSol may offer loan restructuring options, allowing clients to adjust payment terms to better align with their current financial situation. This can help clients avoid default and keep them engaged with the bank.
- **Insurance products**
  BancoSol offers and sometimes requires credit insurance products that protect both the bank and the borrower in case of unforeseen circumstances, such as health issues or natural disasters, that could impact successful repayment.
- **Risk management in micro-lending**
  Microfinance involves lending to individuals with little or no credit history, which creates high default risks. BancoSol implemented rigorous risk assessment models, credit scoring systems, and borrower education programs to mitigate the risk of loan defaults.

Microfinance involves lending to individuals with little or no credit history, which creates high default risks

RACISM AND DISCRIMINATION IN UNBANKED POPULATIONS

Discrimination is just one of the many obstacles unbanked populations are faced with when trying to get access to financial services. Whilst some people may choose to be unbanked for various reasons, many do not. If we take the US financial system as an example, we can see huge disparities in the number of unbanked people in white vs other ethnic groups. According to Edelman's 2021 Trust Barometer Report, which focused on addressing racism in America's financial system, Black and Latine households are around five times as likely to be unbanked than White households. Black Americans also make up only 3% of mortgage applications, but face the highest denial rate of any racial group. "People of colour are forced to find alternative solutions," says the report. "Black and Latinx respondents report being more likely to leverage resources outside of the system, such as pawn shops and payday lending (51% of Black Americans and 47% of Latinx, vs. 31% of White Americans surveyed)."

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> **"Everyone who pursues the American dream has the right to expect to be treated equally and with dignity, regardless of their race, their background, or zip code"**

REDLINING

In September 2023, Washington Trust, the oldest community bank in the US, agreed to pay US$9m to draw a line under allegations it engaged in "redlining", a racist practice implemented by banks whereby non-White people are refused mortgages, or access to mortgages is blocked or impeded. According to a *Guardian* report, since the company was founded in Rhode Island in 1800, the bank has "never offered its home loan services at a branch location in a majority-Black or Latino neighbourhood throughout the state, including in the state capital of Providence, where the vast majority of the state's Black and Latino population live." Not only that, but of the 7,502 residential mortgages issued by the bank between 2016 and 2021, only 142 were from residents in majority-Black and Latine neighbourhoods. Yet the bank's rival lenders approved four times as many loans from residents in similarly-situated Black and Latine communities. These disparities were highlighted several times in the bank's own internal and external risk assessments, but according to the US Justice Department's investigation, it "took no meaningful action" to address the issue.



"Everyone who pursues the American dream has the right to expect to be treated equally and with dignity, regardless of their race, their background, or zip code," said US Attorney Zachary Cunha for the District of Rhode Island, who was the prosecutor in the Washington Trust case. "When communities are denied access to fair lending, families are denied the opportunity to build stability and financial success. I am pleased that, as a result of the hard work of attorneys in my office and the department's Civil Rights Division, Washington Trust has agreed to take targeted and extensive measures to make meaningful lending services available for all Rhode Islanders, regardless of race or background."

The measures taken by Washington Trust included investing in a US$7m subsidy fund aimed at helping residents in majority-Black and Latine neighbourhoods to get access to mortgages and other loans, plus an additional US$2m invested in public outreach programmes. It was also instructed to open branches in "communities of colour" and to assign specific mortgage officers to serve those communities.

Washington Trust was not the only US bank accused of redlining. American Bank of Oklahoma, City National Bank (Los

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Angeles), Patriot Bank, ESSA Bank, First National Bank of Pennsylvania and Ameris Bank were amongst the other institutions fined millions of dollars by the US Justice Department for the practice.

GENDER DISCRIMINATION

According to the World Bank, women make up the majority of the global unbanked population. "Compounding this issue is the fact that the benefits of the digital age are not being shared equally," it says. "Women – especially those living in poor and marginalised communities – are most likely to be on the wrong side of a persistent digital divide. Two hundred million more men than women have access to the internet, and women are 21% less likely to own the mobile phone that helps them transfer money, run a business and connect with their community more effectively."

One major contributor to so many women being unbanked is a lack of formal identification. Many cultures still place men in dominant positions leading to the marginalisation of women in legal and financial matters. In these cultures, having a formal ID is often not a priority because women are often financially dependent on their fathers, husbands, or other male relatives.

Most banks require some form of formal identification in order to open a bank account, but some microfinance institutions make efforts to work around this issue by accepting other types of identification, such as community-based ID verification whereby other individuals, such as village elders or other members of the community confirm the person is who they say they are. Other non-traditional forms of ID may also be considered, such as ID cards from trade organisations or religious groups.

BancoSol issued Bolivia's first gender bond, a US$30m bond aimed at providing finance for up to 4,500 micro and small enterprises led by women

BANCOSOL GENDER BONDS: TARGETING THE GENDER GAP IN FINANCIAL INCLUSION

Obtaining the financing to launch a small business can prove difficult for women who are unbanked. With this in mind, In June 2024, BancoSol issued Bolivia's first gender bond, a US$30m bond aimed at providing finance for up to 4,500 micro and small enterprises led by women in the country. The project seeks to increase access to credit for MSEs in Bolivia, strengthening BancoSol's Avanza Mujer (Advance Women) strategy which promotes the inclusion and growth of businesses led by women. The project seeks to encourage the growth of BancoSol's portfolio with underserved clients in the Amazon region, promoting social and rural development. "The resources obtained will allow us to expand access to financing for businesses led by Bolivian women, contributing to closing economic gaps and sustainable development," said Verónica Gavilanes, Deputy General Manager of BancoSol.

