



ISLAMIC FINANCIAL SERVICES BOARD

TN-3

**TECHNICAL NOTE ON FINANCIAL INCLUSION
AND ISLAMIC FINANCE**

December 2019

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit **www.ifsb.org**.

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ABBREVIATIONS

AMF	Arab Monetary Fund
AML/CFT	Anti-money laundering/countering the financing of terrorism
BCBS	Basel Committee on Banking Supervision
CDD	Customer due diligence
CGAP	Consultative Group to Assist the Poor
CPMI	Committee on Payments and Market Infrastructures
CSR	Corporate social responsibility
FATF	Financial Action Task Force
FinTech	Financial technology
FSB	Financial Stability Board
FT	Financing of terrorism
G20	Group of Twenty
GPFI	Global Partnership for Financial Inclusion
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFS	Institutions offering Islamic financial services
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRTI-IDB	Islamic Research and Training Institute of the Islamic Development Bank
KYC	Know your customer
MFI	Microfinance institution
ML	Money laundering
MNO	Mobile network operator
MSME	Micro, small or medium-size enterprise
NBFI	Non-bank financial institution
NGOs	Non-government organisations
PSIA	Profit-sharing investment account
RBA	Risk-based approach
RSA	Regulatory and supervisory authority
SDGs	Sustainable Development Goals
SME	Small or medium-size enterprise
SSB	Standard-setting body
TC	Technical Committee of the IFSB
TF	Task force
TN	Technical note
UN	United Nations

SECTION 1: INTRODUCTION

1.1 Background

1. Financial inclusion is now a priority among global policymakers and financial sector regulators. In the aftermath of the Global Financial Crisis of 2007–8, the Group of Twenty (G20) during its Summit in 2010 formally recognised the importance of financial inclusion as one of the pillars of the global development agenda. In its official communiqué,¹ the G20 called on relevant international standard-setting bodies (SSBs) to consider how they can further contribute to encouraging financial inclusion, consistent with their respective mandates.

2. Financial inclusion is also positioned prominently as an enabler of at least seven of the seventeen 2030 Sustainable Development Goals (SDGs) adopted by the United Nations (UN) in 2015.² These goals include SDG 1, on eradicating poverty; SDG 2, on ending hunger, achieving food security and promoting sustainable agriculture; SDG 3, on promoting health and well-being; SDG 5, on achieving gender equality and economic empowerment of women; SDG 8, on promoting economic growth and jobs; SDG 9, on supporting industry, innovation and infrastructure; and SDG 10, on reducing inequality. Additionally, in SDG 17, on strengthening the means of implementation, there is an implicit role for greater financial inclusion through greater savings mobilisation for investment and consumption that can spur growth.

3. Financial inclusion has garnered the attention and support of many development institutions, multilateral development banks, international organisations and other relevant government organs (including financial sector regulators) as a means to promote inclusive growth. A study³ by the Basel Committee on Banking Supervision (BCBS) found that, of the 52 jurisdictions which responded to a 2013 range-of-practice survey on the regulation and supervision of institutions relevant to financial inclusion, 36 have a national financial inclusion strategy, a national microfinance strategy, or a specific policy statement establishing a financial inclusion mandate or goal at the national or organisational level.

4. The international financial architecture, recognising the growing need for policy and regulatory direction towards the financial inclusion objective, has witnessed the emergence of

¹ G20 Meeting of Finance Ministers and Central Bank Governors, Communiqué, Busan, Republic of Korea, 5 June 2010.

² See www.uncdf.org/financial-inclusion-and-the-sdgs

³ BCBS (2015), “Range of Practice in the Regulation and Supervision of Institutions Relevant to Financial Inclusion”, Basel, January.

new initiatives, such as the G20's Global Partnership for Financial Inclusion (GPFI)⁴ and the appointment of the UN Secretary General's Special Advocate for Inclusive Finance for Development. The financial sector SSBs have also responded in line with their mandates, engaging increasingly to incorporate financial inclusion in their work. The recent GPFI report entitled *Global Standard-setting Bodies and Financial Inclusion: The Evolving Landscape* (March 2016) considers standards and guidance relevant to financial inclusion from the Financial Stability Board (FSB) and six SSBs, including the BCBS, the Committee on Payments and Market Infrastructures (CPMI), the Financial Action Task Force (FATF), the International Association of Deposit Insurers (IADI), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO).

5. In line with the global trends, financial inclusion is also an important agenda item among the wider Islamic Financial Services Board (IFSB) membership, with particular relevance for the Islamic financial services industry (IFSI). Recent estimates⁵ suggest that, on average, approximately 9% of the population across 35 selected Muslim-majority countries financially exclude themselves from the formal financial sector due to religious reasons.⁶ This figure translates into nearly 40 million individuals financially excluded from the formal financial system, thus representing a specific gap for the IFSI to bridge.

6. Accordingly, and in line with the institutional mandate,⁷ the Council of the IFSB, in its 29th meeting held on 14 December 2016 in Cairo, Egypt, approved the IFSB's Work Plan for 2017 which included, among others, the preparation of a new technical note (TN) on financial inclusion and Islamic finance, and the setting up of a task force (TF) to guide its preparation. Subsequently, the IFSB Secretariat duly formed the project team consisting of assigned IFSB staff and externally appointed subject-matter expert consultants, and a TF through invitations to international organisations, multilateral development banks, and regulatory and supervisory authorities (RSAs), in line with the relevant IFSB rules and procedures and in consideration of the nature, scope and intended objectives of the TN.

⁴ The GPFI was established at the G20 Seoul Summit in December 2010 as the main implementing mechanism of the G20 Financial Inclusion Action Plan and a platform for peer learning, knowledge sharing, policy advocacy and coordination among G20 and non-G20 policymakers and other stakeholders.

⁵ See Chapter 3 in the World Bank-Islamic Development Bank's global report on Islamic finance (2016): *Islamic Finance – A Catalyst for Shared Prosperity?*

⁶ The range between countries is much higher, going as high as 33.6% of the population. See Table A, "Islamic Financial Institutions and Financial Inclusion by Country", in Appendix A-1 of this document.

⁷ Article 4(a) of the IFSB's Articles of Agreement states that the objective of the IFSB is to promote the development of a prudent and transparent IFSI through introducing new, or adapting existing, international standards consistent with Sharī'ah principles and recommending these for adoption. In addition, the IFSB's Strategic Performance Plan 2016–2018 (SPP) underlines the importance of financial inclusion due to its intimate connections with financial stability and cross-sectoral implications. The SPP also emphasises the need for further studies on how financial inclusion policies can support microfinance activities. In this regard, the development of new standards and regulations related to financial inclusion, and to microfinance as an indispensable part of financial inclusion, is of significant importance within the mandate of the IFSB.

7. The TF, under the direction and guidance of the IFSB Technical Committee (TC) as well as some specific directives from the IFSB Council, has developed this TN. The work has been further informed by a survey of RSAs⁸ with regulatory and supervisory responsibility for financial inclusion in their jurisdiction. This survey, and the TF's own deliberations, identified a number of areas in which specificities of Sharī'ah were needed to be addressed for the regulatory and supervisory initiatives in Sharī'ah-compliant financial inclusion and microfinance activities.

1.2 Objectives and Scope

8. Broadly, the aim of this TN is to provide guidance on good practices in regulating the financial sector to enhance financial inclusion through Islamic finance, while also considering proportionality in balancing the benefits of regulation and supervision against the risks and costs. The TN underscores the importance of financial inclusion, due to its intricate connection with economic growth, shared prosperity and poverty reduction, while furthering an understanding of how financial inclusion policies and regulatory initiatives can support Islamic microfinance/savings/investment activities. The TN also covers recent developments in enhancing financial inclusion through digital finance and financial technology (FinTech) platforms⁹ while further identifying the current main challenges and emerging issues, as experienced by the market players and regulators, in microfinance and financial inclusion related to Islamic financial services. Finally, the TN explores practical modalities for the integration of social finance modes in Islamic finance (e.g. *sadaqah*, *waqf* – each based on their Sharī'ah parameters) with the commercial IFSI to promote financial inclusion.

9. Based on the above, the key objectives of this TN are:

- to provide international benchmark guidelines on regulatory and supervisory policies to support financial inclusion initiatives in the IFSI;
- to provide guidance to RSAs on the application of the proportionality principle so that the benefits of regulation and supervision can be balanced against the risks and costs;
- to factor in recent developments in enhancing financial inclusion through Sharī'ah-compliant mechanisms by digital finance and FinTech platforms;

⁸ The survey exercise was conducted from October to December 2017.

⁹ However, the scope of this TN excludes discussion of crypto-assets and blockchain technology.

- to consider a modality for the integration of modes of Islamic social finance (e.g. *sadaqah*, *waqf* – each based on their Shari’ah parameters) with the commercial IFSI; and
- to highlight challenges in, and propose solutions to, emerging regulatory issues in microfinance and financial inclusion activities in the IFSI.

10. The TF further noted the currently limited involvement of both conventional and Islamic commercial banks in financial inclusion activities and the active involvement of different types of non-bank financial institutions (NBFIs) in the propagation of financial inclusion that includes microfinance. Overlaps of regulatory functions on financial inclusion activities, often between banking sector and capital market regulators, were also discussed by the TF. Based on these deliberations, the TF resolved that, where needed, the TN is to extend its scope beyond the Islamic banking sector and cover the role of NBFIs and the Islamic capital market in promoting financial inclusion. In addition, the TN will cover microfinance activities, which current evidence suggests represent a majority of the Shari’ah-compliant financial inclusion efforts. The TF further resolved that the TN will not include the *takāful* sector in its scope, as a recent joint IFSB–IAIS working paper (WP) has already covered the regulation and supervision of *micro-takāful* activities.¹⁰

11. In addition to the above aspects, it is worth mentioning that the TN does not intend to cover the overarching technological aspects of, or strategies for, developing regulations for digital finance (e.g. FinTech, RegTech, SupTech); however, the IFSB plans to cover these issues in a separate work in the near future (see also section 2.3.4). Moreover, the TN is unable to offer much insight into resolution of failed financial inclusion service provider(s) offering Shari’ah-compliant products, given the fact that these matters fall under the purview of the country’s legal framework. However, the TN notes that where the legal process does not make any reference to Shari’ah, this problem also exists for the IFSI transactions, and the financial inclusion activities may be no different in such a case. In this respect, the IFSB plans to address the issue of resolvability and recovery of IIFS in a separate technical note in the near future (see discussion in section 3.3.6).¹¹

¹⁰ See IFSB–IAIS (2015), “Issues in the Regulation and Supervision of *Microtakāful* (Islamic Insurance)”, www.ifsb.org/download.php?id=4413&lang=English&pg=/index.php

¹¹ During the public consultation of the exposure draft of TN-3, the industry had recommended to address these issues of technological regulations and resolvability of financial inclusion service providers in this TN. However, the task force viewed these as beyond the scope of TN-3, as these issues are addressed separately, or will be addressed by the IFSB in the near future. However, some discussion on these issues has been presented in this TN.

12. The IFSB envisages that this TN will serve as a useful complement to RSAs in identifying appropriate regulatory flexibilities for various types of institutions and/or activities involved in financial inclusion, proportionate to the risk exposures and implications for financial stability (proportionality). The TN can also be used by jurisdictions as a benchmark for assessing their regulatory and supervisory systems in relation to financial inclusion and microfinance activities in the IFSI.

13. The IFSB, in line with its mandate, addresses its guidelines for the benefit of RSAs;¹² however, it does not exclude other authorities (e.g. government ministries, specialised supervision authorities, etc.) from utilising the guidance in this TN for the purposes of their rules and regulations. The TN particularly notes that NBFIs and other financial inclusion service providers that are deposit-taking may also be prudentially regulated and supervised to protect depositor confidence and financial stability, and also prevent regulatory arbitrage (see discussion in section 3.3). In principle, clients of financial inclusion products should get the same level of protection irrespective of the status of the service provider. Thus, non-bank financial services providers cannot be left completely unregulated. The core objectives of financial sector RSAs include, among others, financial stability, financial integrity, consumer protection and financial inclusion. While the objectives of financial integrity and consumer protection would apply to all financial institutions, prudential regulatory requirements can be lowered for smaller NBFIs serving the financially excluded since they may pose less or no systemic risks. As the size of the financial institution becomes larger, prudential regulations can be imposed incrementally to ensure financial stability (see discussion on proportionality in section 2.3.1).

14. While the IFSB standards published to date are primarily for the commercial IFSI, they are referred to in this TN wherever appropriate relevance is established. These standards include, but are not limited to, IFSB-1: *Guiding Principles of Risk Management of Institutions offering Islamic Financial Services (IIFS)*; IFSB-3: *Guiding Principles on Corporate Governance for IIFS*; IFSB-9: *Guiding Principles on Conduct of Business for IIFS*; IFSB-10: *Guiding Principles on Sharī'ah Governance Systems for IIFS*; and IFSB-12: *Guiding Principles for Liquidity Risk Management of IIFS*.

1.3 Main Premises and General Approach

15. The starting-point for development of the TN has been an analysis of the existing policy documents on financial inclusion and microfinance by the various international financial sector

¹² Normally, this includes central banks, capital market authorities, insurance authorities, financial services authorities, supervision agencies, etc.

organisations and standard-setting bodies, including the GPFI and its implementing partners, as well as the FSB, BCBS, IOSCO, IAIS, CPMI, IADI and FATF. Relevant useful work by the Consultative Group to Assist the Poor¹³ (CGAP), a global partnership of 34 leading organisations that seek to advance financial inclusion, was also referred to in the analysis. These policy documents were then assessed for their applicability to the IFSI, and to identify areas where they did not adequately address the specificities of Islamic finance in general, and Islamic financial inclusion and microfinance in particular.

16. The analysis of these policy documents showed that, while efforts have been initiated by the SSBs to enhance regulatory capacity (especially in terms of inclusive finance), specific standards and guidelines aimed at enhancing the potential of Islamic finance for further increasing financial inclusion are generally absent.¹⁴ Furthermore, studies conducted by SSBs in which integration between inclusive finance and the IFSI has been carefully examined are almost non-existent. Surveys on financial inclusion progress and developments by the SSBs did not include questions on Islamic finance, although a notable exception is the CGAP's survey of Islamic microfinance institutions (MFIs), the results of which have been published in 2008 and 2013 in two focus notes entitled "Trends in Sharia-Compliant Financial Inclusion" and "Islamic Microfinance: An Emerging Market Niche".

17. This information gap supports the IFSB's efforts in this TN to address the relevant needs in the Islamic financial inclusion and microfinance space. Aside from international organisations, the existing guidelines on financial inclusion and microfinance (including digital financial inclusion) from national RSAs, as well as relevant articles and research papers by the Islamic Research and Training Institute of the Islamic Development Bank (IRTI-IDB), were also referred to in order to assist in the preparation of this TN for the Islamic finance industry.

18. The general approach to this TN, in line with the IFSB's organisational objectives,¹⁵ is to build upon the standards adopted by relevant international organisations and to adapt or supplement them only to the extent necessary to deal with the specificities of Islamic finance. Hence, while no specific policy document from conventional standard setters can be used as a benchmark for this TN (due to non-availability at this time that fully covers the objectives of this TN), care has been taken to ensure that the guidelines in this document do not depart

¹³ CGAP is not an international standard-setting body per se, but CGAP publications cover a wide range of financial inclusion topics, including consensus guidelines, focus notes, technical guides and other papers.

¹⁴ This, however, is not a limitation on the part of these organisations, since it is the IFSB, in line with its institutional mandate, that is the responsible body for standard-setting activities related to Islamic finance.

¹⁵ The first objective of the IFSB is "to promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Sharī'ah principles, and recommending these for adoption".

from internationally accepted principles and practices, as applicable (by duly referencing, where possible, existing international guidelines, including IFSB’s own published standards).

1.4 Specific Approach: Institution- or Activities-based Regulation?

19. A number of specific approaches are taken by regulators globally in the development and implementation of regulations. For instance, a regulator may take an “institution-based” (also known as “entity-based”) approach, which involves setting prudential rules depending upon the type of institution. Thus, under this approach, different kinds of institutions will be subjected to different rules about, for example, permitted activities or capital adequacy. A relevant example from the banking sector today is the marking of some banks as “systemically important financial institutions,” which are generally required to comply with more stringent prudential regulations.

20. On the other hand, regulators may take an “activities-based” (or “functions-based”) approach, which involves identifying and overseeing the riskiness of financial activities and developing regulations that correspond to those activities. Thus, under this approach, regulations will target the more risky products with stringent prudential requirements, and less risky products with less stringent prudential requirements. This approach ensures that, regardless of the type of institution, risky products are dealt with identically and none are excluded, for institutional reasons, from being subject to stringent prudential regulations, particularly if they are involved in complex financial transactions with implications for systemic stability (e.g. in conventional finance, exposures in the derivatives market). An activities-based approach also avoids any unreasonable application of strict regulations to various institutions (e.g. applying bank-centric regulations to non-bank financial institutions).

21. This TN does not prescribe one approach over the other, and leaves the choice to the discretion of the national RSAs. Globally, both approaches are practised and may have the same implications (in terms of the smooth functioning of the financial system and ensuring its stability), although some major financial sector organisations have recently moved towards the activities-based approach for systemic risk regulations.¹⁶

22. Nonetheless, for the purposes of this TN, the TF has recommended adopting an activities-based approach for developing policies and guidelines, as several different types of institutions¹⁷ are involved in Islamic financial inclusion and microfinance activities. A relatively

¹⁶ For instance, IAIS released its consultation paper in December 2017 on an “Activities-Based Approach to Systemic Risk for Insurers”. This initiative by the IAIS had previously been welcomed and encouraged by the FSB in its press release of 21 November 2017.

¹⁷ As discussed in section 2.3 of the document.

recent survey by CGAP¹⁸ has also revealed the significantly more active involvement of different types of NBFIs in Islamic microfinance activities as opposed to commercial banks.¹⁹

23. Hence, three sections of this TN (Sections 3, 4 and 5) are dedicated to the prudential guidelines and regulations for each of the three main activities of Islamic financial inclusion and microfinance: financing, deposit taking and investments (equity-based financing). This activities-based approach facilitates relatively easier utilisation by the RSAs of the guidance provided in this TN with respect to specific activities.

24. The TN, however, does not completely refrain from highlighting issues specific to the regulation and supervision of particular types of institutions, and discusses them in Section 2 where such issues are presented, particularly in respect to the proportionate implementation of the various activities-based guidance in this TN.

25. The TN also fully recognises that while prudential regulations require an important consideration of proportionality with respect to different types of institutions, in contrast, most non-prudential regulations are generally applicable to all types of service providers. In particular, non-prudential objectives of financial consumer protection and anti-money laundering/countering the financing of terrorism (AML/CFT) are best achieved through a single set of rules applicable to all providers of a given service. However, where necessary, due guidance on proportionality with respect to non-prudential regulations is provided in Section 6 of this TN.

¹⁸ CGAP Focus Note No. 84: "Trends in Shari'ah-Compliant Financial Inclusion", March 2013.

¹⁹ See Figure A, "Institutions Offering Islamic Microfinance Products", in Appendix A-2 of this TN.

SECTION 2: PRELIMINARY ISSUES

26. This section defines various preliminary issues in financial inclusion, setting the stage for an appropriate interpretation of the regulatory, supervisory and other guidelines provided in this document. It clarifies the working definition of “financial inclusion” as adopted in this TN, and highlights the specificities of financial inclusion activities through Islamic finance. It also discusses, at an early stage, the challenges that different types of institutions bring to the regulatory and supervisory framework, and some of the steps that can be undertaken to address them. The TN, however, does not specifically identify any list of necessary pre-conditions (e.g. payment and settlement infrastructure, credit information, collateral registries, debt and solvency framework, and consumer protection) for financial inclusion and Islamic finance, since these are expected to be similar for both conventional and Islamic financial inclusion activities. Where differences exist, and where the Sharī’ah-compliant activities require specific considerations, the TN has covered these aspects under appropriate headings in various sections of this TN.²⁰

2.1 Working Definition of “Financial Inclusion”

27. There is no universally agreed-upon definition of “financial inclusion”. Several different definitions are used globally by various organisations that refer to a set of activities with relatively identical objectives. These objectives include enhancing access to formal financial services for the segments of society that are currently either unserved or underserved by formal financial institutions. This is usually achieved by addressing those constraints that make it difficult for people to access and/or use financial services and products offered by the formal financial institutions that are appropriate to their needs. These financial services and products are not limited to accessing credit, but also include savings (defined broadly to include transaction accounts), payments, insurance and investments.

28. For the purposes of this TN, conventional “financial inclusion” refers to “a state where individuals and businesses in a society have access to, and usage of, a range of affordable and quality financial products and services that appropriately and justly meet their needs; and that are delivered by formal financial services providers in a transparent and simple manner, enabling informed understanding and decision making by the customer”. The ultimate goal of financial inclusion is to enhance the livelihood of beneficiaries while contributing to the overall well-being of the society.

²⁰ The IFSB provides guidance on necessary conditions for effective supervision of IIFS in its standard IFSB-16 in section 2.1.

29. This definition encompasses all the key components of financial inclusiveness:

- Financial products and services are available and accessible by both *individuals and businesses*, reflecting that micro-, small and medium-size enterprises (MSMEs), particularly in emerging and less-developed economies, often find it difficult to access finance at an affordable price.
- The definition stresses both *access to* and *usage of* the financial products and services, since access might be available, but a lack of awareness by consumers may limit their usage of these products.
- It reinforces the achievement of a balance between *affordable* products that do not compromise on a certain level of *quality* in terms of efficiency, safety and reliability.
- It highlights aspects of consumer protection and caveat emptor by way of ensuring the *appropriateness/justness* of financial products that are *understood* by the customer and offered by the service providers in a *transparent* and *simple* manner.
- Finally, it clarifies an intention to support financial inclusion activities by the *formal financial services providers* to ensure regulatory coverage and protection of the participants/stakeholders involved.

30. On the last point specifically, several researchers have indicated that the financially excluded may have other informal conventional options (e.g. private moneylenders, friends and family, tribal heads in rural areas, non-licensed pawnbrokers, etc.), which may offer customers better value than formal products and providers.²¹ However, there are sometimes severe risks associated with informal lenders using illegal or exploitative means in a case of non-payment to recover the dues, which can force generations of a borrowing individual to fall into the poverty trap or even worse.

31. Nonetheless, the entrenched presence of such informal financial services providers, at least in some societies presently, cannot be ignored. Through a proportionate combination of prudential and non-prudential regulations, these providers can be brought into the regulatory ambit for the purposes of oversight, risk management and consumer protection.

32. Hence, “formal financial services providers and facilitators” in this TN refers to entities that have a recognised legal status and includes those with widely varying regulatory attributes, subject to differing levels and types of external supervision. The definition should not be understood to be referring to commercial financial institutions only (e.g. traditional banks); rather, traditionally informal institutions (e.g. non-government organisations [NGOs],

²¹ As may be indicated where there is access to formal financial products and services, but limited or no usage by financially excluded and underserved customers.

cooperatives, religious institutions, FinTech platforms and crowdfunding entities) may well come under this category if the RSA enables a framework to regulate them.

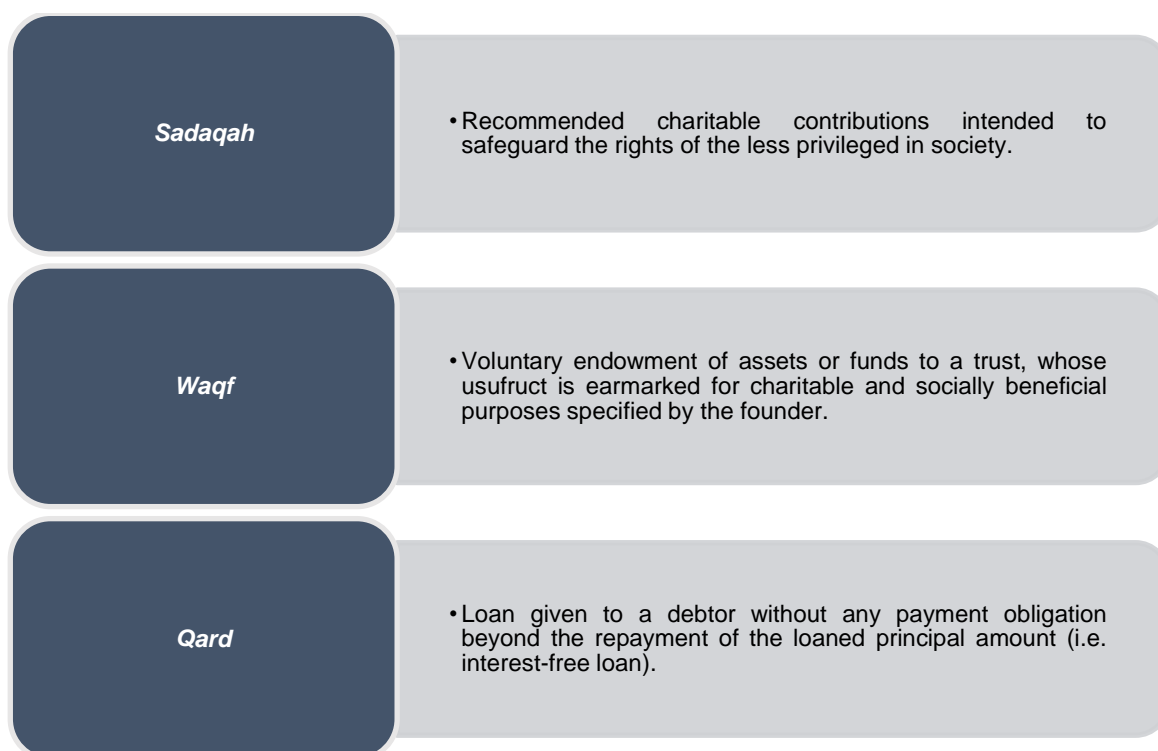
33. As a last point, sometimes a distinction is made between “financial inclusion” and “microfinance” – a key distinguishing factor being that microfinance is often associated with a provision of credit to the poor or less well-to-do segments of society with the intention of helping them to elevate themselves out of poverty. There are also some other terminologies in use, including “micro-credit”, “micro-loan”, “micro-saving”, “financial services accessibility”, and so on. This TN, which uses an activities-based approach in its various sections, does not always make this distinction in terminologies but refers to all activities that will enable the objectives described in paragraphs 27 and 28 to be achieved. The TN does, however, achieve a differentiation between activities by microfinance and other informal institutions vis-à-vis the commercially established institutions through appropriate discussion of proportionality in various sections.

2.2 Specificities of Financial Inclusion in Islamic Finance

34. The concept of financial inclusion is well grounded in the Islamic economic and financial system. Justice, transparency and equality form the foundation of an Islamic economic system with the objective of developing a prosperous economic and social system. Islamic economics gives just weight to both individual and societal interests and hence encourages social harmony. Social solidarity is also supported by the subsystems of the Islamic economic system, including Islamic finance, which is anchored in a number of fundamental principles such as sanctity of contracts, links to the real economic sector and risk sharing.

35. The Islamic financial system’s endorsement of justice and risk sharing provides for the establishment of a clear link between the Islamic concept of development and the notion of financial inclusion, in view of their holding a common goal of enabling the development of marginalised individuals and communities. Islamic financial contracts, particularly risk-sharing financing instruments and social solidarity instruments such as *sadaqah*, *waqf* and *qard* (see Figure 2.2.1), can be utilised for financial inclusion. The social solidarity instruments in an Islamic economic system are intended specifically to safeguard the rights of the less able through the income and wealth of the more able, thus ensuring social protection and poverty alleviation, leading to wider social and financial inclusion.

Figure 2.2.1: Key Social Solidarity Instruments in Islamic Finance



36. In essence, while the concepts of financial inclusion and microfinance are in harmony with the objectives of Sharī'ah, Islamic finance has its own specificities and governing principles for Sharī'ah compliance that differentiate it from the conventional financial services business. The rules and procedures are derived from Sharī'ah (Islamic law), which requires offering institutions to comply with factors beyond the traditional regulatory and supervisory measures. Islamic financial inclusion and microfinance activities are also required to comply with these additional measures based on the Sharī'ah. Some of these specificities are discussed below.

2.2.1 Permissible and Impermissible Activities

37. There are Sharī'ah rules in relation to permissible and impermissible activities. Sharī'ah deems some activities as prohibited (*haram*), and businesses and/or individuals engaged in these activities may not avail themselves of Sharī'ah-compliant financial solutions. The commonly prohibited businesses in Islamic finance are those dealing with liquor, gambling, vice-related activities (e.g. pornography, trafficking, etc.) and interest-based lending businesses. Hence, operators in Islamic financial inclusion activities must ensure that their operations comply with rules of *halal* (permitted) and *haram* (prohibited), and that they only finance activities (of counterparties) that are permissible in Sharī'ah.

2.2.2 *Sharī'ah Contracts*

38. On the transaction level, Sharī'ah requires contracts to be free of *ribā* (interest), major *gharar* (excessive uncertainty) and *maysir* (zero-sum/gambling outcomes). Since interest is prohibited in Islamic finance, money can only be lent at par value. Therefore, interest-based lending, which is the typical feature of conventional finance, is prohibited in Islamic finance. Instead, Islamic finance utilises a number of different Sharī'ah-compliant contracts to enable financial intermediation activities. Commonly used Sharī'ah-compliant contracts include *murābahah*, *ijārah*, *salam*, *muḍārabah*, *mushārah* and hybrids (i.e. a combination of two or more of these contracts).²² Each of these contracts has its own set of rules and operational mechanisms that lead to different sets of rights and responsibilities for the contracting parties.²³ Intermediation activities for the purposes of Islamic financial inclusion and microfinance are required to comply with the specific rules of these contracts. Any regulatory and supervisory guidelines need to be cognisant of these rules and provide clarity about these contracts in the marketplace.

2.2.3 *Sharī'ah Advisers/Board and Sharī'ah Reporting*

39. Islamic finance activities need to be under ongoing supervision by qualified experts who are well versed in the principles of Islamic finance and Sharī'ah. The activities/institutions may be supervised either by a Sharī'ah adviser or by a team of three or more experts forming a Sharī'ah board. (The particular requirements for Sharī'ah supervision can differ between jurisdictions.) The regulatory and supervisory guidelines on Islamic financial inclusion and microfinance activities need to be clear in terms of who or what constitutes a Sharī'ah adviser/board and spell out in detail the “fit and proper” criterion in relation to it.

40. Regulatory and supervisory guidelines also need to clarify the need for Sharī'ah review and audit on Islamic financial inclusion and microfinance activities, including the frequency and type of reporting – whether to the general public, the board of the operator, or the regulator for supervision purposes.

41. A counterbalancing argument, however, is that many of the institutions involved (particularly in microfinance) are small, and an option for reducing the costs of operations may be to rely on a single Sharī'ah adviser each, or for a number of smaller service providers to engage a Sharī'ah consultancy firm, or for one adviser to collectively serve a number of smaller service providers. An additional modality may be when voluntary Sharī'ah services may be

²² For the meanings of these and other Sharī'ah contracts and terminologies commonly used in Islamic finance, please see the IFSB Glossary available at: www.ifsb.org/terminologies.php

²³ These rights and responsibilities, and their regulatory treatment, are discussed as appropriate in the following sections of this TN.

offered by Sharī'ah advisers, Sharī'ah advisory firms or Sharī'ah boards of firms (e.g. Islamic banks) to the smaller service providers as part of social solidarity/corporate social responsibility (CSR) efforts. (This modality is discussed further in Section 6 of this TN.)

2.2.4 Products – Mechanism and Operations

42. Aside from complying with *halal/haram* activities and utilisation of Sharī'ah contracts, the Islamic jurisprudence of transactions also has provisions regarding the way products function and contracts of exchange are executed. The regulatory and supervisory guidelines need to elaborate on the Islamic jurisprudence of transactions that would govern the execution of Islamic financial inclusion and microfinance contracts. Generally, these are common in both the conventional and Islamic activities in relation to guidelines on transparency, disclosure and fairness to the consumers, as well as abstention from fraud, manipulation and exploitation of buyers due to information asymmetry. The Islamic jurisprudence of transactions typically requires offer (*ijab*) of products in clear terms and acceptance (*qabul*) by the buying party in clear terms with sufficient information to enable reasoned decision making (The offer and acceptance may not be by way of uttering words, but may be through the action of giving and taking.) This factor is of importance in both conventional and Islamic microfinancing business, where the financial literacy of the customer is always a concern.