POLITICAL BIAS

Nigel Farage, the leader of UK political party, Reform, was famously (allegedly) "debanked" by private bank Coutts in July 2023. Leaked documents showed the bank was concerned about Farage as a client due to his "xenophobic, chauvinistic and racist views".

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By law, financial firms are required to do extra checks on political figures, their families and close associates

By law, financial firms are required to do extra checks on political figures, their families and close associates. "However," warns the FCA, "if rules are applied inappropriately by firms, then individuals may find themselves excluded from products or services through no fault of their own." Partly in response to the Farage incident, the FCA carried out a review into how PEPs were being treated by banks this year and also looked into whether or not people were being refused bank accounts due to their political beliefs. It found no evidence to suggest this was the case. However, it did identify some potential areas where banks could improve access to bank accounts more generally.

"The FCA has asked account providers to review their overall approach to account denials and closures – and particularly to ensure that vulnerable consumers aren't losing out," said the regulator. "Providers should also ensure people aren't denied access just because they can't produce standard forms of ID, and make it clear which alternative forms of ID are acceptable. Where accounts are closed or denied, the regulator has reminded providers that they should act in line with their obligations under the Consumer Duty, including communicating in a way that is clear and helpful for customers." The FCA noted that the report used data relating to cases that pre-date the Consumer Duty regulation, which it hopes will address some of the issues highlighted.



RISKS FACED BY THE UNBANKED AND UNDERBANKED

Both the underbanked and the unbanked are vulnerable to a variety of financial risks that prevent them from achieving financial security. Alternative financial services are notoriously high cost – even though they are aimed at individuals who are often on lower incomes. Payday loans for example, often charge interest rates of 400% or more. Cheque cashing services and pawn shops also have high fees and interest rates. High-cost loans can lead to a cycle of debt as they become impossible to pay off and more debt is taken on to pay for existing debts, deepening financial insecurity. The use of remittance agents is accompanied with the risks of being drawn into money mule operations and theft of funds by individuals masquerading as the named beneficiary. Some companies charge fees for paper billing, meaning those who don't have access to the internet or cannot pay bills online, are often subject to additional charges

Having limited access to credit also

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makes it very difficult for someone to improve their credit rating, excluding them from opportunities to secure affordable loans or mortgages which would allow them to create long-term wealth and financial security. A heavier reliance on cash exposes unbanked and underbanked individuals to theft or loss, without any way to recover lost funds. People using alternative financial services are generally outside the scope of consumer protections that regulate traditional banks and this lack of legal protection means they are more vulnerable to fraud, identity theft, and deceptive financial practices.

RISK VS REWARD

While services like M-PESA come with their own risks, they play a crucial role in safeguarding vulnerable individuals, for whom the consequences of those risks could be severe. Not only is providing financial services for all groups of people a moral obligation for banking organisations, it is also a huge business opportunity. "The inclusion of previously untapped markets presents new revenue streams for financial service providers," writes Pedro Ferreira for *Finance Magnates*. "As innovative payment solutions gain traction in developing nations, financial institutions, fintech startups and technology companies have the opportunity to expand their customer base. This diversification of markets contributes to the growth and resilience of the industry, fostering a more interconnected global financial ecosystem."

Global collaboration and a more nuanced approach to regulation is essential if we are to provide banking for all, says Ferreira. "As innovative payment solutions operate across borders, harmonising regulatory frameworks becomes crucial. This trend prompts industry players to engage in constructive dialogues with regulators and policymakers, fostering an environment that supports financial inclusion while addressing potential risks and challenges."

However, to truly benefit from these new revenue streams, Ferreira warns banks must ensure they put the needs of the underserved communities at the centre of the products and services they create, focussing on solving problems rather than making profits. "To effectively cater to the needs of diverse populations, financial service providers must develop solutions that are user-friendly, culturally sensitive, and aligned with the unique challenges faced by unbanked and underbanked individuals."

As the Washington Trust and other redlining lawsuits in the US have demonstrated, banks will face regulatory consequences if they do not try to reach out to underbanked and unbanked communities. Whilst there are GRC risks involved with working with a harder-to-reach customer base, in the long term, allowing unbanked individuals to access financial services actually helps to reduce financial crime by protecting vulnerable groups from exploitation, lowering dependency on informal and illicit channels and improving financial transparency and traceability.

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About RiskBusiness

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RiskBusiness was founded in 2003 and today has principal locations in Birmingham, London, Buenos Aries, Amsterdam, Hong Kong, New York, Singapore, Toronto, and Zurich. To learn more, visit **www.riskbusiness.com**

Contacts

Carrie Cook, Editor:
carrie.cook@riskbusiness.com

General enquiries:
info@riskbusiness.com

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