43. There are also rules in relation to exit and restructuring requirements from a financing transaction, including additional operational considerations with respect to late-payment penalties, treatment of early payment, etc. These considerations are typically premised on the Sharī'ah contract (e.g. *murābahah*, *ijārah*, *salam*, etc.) on which the transaction was originally structured.

2.2.5 Sources of Funds – Social Solidarity Instruments

44. Aside from own funds, donations, grants and subsidies from various individuals, institutions and governments/donor agencies are typical features of financial inclusion and microfinance activities. Accordingly, NGO-type microfinance institutions are typically non-deposit-taking institutions. In Islamic finance, there are particular contracts that enable donations/grants, such as *sadaqah* and *waqf*.²⁴ These social solidarity instruments, in turn, have their own specific concepts and contractual obligations that need to be duly considered by the institution collecting these funds and utilising them for financial inclusion activities.

²⁴ See Figure 2.2.1 in this document, as well as the IFSB Glossary – www.ifsb.org/terminologies.php – for a detailed discussion of this topic.

45. While these non-commercial contracts are considerably easier to manage in non-deposit-taking institutions, there is a need for further regulatory thinking in terms of integration when they are utilised to raise deposits in commercial deposit-taking institutions. For instance, a temporary cash *waqf* deposit with a specified maturity for withdrawal will likely attract a new set of specific regulatory and prudential guidelines.

2.2.6 Commensurate Prudential and Non-prudential Regulations

46. From a regulatory and supervisory perspective, the various specificities highlighted above create the need for commensurate prudential regulations on matters such as solvency requirements, liquidity buffers, Shari'ah compliance issues, etc. Policymakers will have to carefully balance the costs of regulatory compliance against those of facilitating financial inclusion and microfinance activities.

47. Both deposit-taking and non-deposit-taking institutions will also need regulations – in particular for non-prudential issues – in terms of consumer protection, financial literacy, financial reporting and transparency, as well as know-your-customer (KYC) rules and financial crime risk management. Given specifics from Shari'ah law, these institutions require appropriate adjustments in business processes in the form of Shari'ah governance requirements to ensure that non-prudential regulatory issues are soundly addressed.

2.2.7 Creditor Rights and Dispute Resolution

48. Financial intermediation activities call for resolution mechanisms in the event of a contracting party failing its obligations. A common restructuring process in conventional finance typically involves according more time to the client to settle its obligations in exchange for additional compensation for the lending party. The specificities of Shari'ah contracts utilised in transactions, combined with prohibition of interest (*ribā*), usually require a different restructuring process in Islamic finance. The specific restructuring process would depend on the type of contract used. Hence, for instance, microfinancing done on a *murābahah* sale basis of underlying assets creates a debt obligation on the client; a default event then creates complications, as the financing party is prohibited by Shari'ah from simply rolling over the outstanding obligation for additional time in return for higher compensation from the client.

49. As such, regulations must provide clarity on how defaults and non-performance of obligations should be approached. This need is particularly pronounced in the context of financial inclusion and microfinance, where a relatively atypical segment is introduced into the formal financial sector, bringing with it new risk considerations. Processes of increasing financial inclusion will change the nature (and sometimes also the level) of risks, due to a

variety of factors, including the characteristics of currently financially excluded customers (which differ from the “already served” with which the RSAs are most familiar), as well as the nature of the products, services and providers capable of reaching them, and especially the innovative approaches needed to accomplish significant increases in financial inclusion.

2.2.8 Other Considerations

50. A further consideration arising from Islamic financial inclusion and microfinance activities is the segregation of funds in mixed operators; that is, when institutions operate both conventional and Islamic finance activities, funds mobilised through Sharī'ah contracts should only be used to finance Sharī'ah-compliant activities. Hence, this calls for regulations preventing a spillover of funds mobilised through Sharī'ah contracts into the conventional business.

51. A common policy initiative by the national RSAs is to provide credit guarantees to enhance the eligibility of MSMEs and other clients. This initiative also calls for due consideration of Sharī'ah rules in the provision of guarantees for consumers that wish to avail themselves of Islamic financial inclusion and microfinance services.

52. A related concern will be ensuring the availability of skilled human capital who understand the due rights and responsibilities arising from the various Sharī'ah-compliant activities to run and manage the operations of the Islamic financial inclusion and microfinance businesses.

2.2.9 Working Definition of “Financial Inclusion” in Islamic Finance

53. Premised on the various discussions above, this TN proposes a working definition of “financial inclusion” in Islamic finance as follows: “a state where individuals and businesses in a society have access to, and usage of, a range of affordable and quality *Sharī'ah-compliant* financial products and services that appropriately and justly meet their needs; and that are delivered by formal financial services providers in a transparent and simple manner *while duly complying with the rules of Sharī'ah*, thus enabling informed understanding and decision making by the customer.” The ultimate goal of both conventional and Sharī'ah-compliant financial inclusion is to enhance the livelihood of beneficiaries while contributing to the overall well-being of the society.

54. An important implication of the above definition is that it addresses the condition of voluntary financial exclusion due to faith-based reasons; this is a scenario where the financially excluded are not necessarily “unbankable” or “uninformed”; rather, they chose not to avail

themselves of presently available financial facilities whose mechanisms contravene certain religious beliefs.²⁵ Hence, for a number of jurisdictions,²⁶ the success of the commercial IFSI was due partly to its ability to attract voluntarily excluded bankable customers.

55. Hence, for the purposes of this TN, and generally regarding financial inclusion activities in Islamic finance, it is not only restricted to the low-income segments of society but may well include those “bankable” segments that are refraining from availing themselves of one or more of the financial services in the form of financing, savings, *takāful* products and investments, due to reasons of Shari’ah non-compliance of the operational mechanisms.

2.3 Types of Institutions and Regulatory Implications

56. A variety of institutions are involved in the provision of financial inclusion services – both formal and informal.²⁷ They differ in terms of their size, nature of risks taken, business models and operational complexities. In recent times, the progress made in FinTech has opened doors to even more considerations, reflecting evolving risks and multiple types of participants, products, services and distribution channels. Such developments make supervision of financial inclusion activities an even more complex and challenging task. This subsection discusses some of the regulatory and supervisory considerations based on the different types of institutions involved in financial inclusion activities.

2.3.1 Proportionality

57. The different types of institutions involved in financial inclusion mean that a “one-size-fits-all” approach to regulation and supervision is unsuitable. Hence, the TN encourages RSAs to adopt a proportionate approach to the regulation of institutions involved in financial inclusion activities. The intention is to ensure that regulations do not overburden certain institution types by way of increased regulatory compliance costs and by restricting competition and/or creating certain barriers to entry. These two factors are particularly important, since a recent regulatory and supervisory objective in financial inclusion has been to bring the mostly informal institutions within the regulatory ambit for the purposes of sound monitoring and stability of the financial system. Other non-prudential objectives include consumer protection and AML/CFT risk mitigation.

²⁵ See the discussion in paragraph 5 of this TN, as well as Table A in Appendix A-1.

²⁶ As identified in the survey of RSAs conducted as part of the due process in this TN's preparation.

²⁷ Compared to the traditional financial sector, financial inclusion activities may involve a wider variety of institution types ranging from established commercial institutions to branchless/agent banks, mobile network operations, and informal institutions such as NGOs, non-profit charitable institutions and so on.

58. A number of methods are currently being used by different regulators globally to introduce proportionality in a regulatory regime. Two specific approaches identified²⁸ are the categorisation approach and the specific standard approach.

- i. The *categorisation approach* involves establishing categories of institutions according to different qualitative and/or quantitative characteristics and applying a specific regulatory regime for each. These characteristics include size of financial indicators (e.g. assets, deposits, etc.), cross-border activity, and the risk profile of institutions. This approach enables the establishment of consistent prudential rules for institutions sharing similar characteristics in a particular jurisdiction and, accordingly, developing a commensurate approach for supervising the groups of institutions under each category.
- ii. The *specific standard approach* involves establishing tailored criteria for the application of specific requirements for a subset of prudential standards, such as disclosure requirements, liquidity ratios, large exposure limits and market risk. Hence, under this approach, exemptions or simplifications are made based on specific targeted areas of regulations, thus allowing a more granular tailoring of regulatory requirements that takes account of the specific characteristics of each institution or business activity and its overall risk profile.

59. In general, although different criteria may be used under either of the two approaches described above, the size of the institution in terms of financial indicators is a prominent feature. It is also possible to use a combination of these approaches, and the TN does not specifically recommend one over the other. The following sections provide generic recommendations on proportionality in relation to various activities in financial inclusion, and RSAs may adopt whichever approach is appropriate for their jurisdiction. In light of the activities-based approach taken in this TN, the implication for the *categorisation approach* would be to segregate institutions according to their activities/functions and risk profiles. With the *specific standard approach*, on the other hand, the requirements for prudential regulations would depend upon the institutions' activities and associated risk profiles.

60. Overall, the principle of proportionality needs to be recognised and applied at every step of the legislative and regulatory process so that existing and new legislation and regulations are applied to institutions involved in financial inclusion in a proportionate way. Specific to Islamic finance, the principle of proportionality also needs to be applied to the

²⁸ Adopted from Financial Stability Institute (August 2017), *FSI Insights on Policy Implementation No. 1 – Proportionality in Banking Regulations: A Cross-country Comparison*, Bank for International Settlements.

Shari'ah Governance Framework to help lower operational costs (see also discussion in section 2.2.3).

2.3.2 Inter-agency Coordination

61. The different institutional types also bring with them various other authorities²⁹ responsible for their licensing, registration, regulations and monitoring. The IFSB's survey of RSAs³⁰ identified several other organisations that had supervisory responsibility over financial inclusion activities by different institutions in a jurisdiction (see Table 2.3.2.1).

Table 2.3.2.1: Institutions with Supervisory Responsibility over Financial Inclusion Activities by Various Institutions*	
Service Provider	Supervisory Authority
Commercial banks	Central Bank, Banking Control Commission, Financial Services Authority
Other deposit-taking institutions	Ministry of Finance, Financial Services Authority
Non-bank financial institutions	Securities and Exchange Commission, Ministry of Labour and Social Development, Associations of Non-Bank Microfinance Finance Institutions, Banking Control Commission, Ministry of Commerce and Industry, Financial Services Authority
Microfinance banks/ micro-credit institutions	Microfinance Authority, Ministry of Finance, Central Bank
Pawnbroking firms	Financial Services Authority, Ministry of Finance, Central Bank
NGOs	Ministry of Justice, Ministry of Domestic Affairs

²⁹ Other authorities which are traditionally not understood to be central banks or securities and exchange commissions.

³⁰ The survey exercise was conducted from October to December 2017.

Cooperatives	Ministry of Labour and Social Development, Provincial Government, National Cooperative Financing Agency, Ministry of Cooperatives, Ministry of Agriculture, Cooperative Development Authority
FinTech/crowdfunding/mobile network-based operators	Central Bank, Securities and Exchange Commission, Ministry of Communication/Communications Authority

** Not all activities mentioned in the table may be Shari'ah-compliant, as the table is simply a representation of some of the practices in some jurisdictions.*

Source: IFSB RSAs Survey 2017 (as part of the TN-3 due process), IFSB Summit 2017 proceedings

62. Importantly, the presence of several authorities having a mandate over, and supervisory responsibility for, institutions involved in financial inclusion activities calls for a strong inter-agency coordination mechanism. This TN strongly recommends the establishment of a coordination body, either as a separate new forum or by empowering and enhancing the role of any existing inter-agency coordination committee within a jurisdiction to champion and coordinate the various other agencies on financial inclusion initiatives. A specific agency may be designated to lead the efforts for inter-agency coordination on financial inclusion (e.g. a central bank may set up a new committee or leverage by empowering an existing one). The body may establish subcommittees as appropriate, and comprising members nominated from various agencies, tasked with specified functions and responsibilities of the overall financial inclusion agenda.

63. This coordination body shall monitor that national financial inclusion targets (if any) are being achieved in a timely manner, and that duplication of effort and overlaps in responsibilities are avoided to ensure the efficient implementation of the financial inclusion mandate and achievement of its objectives. Furthermore, there is a need to have uniformity of regulatory standards for similar activities across different institutions to minimise regulatory arbitrage.

64. Recent progress made in FinTech and digital financial inclusion platforms³¹ also brings together several participants from different industries in the common pursuit of financial inclusion activities. Importantly, this sometimes includes participants from outside the financial sector – for example, mobile network operators, which are required to comply with non-financial sector regulatory regimes and, hence, are supervised by different authorities from those in the financial sector. Effective inter-agency coordination becomes even more

³¹ See the related discussion in section 2.3.4.

significant in such situations to prevent ambiguities and overlaps that can lead to conflicting regulations for service providers. Where jurisdictions implement the Islamic social finance models to support financial inclusion (see Section 7), the coordination body may also include authorities that have a mandate over these activities/institutions (e.g. ministries of religious affairs, oversight bodies, etc.).

65. The coordination body, or a specific committee within it, shall be tasked to ensure that regulations for participants from different industries in financial inclusion activities are implemented smoothly, and do not create ambiguities. Importantly, the committee has to oversee, and intervene if necessary, to ensure that situations of conflicting regulations and/or regulatory arbitrage³² are properly mitigated.

2.3.3 *Regulatory Arbitrage*

66. The implementation of different regulations for a particular activity (e.g. financial versus non-financial sector regulations for financial inclusion activities) creates regulatory arbitrage risks if they are not properly managed and/or coordinated by the various authorities involved.

67. For example, regulatory arbitrage risks may arise when regulations by an authority for a specific activity are simpler than those by another authority for the same activity carried out by institutions in different sectors – this can be termed as “cross-sectoral arbitrage” (e.g. less restrictive regulations for financial cooperatives compared to microfinance banks which provide an incentive for the financial cooperatives to keep their legal form although by the substance and risk of their activities they should register and be regulated as microfinance banks).

68. In all instances, “regulatory arbitrage” describes a situation where a particular service provider attempts to benefit from the relaxed regulatory regime without there necessarily being a corresponding reduction in the underlying risk, hence earning itself an undeserving advantage even though the risk exposures have become insufficiently regulated.

69. Regardless of the manner adopted by a service provider, the risk increases and poses a threat to financial stability when exposures are not in appropriate reach of the supervisory authority. The risks associated with regulatory arbitrage are particularly exacerbated in financial inclusion activities, given the presence of several sectoral authorities (such as those responsible for financial consumer protection or market conduct, telecommunications, competition and data protection), leading to greater risks of supervisory overlaps, gaps,

³² See the related discussion on regulatory arbitrage in section 2.3.3.

inefficiencies and uncertainty, especially with innovation and rapid market evolution in many countries. Thus, the concepts of inter-agency coordination and risks of regulatory arbitrage are very closely interlinked.

70. The TN recommends an inter-agency mechanism to achieve harmonisation in rules regarding specific activities in financial inclusion. This harmonisation reduces incentives for service providers to use strategies to avoid supervision by a specific authority since it would result in rules of similar strength by different authorities.

2.3.4 *Digital Financial Inclusion (FinTech)*

71. Digital financial inclusion involves the deployment of digital means to reach financially excluded and underserved populations with a range of formal financial services. The concept is particularly noteworthy, and is rapidly gaining traction, since it enables formal financial institutions to reach previously unserved areas (e.g. rural areas, suburbs, villages) in an efficient and cost-effective manner. Reduced operational expenditure (e.g. by avoiding setting up physical branches) also enables service providers to potentially lower transaction costs for the customer, thus increasing affordability and usage.

72. However, digital financial inclusion presents a potential new set of operational, settlement, liquidity, credit, consumer protection and money laundering and financing of terrorism (ML/FT) risks requiring an unorthodox regulatory and supervisory approach by the RSAs. A number of factors³³ contribute to the specific risks of FinTech platforms versus those associated with traditional financial institutions:

- i. *New providers and new combinations of providers:* FinTechs usually comprise new service providers, either exclusively or in partnership with existing financial services institutions. Accordingly, consideration of differentiated licensing regimes may be required. Setting proportionate requirements for licensing and regulation and determining the best approach for supervision is challenging, with new institutional types, especially those that are reliant upon other financial and non-financial firms for important aspects of their business. Issues of liability, dispute resolution, redress, and enforcement of rules also arise when a financial product is delivered by one type of provider (e.g. a mobile network operator) but resides on the balance sheet of another (e.g. a commercial bank). Having multiple providers also increases the risks regarding data security and privacy.

³³ Based on 2016 GPFI White Paper, "Global Standard-Setting Bodies and Financial Inclusion", Part IV.A.

- ii. *New products and services:* Digital financial inclusion typically introduces new products and services (e.g. web-based crowdfunding, peer-to-peer fund transfers, etc.) that require a specific regulatory approach based on their structure and characteristics. FinTechs also often bundle their financial services with other financial and non-financial products and services (e.g. a payment system facility with ride-hailing/taxi services). This bundling adds the challenge of combining multiple regulatory guidelines of different industries into a meaningful framework for such FinTechs. Importantly, policy and regulatory clarity is essential to ensure that responsible financial innovation takes place.
- iii. *Financially excluded and underserved customers:* These sets of customers, particularly those among the low-income segments, are usually inexperienced with formal financial services and may not be adequately familiar with the use of digital technology. They may also have limited literacy and numeracy. Such customers may also not be aware of their own rights as consumers and are vulnerable to exploitation by providers and their agents. Hence, consumer protection issues are of utmost importance for this segment of customers and go somewhat beyond the scope of traditional financial inclusion and microfinance activities. RSAs will need to have in place a robust consumer protection regime that is complemented by effective financial literacy programs.
- iv. *Digital technology:* Digital financial services rely on digital means of communication, from the offering and delivery of a product through the entire product life cycle, including complaints handling. The digital technology may vary in quality, impacting on data privacy and security. Online risks, including hacking, give rise to concerns about data security and privacy breaches, and about how traditional supervision (e.g. offsite and onsite supervision and external audits) is to be conducted when platforms are based on digital technology. Importantly, network integrity is also of the utmost importance, particularly in jurisdictions where mobile money has gained a sizeable volume of transactions, and strong protocols are essential to ensure foolproof digital security. Hence, RSAs may need to encourage financial institutions to share best practices in technology risk management, coordinate efforts to mitigate cyber risks and allow confidential exchange of intelligence on cyber threats.
- v. *Use of agents:* Agents and agent networks may introduce new risks, particularly operational risks, many of which are due to the outsourcing of core banking functions to agents by the financial services providers and the resulting challenges to effective training and oversight and recourse mechanisms. This, in turn, introduces an increased

risk of fraud and theft, lack of transparency, and misappropriation due to customers' lack of knowledge, poor cash management by the agent, and failure to handle customer data confidentially. In addition, agents may not be well-trained in, or may for other reasons fail to comply with, AML/CFT obligations, including performing customer due diligence, handling records and reporting suspicious transactions. Hence, RSAs need to ensure that risk management practices for outsourcing arrangements remain effective amid intensification of technological advances in a more globalised and digitised environment, while enabling more flexibility in arrangements to facilitate innovation.

73. Aside from the above general factors, the processes, subject matter and transactional modalities of FinTech platforms in Islamic finance must be in compliance with Shari'ah.³⁴

74. Hence, digital financial inclusion has introduced a new regulatory challenge for the global financial industry regulators and standard-setting bodies.³⁵ For established financial institutions, ex-ante regulations whereby certain rules and standards are a condition for setting up operations are appropriate. However, for new start-up institutions, including FinTechs, the ex-post regulatory model may be appropriate, since these institutions are smaller in size and the risks are not well understood. The ex-post regulatory framework would involve minimal regulations initially for smaller start-ups. As the institutions grow in size and the risks become better understood, more stringent regulations are imposed.³⁶ The ex-post regulatory framework recognises proportionality by using a "test-and-see" approach for regulating newer types of institutions, including FinTechs, which promote inclusive financial services.³⁷

75. Accordingly, a number of RSAs have responded by way of introducing regulatory sandboxes that enable the authorities to improve their understanding of the business models and risks of FinTechs. The aim of the sandbox is to allow firms to test innovative products, services and business models in a controlled market environment, while ensuring that appropriate safeguards are in place. To that extent, sandboxes enable both the RSAs and the FinTechs to experiment with a view to finding an appropriate mix that encourages the development of innovative financing techniques while protecting customers and maintaining financial stability. More streamlined and embedded regulations on FinTech are likely to follow

³⁴ See the discussion in section 2.2.

³⁵ For example, what licensing and capital requirements should apply to the entity that owns the website providing the platform? What AML/CFT guidelines or other client identification requirements should apply, and who should bear responsibility for satisfying them?

³⁶ Stijn Claessens and Liliana Rojas-Saurez (2016), *Financial Regulations for Improving Financial Inclusion*, Center for Global Development,

<https://www.cgdev.org/sites/default/files/CGD-financial-regulation-task-force-report-2016.pdf>

³⁷ United Nations ESCAP (2017), *Financial Regulatory Issues for Financial Inclusion*, https://www.unescap.org/sites/default/files/S6_Regulatory-Issues-for-FI.pdf

based on RSA experiences through the sandbox; however, this may be difficult if FinTechs keep evolving and coming out with newer products and services.

76. Overall, regulation and supervision of digital financial inclusion activities is a developing area and the TN, in its various guidelines, duly highlights specific considerations and/or treatments that may be essential for FinTechs and that differ from the typically non-digital financial inclusion activities.³⁸

2.3.5 *Guidelines for Mixed Businesses*

77. A specific challenge in Islamic finance also arises when service providers operate both conventional and Sharī'ah-compliant businesses.

78. "Mixed businesses", for the purpose of this TN, refers to service providers that have both Sharī'ah-compliant and conventional products and services related to financial inclusion. For instance, a crowdfunding platform may support fund-raising activities by both interest-based mechanisms as well as Sharī'ah-compliant alternatives. Importantly, for the purpose of this discussion, a "service provider" is one single legal entity operating both Islamic and conventional financial inclusion activities, but observing the approved Sharī'ah parameters related to the separation of funds and profit/loss accounts.

79. While the commercial IFSI has particular established guidelines in relation to the rules and regulations regarding mixed businesses,³⁹ their implementation is likely to be a costly exercise, particularly for the smaller service providers in financial inclusion. The guidelines in various sections of this TN are also applicable to such mixed businesses for the Sharī'ah-compliant portfolio. However, the implementation and applicability is to be determined by the relevant local RSA, keeping in view the market infrastructure available for supporting regulatory requirements in a Sharī'ah-compliant manner, as well as the cost implications. As a result, a proportionate approach also needs to be determined in terms of applicable Sharī'ah-specific prudential and non-prudential requirements from operators of mixed businesses.

80. Regardless of the above, the mixed-business operators of financial inclusion activities must comply with some basic operational requirements. The operator has to ensure separation of funds – to the extent that the financing, investment or deposit-raising activities of the Sharī'ah-compliant business are not co-mingled with conventional funds. This aspect is

³⁸ The IFSB has also launched a work stream on FinTech, RegTech and SupTech, and plans to issue a working paper in the near future that will address the subject in detail and more precisely.

³⁹ For example, separation of funds in banking and *takāful* businesses (Islamic window guidelines) and Sharī'ah screening methodologies in the capital markets (screening for prohibited activities, purification of tainted income, etc.).

particularly important for deposit-taking institutions, where funds raised through Sharī'ah-compliant mechanisms must be used for Sharī'ah-compliant financial intermediation or invested in Sharī'ah-compliant assets.

81. In the case of non-deposit taking service providers engaged in Sharī'ah-compliant microfinancing, their source of funds may be donations, grants or other sources of funds that may not necessarily have been earned in a Sharī'ah-compliant manner. The only requirement in this situation (and subject to permissibility of such an arrangement under the application of Sharī'ah principles in the relevant jurisdiction) is to ensure that the microfinancing activity on the assets side is conducted in a fully Sharī'ah-compliant manner.

82. The supervisory authority must have appropriate mechanisms to supervise and mitigate any risk that the above guidelines are not met by mixed-business service providers. Such service providers must satisfy the supervisory authority that they have in place an effective and robust internal system that achieves a separation of the Islamic and conventional transactions, and that the business activities claimed to be Sharī'ah-compliant are in fact truly in compliance with Sharī'ah rules and principles, with appropriate risk management policies and practices in effect.

83. Where applicable and enforced by the local authority, the mixed-business operator must also ensure that its Islamic financial inclusion business complies with the various guidelines for Sharī'ah-compliant financing, investment and deposit-taking activities set out in this TN. This requirement includes both prudential and non-prudential guidelines relating to capital adequacy, liquidity management, resolution and insolvency, consumer protection, corporate governance, etc.

2.3.6 *Islamic Social Finance*

84. An additional consideration in relation to financial inclusion and poverty alleviation activities in Islamic finance is the presence of Islamic social finance institutions that utilise social solidarity instruments⁴⁰ for their activities. The IFSB survey carried out to support preparation of this TN identified several countries with *waqf* institutions, Islamic foundations, and other types of charitable organisations/NGOs utilising social solidarity instruments for financial inclusion as well as poverty alleviation activities.

85. However, an overwhelming majority of the RSAs also indicated that these social finance activities fell outside the regulatory ambit of all the financial sector RSAs in the

⁴⁰ See Figure 2.2.1 in this TN and the discussion in section 2.2.5.

jurisdiction and were registered and supervised by separate and specialised ministries/religious councils. Some RSAs also suggested that these institutions were not established from a financial inclusion perspective but more for charity purposes – and, hence, did not require financial sector regulations.

86. An emerging practice in Islamic finance is the integration of social solidarity instruments by the commercial IIFS into their products and services. The IFSB survey for this TN identified a few countries where IIFS utilised, for instance, temporary cash *waqf* to offer specialised deposit products to customers. These products had a fixed maturity period during which the profits were earmarked for certain social and charitable projects; at the end of the maturity period, the depositors could withdraw their temporary cash *waqf* placements.

87. Although this trend is still relatively new, with only a few practical cases, it does mark a direction of regulatory interest that requires corporate governance standards and supervision by the RSAs.

88. Recognising the development phase of this integration of Islamic social finance into the commercial IFSI, the TN discusses this concept and its related implications in Section 7. It approaches the discussion from an exploratory perspective, highlighting the current modalities in practice through specific country case studies and proposing commensurate regulatory frameworks for their supervision. It also discusses feasible product mechanisms supported by Islamic social finance contracts, as well as their usefulness for achieving the objectives of financial inclusion.

89. Overall, while various guidelines in this TN are not directly intended for Islamic social finance institutions, the specific authorities with a mandate over them may consider utilising some or all of these recommendations, as applicable, for their supervision. On the other hand, the commercial IFSI is expected to comply with the various guidelines in different sections. Therefore, the guidance in Section 7 specifically addresses Islamic commercial financial institutions that utilise Islamic social finance contracts to offer certain products and services.

SECTION 3: FINANCING ACTIVITIES – REGULATION AND SUPERVISION

90. This section of the TN outlines the key prudential regulatory and supervisory guidelines for Sharī'ah-compliant financing activities⁴¹ undertaken for the specific purpose of achieving financial inclusion objectives. The section provides the Sharī'ah parameters that the service providers in financial inclusion initiatives are expected to comply with in order for their products and services to qualify as Sharī'ah-compliant. It also discusses specific recommendations for the proportionate implementation of regulations for supporting the Sharī'ah-compliant financing activities by various institutions involved in financial inclusion.

3.1 Permissible and Impermissible Activities

91. Financing activities in financial inclusion comprise a variety of forms and mechanisms ranging from plain-vanilla microfinance loans and financing of specific asset purchases (e.g. equipment) through to working capital financing (e.g. spot payment for deferred delivery of commodities) and other means such as transfer of credits for purchases (e.g. mobile network credits that can be sold for cash or exchanged for goods).

92. Under all circumstances, regulatory/supervisory authorisation of financing activities in Islamic financial inclusion initiatives can only be extended by the relevant authority under the condition that the (a) product structure, (b) operational mechanism, and (c) overall objectives of the financing transaction by the service provider do not contravene the principles of Sharī'ah⁴² (as ascertained by a competent approval authority – see paragraph below). These conditions apply to all types of service providers that claim to offer Sharī'ah-compliant financial inclusion products and services and are under the relevant authority's mandate. The service providers who operate mixed businesses (both Sharī'ah-compliant and conventional) are required to comply with the guidance in section 2.3.5 as put into effect by the relevant authority.

93. In order to satisfy itself that the service provider meets the condition in the paragraph above, the supervisory authority may require it to seek either: (i) approval of its financing products and services by a centralised approval authority on Sharī'ah where available (e.g. a centralised Sharī'ah board); or (ii) the opinion of and endorsement by a Sharī'ah body.⁴³ The actual requirement by the authority out of the two options above will be on a proportionality

⁴¹ This section, however, does not consider equity-based financing activities, which are discussed in Section 5 of this TN.

⁴² See the relevant discussion in section 2.2.

⁴³ This may be a Sharī'ah board comprised of three or more scholars, an external Sharī'ah advisory firm or an individual Sharī'ah scholar. See the discussion in section 2.2.3.

basis, depending upon the size, complexity, affordability and riskiness of the service provider. Regardless of the supervisory approach, the authority will require the service provider to transparently disclose the basis for its claim as to the Sharī'ah compliance of its financing product.

94. Premised on the above, all financing activities and/or service providers in financial inclusion that do not comply with the requirements in paragraphs 92 and 93 will be deemed to be “impermissible”.

95. The relevant authority may also undertake to restrict some other activities – for example, foreign currency financing, real-estate purchases, etc. However, these activities may be universally applicable to both Sharī'ah-compliant and conventional financial inclusion activities. In addition, where an institutional approach to regulations is undertaken, regulations may also limit the scope of activities by different types of service providers. Once again, these activities will be universally applicable and not raise any specific Sharī'ah issue other than what has already been highlighted in this subsection.

3.2 Financing Modes and Instruments

96. The prohibition of *ribā* (interest) in Sharī'ah entails that loaning of cash may only be done at par value, and without any pre-specified additional consideration between the contracting parties. Hence, the use of “*qarḍ*” (loan) in Sharī'ah-compliant financial inclusion activities may generally be in a social context, without any expectations of returns beyond the repayment of the loan. Actual costs incurred in disbursing funds to the borrower, however, may be included in the *qarḍ*-based financing, as allowed by the approval authority.⁴⁴

97. For any financing activities with an expectation of return, Sharī'ah provides a number of contracts that can be utilised to support financial intermediation. These include sale-based contracts that allow financing through the sale of underlying asset(s), usually in exchange for deferred payment of the price in instalments. The commonly used Sharī'ah-compliant sale-based contracts for financing activities include *murābahah*, *salam*, *istiṣnā'* and commodity *murābahah*.⁴⁵

98. Financial intermediation may also be undertaken through lease-based contracts consisting of periodical rental payments and a binding promise to conduct a sale that transfers

⁴⁴ Here, and elsewhere in this document, the approval authority on Sharī'ah matters is either of the two options specified in paragraph 93 of this TN, and as appropriate to the service provider based on regulatory guidelines.

⁴⁵ For the meanings of these and other Sharī'ah contracts and terminologies commonly used in Islamic finance, see the IFSB Glossary available at: www.ifsb.org/terminologies.php

ownership of the leased asset to the lessee at the end of the lease period. The Sharī'ah-compliant contract of leasing is *ijārah*, with some variations including *ijārah muntahiyah bi al-tamlīk*, *ijārat al-khadamāt* and *ijārah mwşūfah fi al-dhimmah*. Other types of contracts include fee-based ones (e.g. *wakālah*), guarantee contracts (*kafālah* and *rahn*) and equity-based types (*muḍārabah* and *mushārah*).

99. Financial services providers in Sharī'ah-compliant financial inclusion activities may utilise any of these contracts – as a stand-alone contract supporting the product structure, or through financial innovation, achieving a hybrid product structure combining two or more of these contracts – provided that the overall outcome results in achievement of the conditions specified in paragraphs 92 and 93 of this TN.

100. The guiding principle in all circumstances is that the service provider must satisfy the supervisory authority that its financing mode and instruments are in conformity with Sharī'ah, and that the product disclosure sheet duly clarifies the rights and responsibilities of the contracting parties, commensurate with the type of contract utilised (e.g. payment obligations in sales or lease contracts).

101. The supervisory authority must also reasonably satisfy itself that the product structure, as proposed by the service provider, is in fact practical, and not merely paperwork to seek Sharī'ah and regulatory approval. This requirement is to avoid situations where a product is, for instance, approved on a *murābahah* basis involving buying and selling of a subject matter, but in fact the service provider simply provides funds to the client without any actual sale and purchase of that subject matter.⁴⁶

3.3 Prudential Regulations

102. Prudential regulations in the commercial banking sector are normally imposed on deposit-taking institutions for the purposes of maintaining appropriate checks and balances on riskiness of exposures, as well as to maintain a capital buffer to absorb losses on the assets, and to lower the risk of depositors not receiving their full due claims. The overall objective is to prevent institutions from failing and to maintain financial stability in the system. This objective is also applicable in the context of financial inclusion activities based on financing structures that require the counterparty to perform regularly on its instalments/obligations – hence, attracting credit risk to the transaction.

⁴⁶ This requirement is discussed further in section 3.4.2, 'Supervisory Tools and Enforcement Mechanisms'.

103. The key consideration, however, is whether institutions that specialise in financial inclusion activities should follow the prudential requirements applicable to Islamic commercial banks⁴⁷ or have a tighter or lower requirement as compared to these banks – for example, for the capital adequacy ratio.

104. In general, there is no uniform practice by national regulators globally; however, in most of the cases observed, prudential regulations are only applied by authorities on deposit-taking financial inclusion institutions (e.g. microfinance banks), while non-deposit-taking institutions (e.g. micro-credit institutions) are only required to follow the non-prudential regulations.⁴⁸

105. Within the context of prudential regulations, there is currently no international standard-setting consensus on approaching minimum capital and other requirements for service providers specialising in financial inclusion activities. Different jurisdictions have approached the issue in their own tailored manner, reflecting the very different environments in which the service providers operate. Some countries have applied a relatively simple prudential regulatory regime,⁴⁹ while others have adopted the minimum capital requirements as set by the international standards for the banking sector. There is, again, no consensus on what would be the components of capital for institutions specialising in financial inclusion activities.

106. The guiding principle recommended by this TN is that service providers which mobilise deposits from the public for the purpose of financing activities should be regulated under both prudential and non-prudential guidelines. The extent of prudential regulations will be commensurate with the size, complexity and type of financing activities⁵⁰ undertaken by the service provider. Nonetheless, the prudential regulations should cover all important aspects, including capital adequacy, liquidity requirements, risk concentrations, financing limits, provisioning requirements, credit enhancement mechanisms, etc. The supervisory authority should also have in place a mechanism for regular reporting by the deposit-taking service provider and, when necessary, on-site inspection rights by law.

⁴⁷ For example, financial sector regulations benchmarked to Basel III and IFSB-15 guidelines.

⁴⁸ There are known exceptions in some countries where non-deposit-taking institutions are required to comply with prudential regulations. These, however, are classified as going beyond the recommended requirements.

⁴⁹ For instance, some countries have approached capital regulations by setting limits on the aggregate amount of all deposits and advances by the institution in relation to its core capital. Such types of ratio are a cruder measure than the capital adequacy ratio, as it does not use risk weights to reflect the differences in risk associated with different kinds of assets.

⁵⁰ Here, a distinction may be made between the types of activities that a service provider is allowed to undertake – for example, small-sized financing, credit guarantees, asset-purchase financing, etc. Hence, the prudential requirements will vary, depending upon the permissibility of the activities.

3.3.1 Risk Management Framework

107. All institutions involved in financing activities must generally have robust and integrated risk management frameworks, regardless of whether the service provider is a deposit-taking or non-deposit-taking institution. This is to sustain the going-concern viability and reputation of the institution, whether it is a for-profit or a non-profit service provider. The regulatory emphasis, however, is mainly on deposit-taking institutions for reasons of depositor protection⁵¹ and financial system stability. Effective supervision may also be conducted only on deposit-taking institutions for reasons of costs versus benefits/implications to the financial system as a whole.

108. The TN recommends that all service providers in Islamic financial inclusion financing initiatives have in place appropriate policies, systems and procedures to identify, measure, monitor and control their risk exposures. This recommendation is applicable to both for-profit and non-profit service providers whose financing facility imposes payment obligations on the client. Each service provider should have in place an internal control system designed in accordance with its size and complexity, and the nature of its operations. However, service providers at a minimum should ensure that their internal control systems comprise a control environment, risk assessment, control activities, self-assessment and monitoring, as well as accounting, information and communication.

109. The service provider should also have in place an information technology- (IT-) based risk management system that keeps track of, and files, details of the outstanding obligations of its clients, their personal particulars (e.g. in line with applicable AML/CFT requirements), their intended use of the funds received, copies of identity documents of the clients and guarantors (where applicable), and other relevant documents in support of the financing facility extended. Appropriate backups of such files should be stored in a safe location. Where it is not feasible to have an IT-based system, any other manually established bookkeeping system may be used, although any manual system put in place for the purpose of bookkeeping or general monitoring of financing activities is fraught with operational risks; hence, more diligence and care should be observed when handling sensitive and confidential data in a manual set-up.

110. Depending upon the types of financing activities undertaken by the service provider, the risk management system in place should recognise the general risks (e.g. credit risk, market risk, operational risk) as well as specific risks, including Shari'ah non-compliance risks.

⁵¹ Regulations for deposit-taking institutions from a liquidity risk perspective are discussed further in Section 4 of this TN.

For the purposes of establishing the risk management parameters, the service providers may rely on guidance provided by appropriate IFSB standards⁵² or other standards published by international standard-setting bodies,⁵³ or may base it on their local regulatory guidelines.

111. An important consideration, however, is how regulations will specify the rigorousness of the risk management framework, as well as the external audit and validation requirements for different types of service providers. Proportionality⁵⁴ will be an important guiding principle in this regard when approaching risk management and audit regulations, as well as the extent of supervision, for the various service providers in Sharī'ah-compliant financial inclusion initiatives. Effective and ongoing supervision may also be reserved only for deposit-taking institutions, while non-deposit-taking institutions may utilise other forms of monitoring (e.g. through independent boards, corporate governance committees, etc.).⁵⁵

112. In all circumstances, the risk management framework and its monitoring will feed inputs towards the implementation of the various prudential guidelines applicable to the service provider, and hence appropriate regulatory and supervisory clarity needs to be in place to assure some mechanism which can validate the soundness of the risk management system in place at the service provider.

3.3.2 Capital Requirements

113. For the purposes of capital requirements on service providers offering Sharī'ah-compliant financial inclusion activities, this TN benchmarks to the minimum capital requirements as set out in Sections II and III of IFSB-15,⁵⁶ including for nine classes of Islamic financing assets as described in Section IV of that standard, taking into account both credit risk and market risk as appropriate. These minimum capital requirements may be updated by the IFSB from time to time, and the TN is understood to refer to the latest guidelines as and when available.

114. The regulatory authorities have due discretion to approach the minimum requirements set out in IFSB-15 on a proportionate basis, reflecting the specific activities allowed to be undertaken by the service provider. For instance, a service provider that is permitted to offer

⁵² For instance, IFSB-1: *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services (IIFS)*. Available at: <https://www.ifsb.org/download.php?id=4357&lang=English&pg=/published.php>

⁵³ Such as BCBS, IOSCO, FATF, etc.

⁵⁴ See the preliminary discussion in section 2.3.1 of this TN.

⁵⁵ Specific discussion on corporate and Sharī'ah governance is provided in section 6.2.4 under non-prudential guidelines.

⁵⁶ Available at: www.ifsb.org/download.php?id=4371&lang=English&pg=/published.php

almost all the financial services of banks, including current accounts, is likely to have a full implementation of the minimum requirements set out in IFSB-15.

115. In all circumstances, the regulatory authority needs to achieve a balance between the objectives of financial safety and financial access when setting the minimum capital requirements; an overly burdening capital requirement will restrict the financing ability of the service provider, while a too relaxed capital requirement may put the depositors and the financial system at risk.

116. The regulatory authority may also introduce additional indicators for capital adequacy purposes, or require the service providers to hold additional capital if the authority considers appropriate in respect of market or concentration risk and other specific risks.

117. Specific to the case of FinTechs and crowdfunding platforms, while this is a developing area, at present, these platforms are usually identified to be non-deposit-taking institutions since their sources of funds for financing activities may either be investment/equity-based (where funding clients absorb losses, if any) or through donations/contributions, which may not involve repayment to the fund providers.

118. In the first instance, when sources of funds are equity-based, the emphasis in prudential regulations will mainly be on operational risk; hence, capital requirements on the service provider will be for operational risks that may potentially require the service provider to absorb losses as a result of its negligence or misconduct. In the second instance, where donor-based funds are used for financing activities, the emphasis is mainly on non-prudential regulations; hence, capital requirements may not be imposed upon the service provider.

3.3.3 *Financing Limits*

119. A common regulatory feature for institutions specialising in financial inclusion activities is to introduce financing limits. These may be, for instance, a maximum credit transaction size, expressed as a percentage rate of capital held by the institution (e.g. maximum financing size of 10% of total capital to a single client), or simply an absolute amount (e.g. USD 2,000 to a single client). Limits may also be applied in relation to exposures to specific economic sectors (e.g. low-cost housing, FinTech start-ups, etc.), type of clients (individuals, MSMEs, etc.), aggregate limits on a group of clients (e.g. exposure limit of 20% of total capital for the five largest clients) or even in relation to the duration for which the financing is extended (e.g. a maximum of two years).

120. Financing limits may be imposed either on specialised institutions for financial inclusion activities, or on activities by other types of institutions/service providers that wish to offer financial-access products.

121. The TN encourages implementation of financing limits, commensurate with the specific country, region and sector context in which the financial services provider operates. These limits serve as useful prudential regulations that achieve the mitigation of concentration risk while also enabling the supervisory authority to clearly identify activities (or institutions) that are eligible to benefit from a proportionate regulatory treatment. Financing limits also protect the financial system from instability risks due to overexposure to a specific segment, the non-performance by which could lead to the service provider's failure and potentially to spillover effects in the system.

122. Given the heterogeneities in jurisdictional and sector-specific contexts, the TN is not in a position to prescribe recommended limits for financing activities in financial inclusion, and these are expected to vary between countries and within different economic sectors. For instance, an absolute financing limit (e.g. USD 500) may have different implications for different countries depending upon their level of economic development, currency power, purchasing-power parity considerations, etc.

123. Some of the considerations in deriving such limits by the regulatory authority will include the type of client; for instance, financing limits for individual financees may be lower (either as an absolute limit or as a percentage limit to total capital) than for groups of financees or MSMEs. This treatment recognises that the financing needs of groups of financees and MSMEs are typically larger than those of individuals.

124. The authority may also enable more than one window of regulations – for instance, based on size of capital – which will segregate service providers into different categories, and with each category attracting a different financing limit. As the service providers move into higher categories, they will benefit from a relaxation in the financing limit to enable them to offer comparatively larger-sized financing products and services.

3.3.4 *Provisioning*

125. Setting aside provisions for financing portfolios of deposit-taking institutions is a common prudential regulatory requirement. However, the terms of the financing activities by service providers specialising in financial inclusion may differ slightly from those offered by the traditional deposit-taking financial institutions.

126. Financing activities in financial inclusion usually involve more frequent instalment payments (e.g. daily) and shorter financing maturities (e.g. from one month to a maximum of two years). For instance, a microfinance arrangement for a three-month period, unsecured by collateral and with weekly scheduled payments, presents a higher likelihood of default in the event of two months of non-performance than a five-year car finance arrangement, payable monthly and secured by the car itself as collateral.

127. Hence, this TN recommends a proportionate approach to setting aside provisions for financial inclusion-specific financing activities premised on four factors: (i) maturity, (ii) frequency of instalment payments, (iii) collateral, and (iv) probability of default. As seen in the example above, such types of financing are typically extended for shorter durations (maturity), require more frequent instalment payments (frequency), are usually unsecured (collateral) and potentially present a higher likelihood of default (probability of default).

128. For such products and services characterised by the four factors above, two types of provisions should be set aside by the service provider: a general provision on the whole outstanding financing portfolio, and specific provisions depending upon the number of days payments of instalments are overdue.

129. The exact nature of specific provisions is likely to vary between countries, depending upon their local regulations, accounting standards and sector-specific contexts, as well as the permissibility of activities and financing limits and maturities imposed. However, the specific provisioning rates will be higher in percentage terms, as well as quickly moving to a full 100% for a lesser number of days overdue, than stipulated by the traditional regulations for the banking sector. For instance, specific provisioning may start as soon as one day after a payment is missed, and reach 100% as early as 90 days from non-payment.

130. Different provisioning schedules may also be used for financing that has non-performed for the first time in comparison to serial non-performing accounts. This approach takes into account the higher risk of non-payment for accounts that have already not been performing regularly.

131. A simpler “basket approach” may also be utilised where provisions are set aside for the total outstanding financing amounts at each risk grade (substandard, doubtful and loss), and not on an individual financing account basis. Such an approach makes calculation of provisions less tedious, particularly if the service provider has many financing accounts and does not have in place a robust IT system to support its calculations.

132. Yet another option for specific provisions is to base them on the number of instalments missed, which is assumed to be a better indicator of risk than the number of days or months payments are overdue.

133. In all circumstances, the service provider is expected to review its total exposures and assess changes in the riskiness of its assets as frequently as every month, and to make appropriate adjustments to the provisions set aside. The service provider should also send to the supervisory authority, at least once every three months, its schedule of total exposures, showing the provisions made for losses or deterioration in the quality of its risk assets. However, the frequency of this reporting may vary, depending upon the size, nature and complexity of the service provider. The supervisory authority may also have in place other mechanisms, such as on-site supervision, as and when it feels appropriate.⁵⁷

3.3.5 *Credit Enhancement Mechanisms*

134. The “bankability” of clients (whether individuals, groups or MSMEs) for financial products and services can be “credit enhanced” through various mechanisms that are intended to reduce their credit risk and enable clients to avail themselves of a service provider’s financing facility. The simplest way is through availability of collateral. However, the consumers targeted by financial inclusion initiatives often have little or no collateral to support their application. Credit enhancement may also be through third-party guarantees provided by another “bankable” individual or institution (e.g. specialised government agencies that usually provide guarantees for specific financing, such as for women, agriculture, etc. – see case studies for such guarantees in Appendix A-3, “Application of Proportionality in Practice”).

135. In normal circumstances, the mechanism for credit enhancement in financial inclusion activities through Islamic finance must be Sharī’ah-compliant and in conformity with guidance specified in paragraphs 92 and 93 of this TN. However, subject to approval by the relevant approval authority,⁵⁸ an exception to this requirement may be made to the credit enhancement mechanism if the product or service itself and the objective of the financing transaction complies with the principles of Sharī’ah. This exception is made only when a client wishes to avail themselves of Sharī’ah-compliant financing for a permitted (*halal*) activity but possesses only Sharī’ah non-compliant collateral (e.g. interest-bearing government securities or conventional savings instruments).

⁵⁷ Discussed further in section 3.4.

⁵⁸ See footnote 43.

136. This exception is given on the basis of public interest (*maṣlaḥah*), since the main financing contract and its intended activities are Sharī'ah-compliant, but for the benefits to be derived from credit enhancement, the contracting parties agree to utilise a Sharī'ah non-compliant collateral. A further consideration in this exception is that in an event of default, the service provider will have rights to recover its outstanding amount from the client through the principal portion of the collateral (excluding any interest-based income), while any excess from the principal portion and the interest-income portion in total is to be returned to the client. This part of the exception will also only be applicable to financing activities categorised as financial inclusion initiatives.

137. A further option for the client is to secure a third-party guarantee from either a conventional or a Sharī'ah-compliant institution.⁵⁹ Aside from the above, in the conventional microfinance industry, some service providers supporting financial inclusion initiatives have also put in place group-based lending practices whereby a financing facility to an individual client is secured by a group of consumers – usually close relatives, associates, and fellow residents in villages and communities. There are a number of variants of the group-based lending modalities as practised in different jurisdictions, and some regulators may opt to recognise these guarantees as “collateral” or a “credit enhancement mechanism”. Where such recognition is accorded by the regulatory authority, the client may benefit from a lower credit risk rating if the financing is extended on the basis of a group guarantee.⁶⁰ In the specific case of Sharī'ah-compliant group-based financing practices, these need to be reviewed and approved by an approval authority.

3.3.6 *Resolvability and Insolvency*⁶¹

138. Issues surrounding resolvability and insolvency of service providers in financial inclusion activities will be under the purview of the country's legal system. Most countries do not have specialised courts for Islamic finance, and disputes and defaults are handled by the civil courts. Nonetheless, a few countries have enacted laws where civil courts are required to refer to guidelines on Sharī'ah-compliant financial activities by the regulatory authority; these are countries that have in place a centralised Sharī'ah board at the level of the regulator and/or national authority.

⁵⁹ See the related discussion of institutional guarantees (both Islamic and conventional) in section 7.1.2.

⁶⁰ Nonetheless, group-based lending practices have raised issues, from a consumer protection perspective, in cases where they have led to overburdening societal pressure, causing consumers who default to “lose face”. See the discussion in section 6.2.1.

⁶¹ The IFSB has previously issued WP-7: *Recovery, Resolution and Insolvency Issues for Institutions Offering Islamic Financial Services*. The IFSB also plans in the near future to issue a full-fledged technical note on Sharī'ah-compliant resolution and recovery for institutions offering Islamic financial services.

139. Where disputes and insolvency issues involve institutions carrying out Sharī'ah-compliant financial inclusion activities, the legal system may wish to take into account guidelines on Sharī'ah-compliant financial activities issued by the regulatory authority, where available. It may be that these Sharī'ah-compliant guidelines were not intended for financial inclusion activities, but for the commercial Islamic finance industry. Nonetheless, the tenets of Sharī'ah, and the rights and responsibilities of contracting parties in relation to Sharī'ah contracts, are the same, regardless of the nature of the business model or operational modality of the financial services providers.

140. Where the legal process and courts do not make reference to Sharī'ah, this problem also exists for commercial Islamic financial industry transactions, and the Islamic financial inclusion activities may be no different. In general, this issue is normally beyond the control of the regulatory authorities and concerns the legislature and legal system in place. The reliance on court processes is also likely when actions are involved against the service provider.

141. For cases of disputes at a transaction level, it is likely that matters may not be brought to court due to time and cost factors in respect to the small transaction size of financial inclusion-specific financing. However, appropriate disclosures must be made by the services provider, such as in its product disclosure sheet or in the terms and conditions of the product sheet, signed by the customer, which clearly spells out the dispute resolution process to be followed in the event of a dispute, default or any other matter.

142. Specific to transaction-level financial inclusion disputes, an option to settle issues may be by way of arbitration, where two conflicting parties may come to a reasonable agreement. The arbitrator may be a special tribunal set up by the regulatory authority to address disputes in financial inclusion activities, and the contract between the financier–finanee would name this tribunal as the mediator. If this option is selected, the special tribunal may seek Sharī'ah guidance on disputes from a centralised approval authority on Sharī'ah where available (e.g. a centralised Sharī'ah board), or appoint a third-party Sharī'ah body⁶² to its panel to provide guidance on the appropriate rights and responsibilities of the parties involved in the dispute.

143. See also the discussion on recourse options for financial inclusion consumers in section 6.1.4 of this TN.

⁶² This may be a Sharī'ah adviser, a Sharī'ah board comprising three or more scholars, or an external Sharī'ah advisory firm. See the discussion in section 2.2.3.

3.4 Supervision

144. The supervision approach for service providers involved in financing activities specifically for financial inclusion initiatives may differ slightly from that required for supervision of commercial banks. This variation reflects the different product structures, operational mechanisms and business models of the service providers.

145. In contrast to commercial banks' activities, financial inclusion-specific financing normally differs in terms of (i) maturity, (ii) frequency of repayments, (iii) collateral, and (iv) probability of default;⁶³ hence, it requires a proportionate approach to regulations.

146. Correspondingly, supervision of these activities (and financing portfolios) also requires appropriate knowledge of the service providers' business methods and operations by the examiners, along with experience and ability to derive sound interpretations and judgments. The examiners for the financial inclusion segment must be familiar with the differences in regulatory treatment for such financing activities, as well as undertake additional training to acquire the specific examination skills and techniques needed for this sector's (or its specific financing portfolios') supervision.

3.4.1 Supervisory Responsibility

147. The TN recommends establishing a dedicated supervision unit, responsible for the supervisory functions related to financial inclusion activities. There are a number of different ways this may be achieved, as outlined below. The ultimate choice will depend on the specific country's situation, and the TN acknowledges that there is not a "one-size-fits-all" approach.

148. First, the supervision of deposit-taking financial inclusion service providers may be placed with the same authority that supervises commercial banks. The authority may either designate staff within the same supervision team (e.g. a sub-team of non-commercial banking supervisors), or establish a separate department for financial inclusion activities that consists of teams for different functions, including one for supervision. The advantage of the same authority having supervisory function for both commercial and financial inclusion-specific institutions is that it enables a lowering of regulatory arbitrage and improves coordination, as the same authority is cognisant of rules and regulations applicable to both segments.

149. However, country-specific circumstances may mean this first option is not feasible. For instance, a country may have a large number of rural banks, microfinance banks, development

⁶³ As discussed in section 3.3.4 of this TN.

finance institutions, cooperatives, etc. engaged in financial inclusion-specific activities, each with a different authority having a mandate over it. In such conditions, a second option is to establish, in each of these authorities, dedicated supervision units having responsibility over institutions under their mandate, but complying closely with guidelines on inter-agency coordination⁶⁴ to prevent overlaps, ambiguities and risks of regulatory arbitrage.

150. Another consideration for the first option is that the single banking authority itself may not have the resources, specialisation and skills to undertake responsibility for supervision of a whole new segment not necessarily familiar to the authority. In such conditions, a third option is to share supervisory responsibilities among the financial sector regulators (e.g. a central bank, capital markets authority, insurance authority, etc.) while complying with the guidelines on inter-agency coordination.⁶⁵

151. A fourth option also entails establishing a new and separate financial inclusion authority altogether, where certain types of service providers (e.g. microfinance banks, micro-credit institutions, NGOs and other types of non-bank financial institutions) fall under its mandate.⁶⁶ This option is particularly in response to a situation where there is a large number of previously informal or unlicensed service providers engaged in financial inclusion activities. The new authority enables a specific focus to bring such institutions within the regulatory ambit while also effectively licensing, monitoring and regulating them. It also avoids the risk of the central banking authority unintentionally having to divert its focus from the commercial financial sector by taking on responsibility for this segment. This new authority may also be in a better position to introduce some form of registration requirements for the non-deposit-taking service providers who, while not posing any major systemic risk, will still be required to comply with non-prudential regulations (e.g. AML/CFT measures, corporate and Sharī'ah governance, etc.).

152. Specific to the recent emergence of FinTech and crowdfunding, these platforms bring with them their own set of considerations. Not all FinTech and crowdfunding platforms have been introduced with the intention of financial inclusion initiatives; nonetheless, their role in and ability to support financial inclusion initiatives is also generally agreed upon.⁶⁷ Also, most FinTechs and crowdfunding platforms are not usually identified as deposit-taking institutions,

⁶⁴ Presented in section 2.3.2 of this TN.

⁶⁵ Presented in section 2.3.2 of this TN.

⁶⁶ For instance, Bangladesh set up a Microcredit Regulatory Authority (MRA) to promote and foster sustainable development of the microfinance sector by creating an enabling environment for NGO-MFIs. MRA is the central body that monitors and supervises microfinance operations of NGO-MFIs. A licence from the MRA is mandatory in order to operate microfinance operations in Bangladesh as an NGO.

⁶⁷ The IFSB survey conducted as part of the process of developing this TN found that RSAs saw a positive link in supporting the emergence of FinTechs in order to achieve financial inclusion objectives.

since the sources of funds for financing activities may either be investment/equity-based (where funding clients absorb losses, if any) or through donations/contributions that may not require funds to be repaid to the fund providers.

153. The regulatory and supervisory approach to FinTech and crowdfunding platforms is still developing.⁶⁸ In some countries, the central bank has taken the lead in regulating and supervising them (at least through regulatory sandboxes); in others, it is the capital market authority. The various prudential guidelines for financing activities in this section may also be applicable to FinTech and crowdfunding platforms if they are identified by their supervisory authority to be “deposit-taking”. Accordingly, the supervision will also be undertaken by the authority (either a central bank or securities commission) that has responsibility for them.

3.4.2 Tools and Enforcement Mechanisms

154. Supervision tools and enforcement mechanisms depend largely upon the type of institution involved. Proportionality is of prime importance when devising a supervisory framework for financial inclusion activities. For instance, common supervisory interventions for the banking sector in the form of on-site inspections, recommendations for action, corrective enforcement, cease-and-desist orders, and intervention and liquidation may not be feasible (in terms of costs and effort, and with few implications for financial stability) for the NGO type of service providers, which may be in large numbers and in far and remote locations.

155. Nonetheless, supervisory sanctions and corrective actions are important in order to deter, at least, the deposit-taking service providers in financial inclusion from contravening regulatory requirements intended to protect the participants and the financial system. Any proportionate approach towards different types of institutions must still be stringent enough to deter the service providers from violating regulations.

156. The TN does not prescribe any specific supervisory tool or enforcement mechanism for financing activities in financial inclusion; the supervisory authorities have the discretion to identify various types of institutions in their mandate and to evaluate which of the supervisory tools are most effective for each type. The type of proportionate regulations applicable to each type of institution will also be a factor in this decision. For instance, some enforcement mechanisms (e.g. recapitalisation of an institution or forced asset sales) may be more effective for the commercial banks but not really feasible for small rural-based deposit-taking banks, which normally have a fixed capital source (and thus no option for raising new capital through

⁶⁸ See the related discussion in section 2.3.4 of this TN.

stock market listing) and do not have ownership of high-quality unencumbered assets for liquidation.

157. The focus of supervision for the financial inclusion financing activities should be on the service providers' internal risk management framework – that is, systems and policies for extending financing, collecting repayments, effective credit risk mitigation efforts, internal controls and governance, as well as the performance and provisioning of the financing portfolio.

158. Where violations or lax implementation of regulations are observed (both prudential and non-prudential), the TN acknowledges the importance of supervisory sanctions and corrective actions to instil an environment of integrity in the financial system. Hence, actions may include regulatory fines where, despite supervisory warnings, a service provider fails to meet regulations without any reasonable justification. In addition to fines, individuals proven to be deficient in their duties may be subjected to suspensions, removals and even imprisonment, as ruled by the court of law. Specific supervisory sanctions (e.g. a ban on paying dividends, restrictions on new financing or on new deposits mobilisation, orders to write off bad debts, the requirement for higher regulatory reserves) may also be used by the authority where necessary. In the extreme case, the licence of the service provider may be revoked altogether with an instruction to liquidate the assets.

159. The trigger for each of the above supervisory actions is likely to vary between countries; for instance, in some jurisdictions, it may be large losses or the depletion of capital in deposit-taking institutions. Based on the local legislation, some countries may require court orders in order to enforce any supervisory action.

160. The supervisory actions are also applicable to FinTech and crowdfunding platforms when, at a minimum, violations in non-prudential regulations are observed (e.g. misleading claims or fraudulent descriptions of products, engaging in money-laundering activities, etc.). As highlighted above, non-prudential regulations are applicable to both deposit-taking and non-deposit-taking financial inclusion institutions; however, supervision may be comparatively less rigorous for non-deposit-taking institutions.

SECTION 4: DEPOSIT ACTIVITIES – REGULATION AND SUPERVISION

4.1 Categorisation of Deposit-taking Activities

161. Not all service providers in financial inclusion activities are deposit-taking institutions; a financial inclusion service provider may have other sources of funds, including grants/donations, crowdfunding contributions, investment/equity-based funding (where clients absorb losses, if any) or any other mechanism (e.g. Islamic social solidarity instruments⁶⁹) where a repayment to the fund providers is not required or a guaranteed obligation. Under these conditions, a service provider is normally tagged as being a “non-deposit-taking institution” and, hence, most of the prudential regulations are not applicable to such types of service providers.⁷⁰

162. Premised on the above, this section specifically concerns institutions involved in financial inclusion activities that are engaged in sourcing funds through deposit-taking activities. The sources of funds for these service providers include, among others, current and savings accounts, term deposits, and other forms of customer deposits that bring about an obligation on the part of the service provider to return the principal and/or profits (if applicable) to the customer – either on demand or at an agreed date that reflects the maturity period.⁷¹

163. The section outlines the key prudential regulatory and supervisory guidelines for Sharī'ah-compliant deposit-taking activities undertaken by service providers involved in supporting financial inclusion objectives. The section also highlights the liquidity risk management framework applicable to such service providers, as well as Sharī'ah-specific conditions that govern the deposit-taking activities.

4.2 Funds Mobilisation Criteria and Utilisation

164. This TN requires deposit accounts offered by service providers in Islamic financial inclusion initiatives to be in compliance with the principles of Sharī'ah⁷² in terms of (a) product

⁶⁹ See the preliminary discussion in section 2.3.6 of this TN.

⁷⁰ See the related discussion in section 3.3 of this TN. Nonetheless, non-prudential regulations will apply equally for both deposit-taking and non-deposit-taking institutions.

⁷¹ Current accounts based on *qard* and saving accounts based on *wadī'ah* bring about an obligation on the part of the service provider to return the principal, while demand deposits that are mobilised on the basis of reverse *murābahah* bring about an obligation on the part of the service provider to return the principal and profits. As for investment accounts, they do not bring about any obligation on the part of the service provider to return the principal and profits unless the principal is preserved wholly or partially or profits have been generated.

⁷² See the relevant discussion in section 2.2 of this TN.

structure, (b) operational mechanism, (c) rights and responsibilities of the contracting parties (service provider and depositors), and (d) utilisation of funds mobilised.

165. Shari'ah permits a number of contracts for deposit-taking activities by institutions; however, each bears differing rights and responsibilities for the contracting parties. Current accounts are based on *Qard*⁷³ (loan) which is a non-profit-earning contract that enables the service provider to mobilise funds from depositors without any agreement on returns or profits for the customers. In exchange, however, the service provider has to guarantee the deposits in full and return them on demand.

166. In a number of jurisdictions, term deposit products are offered on the structure of commodity *murabahah* (which involves three-party buy-and-sale transactions), which enables the service provider to mobilise funds for a specific period of time, and in return offering a profit portion to the depositors. This transaction guarantees both principal and profits for the depositor by the service provider.

167. Islamic financial institutions may also mobilise funds on an equity basis structured on profit-sharing and loss-absorbing contracts such as *musharakah* and profit-sharing and loss-bearing by the capital provider such as *muḍarabah*, which are commonly termed "profit-sharing investment accounts" (PSIA). While these are loss-absorbing contracts – that is, the customers undertake equity-type risks in exchange for a share in profits of the underlying business activities – the service provider is responsible for operational risks as well as for any negligence/misconduct in managing the funds. In these cases, the PSIA holders are entitled to the full principal amount, and the service provider bears the responsibility for losses. An agency-based investment account structured on *wakalah* also offers an equity-based fund-raising contract where the service provider is entitled to a fixed fee, while investment account holders are entitled to profits (or losses) of the specified underlying business activities.

168. Under all circumstances, funds mobilised by a service provider on a Shari'ah-compliant basis must only be utilised to undertake financing and/or investment activities that are permitted by Shari'ah.

169. Financial services providers in Shari'ah-compliant deposit-taking activities may utilise any of these contracts to mobilise funds, provided that the condition specified in paragraph 164 of this TN is duly met. Those service providers who operate mixed businesses (both

⁷³ For the meanings of these and other Shari'ah contracts and terminologies commonly used in Islamic finance, please see the IFSB Glossary available at: www.ifsb.org/terminologies.php

Sharī'ah-compliant and conventional) are required to comply with the guidance set out in section 2.3.5 and as put into effect by the relevant authority.

170. In order to satisfy itself that the service provider meets the condition in paragraph 164, the supervisory authority may require the service provider to seek (i) the approval of its deposit products by a centralised approval authority on Sharī'ah where available (e.g. a centralised Sharī'ah board), or (ii) the opinion of and endorsement by a Sharī'ah body.⁷⁴ The actual requirement by the authority out of the two options above will be on a proportionality basis, depending upon the size, complexity, affordability and riskiness of the service provider.

171. Regardless of the supervisory approach, the authority will require the service provider to transparently disclose the basis for its claim to the Sharī'ah compliance of its deposit product. The authority will also require the service provider to duly clarify the rights and responsibilities of the contracting parties, commensurate with the type of contract utilised (e.g. *qard*-based, commodity *murābahah*, etc.) in the deposit product disclosure sheet or in its terms and conditions.

172. The supervisory authority must also reasonably satisfy itself that the service provider has taken appropriate measures to ensure that the funds mobilised on a Sharī'ah-compliant basis are in fact also used for Sharī'ah-compliant activities on the assets side of the service provider.

4.3 Liquidity Risk

173. Liquidity risk is important for all deposit-taking institutions where the depositors have the right to withdraw their funds on demand or by giving less than 30 days' notice. Experiences from crises in the financial sector (e.g. the Global Financial Crisis of 2007–8) have shown that not only insolvency, but also illiquidity, can force otherwise solvent banks into bankruptcy. Liquidity risk management and its regulations feature prominently in the post-global financial crisis regulatory reforms by the international standard-setting bodies (e.g. Basel III Liquidity Coverage Ratio, or LCR). Correspondingly, liquidity risk and its management are also essential for all deposit-taking financial inclusion service providers.

⁷⁴ This may be a Sharī'ah board comprising three or more scholars, or an external Sharī'ah advisory firm, or an individual Sharī'ah scholar. See the discussion in section 2.2.3.

4.3.1 Liquidity Requirements

174. A common regulatory requirement for liquidity risk management is for the deposit-taking institutions to maintain adequate liquidity reserves – held as cash and cash equivalents by the institution itself and/or invested in approved eligible liquid securities.

175. The TN acknowledges the importance of liquidity requirements for deposit-taking institutions specifically involved in financial inclusion activities, but it also concedes that such types of institutions may not be comparable to commercial banks in relation to their size, complexity of activities and volume of deposits mobilised. Hence, the TN recommends a proportionate⁷⁵ approach to liquidity requirements, depending upon the type of deposits mobilised by the service providers (e.g. demand deposits, term deposits, investment accounts, etc.).

176. Where a deposit-taking institution in financial inclusion initiatives offers nearly all the financial services offered by established traditional banks, including current accounts, the TN recommends a full implementation of the minimum requirements as set out in IFSB-12⁷⁶ and GN-6.⁷⁷ These minimum capital requirements may be updated by the IFSB from time to time, and the TN is understood to refer to the latest guidelines as and when available.

177. In other instances, the authorities may introduce other specific ratios for the service providers commensurate with their size, riskiness and business modality. For instance, for the less complex and smaller service providers, simple and straightforward ratios such as a specified percentage of all demand deposits/current accounts may be set, as opposed to requiring the implementation of LCR. The eligible components of such liquidity reserves may also be simplified to include cash, gold and other unencumbered approved securities not necessarily complying with the high-quality liquid assets guidelines of Basel III and IFSB GN-6. These simple ratios may vary in relation to the type of deposit mobilised – for instance, 10% of all demand deposits, 5% of all term deposits, etc. Eligible components for liquidity instruments may also include Sharī'ah-compliant securities (e.g. retail *ṣukūk* where available and issued by government) allowing small service providers to invest and hold these instruments, and trade when in need of liquidity.

178. In all circumstances, the regulatory authority needs to balance the objectives of financial safety and financial access when setting the minimum liquidity requirements; high

⁷⁵ Based on guidance in section 2.3.1.

⁷⁶ IFSB-12: *Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services*. Available at: <https://www.ifsb.org/download.php?id=4368&lang=English&pg=/published.php>

⁷⁷ GN-6: *Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services*. Available at: <https://www.ifsb.org/download.php?id=4391&lang=English&pg=/published.php>

liquidity requirements (for depositor protection and financial stability) mean larger amounts of funds being idle as liquidity reserves, and this leads to fewer funds being available to extend as financing to the clients in the financial inclusion segment.

179. Supervisory exemptions on maintaining a certain level of ratios may also be given at the discretion of the authority if the specific activities allowed to be undertaken by the service provider are not on a par with those of its peers (e.g. a deposit-taking NGO which only extends group-based financing using funds mobilised through term deposits, versus a deposit-taking NGO that extends individual unsecured financing, funded mainly by demand deposits).⁷⁸ On the other hand, the supervisor may also request more stringent liquidity requirements on certain institutions in contrast to its peers. There are many considerations that would lead to such an exemption or additional requirements being awarded. They include the availability of emergency liquidity funding, maintenance of an internal reserve fund and deposit insurance protection. These considerations are discussed in the following subsections.

4.3.2 Emergency Liquidity Funding

180. A supervisor needs to assess whether a deposit-taking financial inclusion service provider has access to any emergency liquidity funding – whether from the central bank, other market sources, or the shareholders/patrons of the institution. The latter may be confirmed by way of a binding undertaking by, for example, the parent company of the service provider that assures liquidity support through injections if the need arises.

181. If access to such an emergency liquidity funding is not available,⁷⁹ the supervisory authority may require the financial services provider to comply with higher liquidity ratios than those that apply to institutions that have access to such facilities.

4.3.3 Internal Reserve Fund

182. A regulator may impose an additional prudential requirement on the deposit-taking financial inclusion service provider in the form of maintaining an accumulating reserve fund, built up through contributions from the profits. This internal profit-reserve fund is to be held in

⁷⁸ When discussing extending financing using funds mobilised through term deposits, this does not mean using depositors' funds for extending group-based financing; rather, it means that funds mobilised through term deposits would be utilised in reverse *murābahah*, whereby depositors sell a commodity on a deferred basis to the service provider, which in turn would sell the commodity at spot price to a third party. The service provider would then utilise the funds obtained from selling the commodity at spot price in extending financing to other parties. As for extending financing using funds mobilised through term deposits, it refers to the use of funds deposited with the service provider on the basis of *qard* or *wadi'ah* in extending financing to other parties.

⁷⁹ One particular challenge in many jurisdiction is the relatively underdeveloped Sharī'ah-compliant money markets and availability of related instruments. This challenge creates obstacles for sound liquidity management by IIFS. See further discussion in section 4.3.5.

liquid assets, and set aside from the institution's annual profits (as a percentage of that profit) prior to distribution and appropriations. As the size of this fund increases over time, the prudential percentage of profits to be set aside for the fund will also reduce until a set threshold is achieved.

183. For instance, a service provider may be required to set aside a certain percentage of its profits every year for this fund, until the size of the fund reaches 100% of paid-up capital, following which the contribution may be reduced to a lower percentage of profit until the upper limit of 200% of paid-up capital is achieved. Once the specified upper limit is achieved, only annual adjustments need to be made to ensure that this prudential requirement continues to be satisfied. The funds from this reserve may be invested only in Sharī'ah-compliant government securities and other approved low-risk liquid investments.

184. Institutions that are required to maintain such a fund may benefit from lower liquidity requirements than those that are not subject to the requirement.

4.3.4 Deposit Insurance Protection

185. Deposit insurance provides protection to the deposits of eligible institutions, up to a certain amount. In the event of a member institution's failure, the deposit insurance undertakes the responsibility to reimburse its depositors, as per pre-set terms and conditions. In this process, the deposit insurer contributes to the financial system's stability, protects the depositors and assists in the orderly resolution of the failed bank.

186. At present, there are nearly 140 countries⁸⁰ in the world where commercial banks (or, in general, prudentially regulated financial institutions) are required to participate in a deposit insurance scheme. Financial inclusion service providers that are covered by deposit insurance can benefit from lower liquidity requirements as compared to others that are not covered.

187. The TN encourages authorities to consider the role and participation in deposit insurance of at least the prudentially regulated deposit-taking institutions (including those having either explicit or "perceived" implicit government guarantees) involved in financial inclusion activities. These institutions may include banks, financial cooperatives and other-deposit taking entities. There are two approaches for achieving this.

188. One approach is for these Islamic non-commercial bank institutions to contribute to the same deposit insurance fund as the Islamic commercial banks. Such a unitary insurance

⁸⁰ Sourced from: www.iadi.org/en/deposit-insurance-systems/dis-worldwide/

system makes depositor protection more consistent and levels the playing field among the various institutions. However, a consideration is whether the method used to calculate contributions to this fund by Islamic commercial banks and other financial inclusion institutions should vary according to the specific size, riskiness and complexities of the institutions involved. A variation of distributions should not distort the deposit insurer's ability to effectively conduct its role should a large number of new institutions also join the risk fund.

189. Based on the above concerns, a second approach is for the Islamic non-commercial banks to be subjected to their own separate deposit insurance schemes, more aligned to their business models and risk complexities. Separation of the schemes would enable the deposit insurer to focus on each segment in line with its own specificities. However, a counter-concern is whether these Islamic non-commercial banks have enough "critical mass" for a self-contained deposit insurance scheme.

190. The authorities have the discretion to implement either of the two options above, depending upon their jurisdiction-specific considerations. Financial inclusion services providers that benefit from deposit insurance protection may benefit from lower prudential requirements than apply to those that do not so benefit. Lower requirements may also help the service provider offset the additional cost incurred through premium contributions into the deposit insurance fund.

4.3.5 Sharī'ah Considerations

191. Finally, a key essence of all arrangements in Sharī'ah-compliant financial services activities is that all processes, structures and operational mechanisms must be compliant with Sharī'ah. Related to the discussion in this subsection on liquidity risk, the reserves and funds maintained, as well as the emergency liquidity facilities and deposit insurance protection, must be Sharī'ah-compliant.

192. However, the TN is cognisant of the fact that in some jurisdictions the market infrastructure is still not sufficiently developed to support liquidity risk management through only Sharī'ah-compliant instruments and mechanisms. This is true even for the commercial Islamic banks in many countries; hence, it becomes more difficult for the financial inclusion segment. The IFSB's recent study on emergency liquidity facilities⁸¹ and deposit insurance⁸² highlighted the availability of Sharī'ah-compliant instruments and schemes in only a few countries.

⁸¹ See IFSB WP-1: <https://www.ifsb.org/download.php?id=4405&lang=English&pg=/index.php>

⁸² See IFSB WP-6: <https://www.ifsb.org/download.php?id=4410&lang=English&pg=/index.php>

193. Based on the above, the regulatory and supervisory authority may provide certain flexibilities or alternative arrangements for the affected institutions in order to meet their liquidity risk obligations through options that do not comply with the various Sharī'ah-related guidance⁸³ in this TN. This flexibility is strictly only a temporary solution that can only be used in cases of extreme necessity and is not intended to be treated as an ongoing option. During this process, the regulatory authority must undertake serious efforts to address the shortcomings in availability of Sharī'ah-compliant liquidity management instruments.

4.4 Regulatory and Supervision Issues

194. In general, the discussion on supervision in section 3.4 is also relevant here. However, there are some additional issues, from the perspective of deposit-taking activities, which are discussed below.

195. The supervisory authority assumes the fiduciary responsibility for prudentially regulated deposit-taking financial inclusion institutions. The granting of a licence to a deposit-taking service provider is a signal to the depositor that the government/regulatory authority has effectively assumed responsibility for supervising the intermediary.⁸⁴

196. Before it grants a licence to a deposit-taking financial inclusion institution, the regulatory authority must require the applicant to submit proposed risk management policies and procedures as part of the licensing process. Such policies and procedures should demonstrate, among other things, how the institution will measure, monitor and control any liquidity mismatch between its financing and funding portfolios.

197. The supervisory authority, in turn, must be able to effectively assess that the licensed deposit-taking institution does not contravene the applicable law and regulations. Ideally, all institutions taking deposits, regardless of size, should be subject to effective supervision. However, due to issues of cost-effectiveness and the extent of implications for financial stability, the supervisory authority may choose to undertake more stringent supervision of the financial stability of larger and more important institutions than it imposes on smaller ones. This sort of discussion also raises implications for non-prudential regulations, which are generally required to be implemented equally by all types of institutions, at least on a proportionate basis.

⁸³ See section 2.2, and paragraphs 92, 93 and 165, in this TN.

⁸⁴ This signal of government/regulatory authority's responsibility, of course, does not attempt to negate the importance of transparency and market discipline. However, given that the financial inclusion target segments are normally the marginalised and low-income segments, they may have higher expectations of assurance from the government when an entity is licensed by it.

SECTION 5: INVESTMENT ACTIVITIES – REGULATION AND SUPERVISION

198. This section outlines the key prudential regulatory and supervisory guidelines for Sharī'ah-compliant investment activities⁸⁵ (equity-based financing) undertaken for the specific purpose of achieving financial inclusion objectives.

5.1 Categorisation of Investment Activities

199. Investment activities (or equity-based financing) in financial inclusion may take a variety of forms and mechanisms, including, for instance, equity participation in an investee entity (e.g. equity ownership of an MSME) or a partnership-based agreement with an individual fund-seeking party (e.g. entrepreneur–investor, partner–sleeping partner investment agreement) or an agency-based agreement with an individual fund-seeking party (e.g. agent–investor). Hence, in one form of an entrepreneur–investor agreement, for instance, the fund providers agree to invest in an activity that will be managed and run by the individual fund-raiser (entrepreneur) and then both parties share profits as per their agreement; however, only the fund providers have to take responsibility for the financial losses incurred by the activity during its normal course of operations (referred to as a *muḍārabah* agreement in Islamic finance).

200. An important consideration in the investment-based financial inclusion activities is the specific role of the financial services provider. For instance, is the service provider (a) undertaking equity financing/investments at its own discretion and assessment of the investees; or (b) merely providing a platform to connect fund-raisers and investors, enabling the fund providers to directly assess and undertake equity financing/investments at their own discretion?⁸⁶ The degree of regulation and supervision of the service providers will vary depending upon their specific role in terms of either of these two options.

201. In general, a service provider with a role under option (b) will not be required to comply with prudential regulations; only non-prudential regulations will apply, and with relatively minimal supervision (although the supervisor has to ensure that the service provider does not

⁸⁵ The scope of this section differs from that of Section 3 to the extent that the guidelines here are intended for activities where financing is extended with the investing party assuming the overall business risks of the financed entity or individual (equity investment risk), beyond the traditional credit, market and operational risks for any other debt-based financing activity.

⁸⁶ Nonetheless, the service provider in such settings may still have an obligation to conduct sound initial due diligence on the fund-raising party and to provide relevant information to the investors to enable them to form their own assessments regarding the investment decision.

expand beyond acting as a platform to connect fund-raisers and investors). A number of web-based crowdfunding platforms will fall under this category.

202. On the other hand, a service provider under option (a) may also have two further subcategories: (i) where the service provider is a deposit-taking institution; and (ii) where the service provider is a non-deposit-taking institution. As with previous discussions,⁸⁷ prudential regulations will not apply to a non-deposit-taking institution; only non-prudential regulations will apply.

203. Premised on the above, this section specifically concerns institutions involved in financial inclusion-specific investment activities where the service provider is a deposit-taking institution (including raising funds through PSIAs – see the discussion in section 5.4.1 of this TN) that undertakes equity financing at its own discretion and risk assessment.

5.2 Permissible and Impermissible Activities

204. Regulatory/supervisory authorisation of investment activities in Islamic financial inclusion initiatives can only be extended by the relevant authority under the condition that the Sharī'ah rules and principles,⁸⁸ as endorsed by the approval authority (see paragraph 205 below), are not violated in terms of the (a) equity financing product structure, (b) the product's operational mechanism, and (c) the overall objectives of the investment by the service provider. This condition applies to all types of service providers that claim to offer Sharī'ah-compliant financial inclusion investment products and services, and that are under the relevant authority's mandate. The service providers who operate mixed businesses (both Sharī'ah-compliant and conventional) are required to comply with the guidance in section 2.3.5 as put into effect by the relevant authority.

205. In order to satisfy itself that the service provider meets the condition in paragraph 204 above, the supervisory authority may require the service provider to seek either (i) approval of its investment products and services by a centralised approval authority on Sharī'ah where available (e.g. a centralised Sharī'ah board), or (ii) the opinion of and endorsement by a Sharī'ah body.⁸⁹ The requirement by the authority out of the two options above will be on a proportionality basis, depending upon the size, complexity, affordability and riskiness of the service provider. Regardless of the supervisory approach, the authority will require the service

⁸⁷ See sections 3.3 and 4.1 in this TN for the relevant discussion.

⁸⁸ See the relevant discussion in section 2.2 of this TN.

⁸⁹ This body may be a Sharī'ah board comprising three or more scholars, or an external Sharī'ah advisory firm, or an individual Sharī'ah scholar. See the discussion in section 2.2.3.

provider to transparently disclose the basis for its claim as to the Sharī'ah compliance of its investment product.

206. Premised on the above, all investment activities and/or service providers in financial inclusion that do not comply with the requirements in paragraphs 204 and 205 will be deemed to be “impermissible”.

5.3 Investment Modes and Instruments

207. The commonly used Sharī'ah-compliant contracts for investment activities include *muḍārabah*, *mushārah* and *wakālah*.⁹⁰ These contracts differ in terms of the rights and responsibilities of the contracting parties, particularly towards rights over profits and losses.

208. Financial services providers in Sharī'ah-compliant financial inclusion activities may utilise any of these contracts – as a stand-alone contract supporting the investment product structure, or through financial innovation, achieving a hybrid product structure utilising two or more of these contracts – provided that the overall outcome results in achieving the conditions specified in paragraphs 204 and 205 of this TN.

209. The guiding principle in all circumstances is that the service provider must satisfy the supervisory authority that its choice of investment mode and instrument is in conformity with Sharī'ah, and that the product in either its disclosure sheet or its terms and conditions duly clarifies the rights and responsibilities of the contracting parties, commensurate with the type of contract utilised (e.g. agency-based in *wakālah*, profit-sharing and loss-bearing by the capital provider in *muḍārabah*, and profit-and-loss-sharing in *mushārah*, etc.).

5.4 Prudential Regulations

210. In general, prudential requirements on equity-based financing extended by deposit-taking institutions are more stringent than those applicable for debt-based financing transactions.⁹¹ Given that the financial inclusion segment normally consists of the so-called unbankable individuals and MSMEs, the requirements are likely to be even stricter, posing a challenge for compliance by non-bank institutions and other smaller service providers.

211. To mitigate these potentially stricter requirements, the TN recommends some considerations through which service providers in equity-based financing activities for financial

⁹⁰ For the meanings of these and other Sharī'ah contracts and terminologies commonly used in Islamic finance, see the IFSB Glossary available at: www.ifsb.org/terminologies.php

⁹¹ In traditional banking regulations, risk weights for equity financing can be as high as 250%, while those of debt-based financing are normally between 50% and 150% in the worst case.

inclusion may benefit from a proportionate implementation of regulations. These considerations are discussed in the following subsections.

5.4.1 Proportionality Considerations

212. The TN recommends a proportionate⁹² approach to prudential regulations for equity-based financing activities in financial inclusion, subject to the funding profile of the service provider for undertaking investment activities (i.e. types of deposit mobilised by the service provider).⁹³ In general, funds may be mobilised in a number of ways in Islamic finance;⁹⁴ however, three main categories are identifiable: (i) current accounts, (ii) savings accounts and term deposits, and (iii) PSIAAs.⁹⁵

213. The risks from equity financing for institutional stability and liquidity challenges are greater when funds are mobilised through categories (i) and (ii), in contrast to PSIAAs. The PSIAAs may also be further divided into two categories: (iii-a) unrestricted PSIAAs, and (iii-b) restricted PSIAAs. Restricted PSIAAs are normally placed by sophisticated investors who understand the risks and returns conditions well and are usually involved in active discussions with the service provider in terms of investments to be made using their funds.⁹⁶ In contrast, unrestricted PSIAAs normally rely on the expertise of the service provider to undertake these investments and have little or no say in the investment decisions and risk assessments.

214. The TN recommends that equity financing for financial inclusion objectives by deposit-taking service providers is done using funds mobilised through preferably restricted PSIAAs.⁹⁷ These funds, due to their conditions for rights and responsibilities of contracting parties, significantly reduce the risks of institutional failure as the fund providers bear the responsibility of financial losses under the normal course of business operations, which lowers the prudential requirements for the service provider while also subjecting it to a lesser extent of supervision.⁹⁸

⁹² See the relevant discussion in section 2.3.1 in this TN for methods to achieve this proportionality in implementation of capital regulations.

⁹³ It is important to note that funds mobilised through current accounts, saving accounts and PSIAAs can be utilised by the service provider for undertaking equity financing for financial inclusion. As for term deposits, they can be utilised in reverse *murābahah*, whereby the depositors would sell a commodity at a deferred price to the service provider, which in turn would sell the commodity at a spot price to a third party and utilise the proceeds of the sale of the commodity at a spot price in extending equity financing.

⁹⁴ See the related discussion in section 4.2 of this TN.

⁹⁵ Although PSIAAs are commonly offered by Islamic commercial banks, it is not generally known whether PSIAAs, at present, are a prominent feature of the funding structure of institutions involved specifically in financial inclusion activities.

⁹⁶ Most, if not all, regulators treat restricted PSIAAs as off-balance sheet items and, as such, prudential regulations such as capital requirements do not generally apply to them.

⁹⁷ This is a practical option and should be explored further. In the conventional market space, it is very common for start-ups and MSMEs to benefit from equity funding by, for instance, angel investors. The same concept can be applied in Shari'ah-compliant financial inclusion activities, and the contributors to the PSIA may also include Islamic social finance institutions.

⁹⁸ See the related discussion on PSIAAs in section 3.4 of IFSB-15.

The service provider, however, has to undertake responsibility for strong compliance with non-prudential regulations⁹⁹ relating to, for instance, fiduciary responsibilities and comprehensive and credible corporate and Sharī'ah governance practices.¹⁰⁰

215. In any case, the prudential regulations should cover all important aspects of investment activities, including capital requirements, risk management frameworks, investment limits, provisioning requirements (if any), credit enhancement mechanisms, etc. The supervisory authority should also have in place a mechanism for general reporting by the deposit-taking service provider and, when necessary, on-site inspection rights by law. The various IFSB standards issued¹⁰¹ on different topics of regulation duly consider the case of equity financing, although the approach is from the perspective of an IIFS operating in the commercial IFSI.

5.4.2 Risk Management Framework

216. All institutions involved in investment activities must generally have robust and integrated risk management frameworks, regardless of whether the service provider is deposit-taking or non-deposit-taking. This requirement is to sustain the going-concern viability and reputation of the institution, regardless of whether it is a for-profit or a non-profit service provider. The regulatory emphasis, however, is mainly on deposit-taking institutions, for reasons of depositor protection¹⁰² and financial system stability. Effective supervision may also be conducted only on deposit-taking institutions for reasons of costs versus benefit/implications to the financial system as a whole. A further consideration here is whether the deposit-taking institution attracts funds mainly through PSIAs or other types of deposits; the former attract a lesser extent of prudential regulation and supervision of the service provider.¹⁰³

217. The TN recommends all service providers in financial inclusion investment initiatives to have in place appropriate policies, systems and procedures to identify, measure, monitor and control their risk exposures. This recommendation is applicable to both for-profit and non-profit service providers that undertake investment activities using funds mobilised through deposits.

⁹⁹ Discussed in Section 6 of this TN.

¹⁰⁰ The approach to equity financing through PSIAs is also likely to generate more efficient and productive economic outcomes in contrast to, for instance, using donor-based funds. In the former instance, the service provider has a fiduciary responsibility to ensure that equity financing is undertaken only for viable projects; in the second instance, the fiduciary responsibility on the service provider is not so high, since the funds are donated and do not have to be repaid to the contributors by the service provider.

¹⁰¹ The various IFSB standards issued to date are available at: <https://www.ifsb.org/published.php>

¹⁰² Regulations for deposit-taking institutions from a liquidity risk perspective are discussed further in Section 4 of this TN.

¹⁰³ See the discussion in paragraphs 213 and 214 of this TN.

218. The service provider should also have in place an IT-based risk management system that keeps track of details of the investments undertaken, and of entities or individuals to whom equity financing has been extended. In addition, the service provider should maintain a detailed outlook and plan of the proposed business activity (whether ongoing or to begin afresh), copies of identity documents of key individuals associated with the business activity and of the guarantors (where applicable), and other relevant documents in support of the equity financing extended. Appropriate backups of such files should also be made and stored in a safe location. Where it is not feasible to have an IT-based system, any other manually established bookkeeping system may be used, although any manual systems put in place for the purpose of bookkeeping or general monitoring of equity financing activities are fraught with operational risks; hence, more diligence and care should be observed when handling sensitive and confidential data in a manual set-up.

219. Depending upon the types of businesses invested in by the service provider, the risk management system in place should recognise risks that may affect the expected outcome of the underlying business activity – for instance, changes in technology requiring new investment in interface, changes in rules and regulations requiring retraining of the entrepreneurs, economic factors changing the pricing structure of the product or service offered by the business, and other factors – including price and valuation of assets (e.g. office space, small workshop, etc.) – that were purchased using the equity funds.

220. The service provider should also have legally recognised documentation that validates its rights of equity financing provided to the fund-raising individual or entity, and hence, registering the right of specified share of ownership into the business activity funded. Depending upon the investment mode utilised to put into effect the equity financing transaction, the service provider may also have a say in and control of the operations and key decisions of the business activity funded.

221. The service provider itself will also need to be assessed for sound corporate governance practices and prudent investment principles when undertaking equity financing using funds mobilised through deposits.¹⁰⁴ Here, an important part of assessment will also be the fiduciary risk management, particularly when funds are raised through PSIA for extending equity financing.¹⁰⁵ The service provider may be assessed through review and endorsement by independent boards, executive oversight committees, corporate governance committees,

¹⁰⁴ See footnote 93.

¹⁰⁵ When funds are raised through PSIA, fiduciary risk arises when the service provider fails to act with due care when managing investments, resulting in the risk of possible forgone profits or even losses to the PSIA holders.

etc.¹⁰⁶ The extent of supervision by the authority will be based on the overall approach to regulations for this service provider, and as per proportionality considerations introduced in section 5.4.1 and discussed preliminarily in section 2.3.1 of this TN.

222. In all circumstances, the risk management framework and its monitoring will feed inputs towards the implementation of the various prudential guidelines applicable to the service provider, and hence appropriate regulatory and supervisory clarity needs to be in place to enable a mechanism that results in validating the soundness of the risk management system in place at the service provider.

5.4.3 Capital Requirements

223. For the purposes of capital requirements on service providers undertaking Sharī'ah-compliant equity financing activities, this TN benchmarks to the minimum capital requirements as set out in Sections II and III of IFSB-15,¹⁰⁷ including, specifically, the discussion of PSIAs in section 3.4 and the capital requirements for *mushārakah*, *muḍārabah* and *wakālah* in sections 4.6, 4.7 and 4.9, respectively, of IFSB-15. These minimum capital requirements may be updated by the IFSB from time to time, and the TN is understood to refer to the latest guidelines as and when available.

224. Premised on the proportionality approach proposed in section 5.4.1 of this TN, the regulatory authorities have due discretion to approach the minimum requirements set out in IFSB-15 on a proportionate basis, reflecting the specific activities allowed to be undertaken by the service provider as well as the type of deposits mobilised.

225. As a general rule of thumb, equity financing activities funded through demand deposits and term deposits¹⁰⁸ will require full implementation of the minimum requirements set out in IFSB-15. On the other hand, equity financing activities funded through PSIAs will have some level of exemptions¹⁰⁹ from holding capital, although the service provider still needs to set aside capital for any operational risk¹¹⁰ events. In a situation where the service provider uses donor-based funds for equity financing activities, capital requirements and other prudential

¹⁰⁶ Specific discussion on corporate and Sharī'ah governance is provided in section 6.2.4 of this TN under non-prudential guidelines.

¹⁰⁷ Available at: www.ifsb.org/download.php?id=4371&lang=English&pg=/published.php

¹⁰⁸ See footnote 93.

¹⁰⁹ Guidance on these exemptions is given in sections 3.4, 4.6, 4.7 and 4.9 in IFSB-15.

¹¹⁰ As per Sharī'ah regulations, while PSIAs are loss-absorbing deposits, if any losses arise due to the negligence and misconduct of the service provider, the PSIAs are protected from those losses, and the service provider must compensate their principal amounts in full.

regulations will not apply, and the service provider needs to focus on, and will be supervised for, non-prudential regulations.

226. In all circumstances, the supervisory authority must have mechanisms in place to identify, and deal appropriately with, any risks of regulatory arbitrage¹¹¹ where service providers attempt to unduly benefit (e.g. without appropriate reduction in risk profiles) from the relaxed capital requirements. The supervisory authority may also impose additional capital requirements if the authority considers appropriate in respect of risk exposures undertaken by the service provider.

227. Specific to the case of FinTechs and crowdfunding platforms, as discussed in section 5.1 of this TN, if the FinTechs are merely providing a platform to connect fund seekers and investors, enabling the fund providers to directly assess and undertake equity financing at their own discretion, capital requirements will generally not apply to the service provider.¹¹²

228. On the other hand, if FinTechs are undertaking equity financing at their own discretion and decision, then some level of capital regulations will apply to them, depending upon their sources of funds. In general, most FinTechs and crowdfunding platforms are usually identified to be non-deposit-taking institutions since their sources of funds may be either investment/equity-based (where funding clients absorb losses, if any) or donations/contributions, which may not involve repayment to the fund providers.

229. In the first instance, when sources of funds are equity-based (i.e. loss-absorbing PSIAs), the FinTechs will be required to hold capital for operational and negligence/misconduct risks. In the second instance, where donor-based funds are used for investment activities, capital regulations generally do not apply and the emphasis is mainly on non-prudential regulations.

5.4.4 Investment Limits

230. As with credit financing limits introduced for financing activities,¹¹³ equity financing limits may also be imposed on service providers for them to benefit from relaxed prudential regulations for investment-based products and services. These may be, for instance, a maximum equity financing transaction size expressed as a percentage of capital held by the

¹¹¹ See the relevant discussion in section 2.3.3 in this TN.

¹¹² However, this requirement will depend upon the level of responsibility placed on the service provider to conduct initial due diligence and provide accurate information to the investors. A certain level of responsibility for these items may still require the service provider to hold capital against any potential operational and negligence/misconduct risks. See also footnote 91 and related discussion in paragraph 200.

¹¹³ See the discussion in section 3.3.3 in this TN.

institution (e.g. 5% of total capital to a single investee), or simply an absolute amount (e.g. USD 2,000 to a single investee).

231. Limits may also be introduced in terms of portfolio – for instance, a maximum equity financing portfolio expressed as a percentage of capital held by the institution (e.g. 20% of total capital to all fund seekers), or a maximum portfolio share in relation to others (e.g. a minimum debt-based financing portfolio of 80% and a maximum equity-based financing portfolio of 20%).

232. Limits may also be applied in relation to exposures to specific economic sectors (e.g. real estate, technology, etc.), type of fund seekers (individuals, MSMEs, etc.), or aggregate limits on a group of fund seekers (e.g. equity exposure limit of 10% of total capital for the five largest investees).

233. The TN encourages implementation of equity exposure limits, commensurate with the specific country, region and sector context in which the financial services provider operates. The decision on investment limits will also depend upon the type of deposits mobilised by the service provider, based on the discussion and flexibilities proposed in section 5.4.1 of this TN.

234. Investment limits generally serve as useful prudential regulations that achieve the mitigation of concentration risk while also enabling the supervisory authority to clearly identify activities (or institutions) that are eligible to benefit from a proportionate regulatory treatment. Investment limits also protect the financial system from instability risks due to overexposure to a specific segment, the non-performance by which could lead to the service provider's failure and potential spillover effects in the system. Investment limits also serve as an important barrier to regulatory arbitrage, since these limits make it unattractive for the larger equity investment service providers (e.g. private equities and other fund managers) to apply for a licence under this relaxed regulatory window.

235. Given the heterogeneities in jurisdictional and sector-specific contexts, the TN is not in a position to prescribe recommended limits for investment activities in financial inclusion. For instance, an absolute equity-financing limit (e.g. USD 500) may have different implications for different countries depending upon their level of economic development, currency power, purchasing-power parity considerations, etc.

236. Some of the considerations in deriving such limits by the regulatory authority will include the type of entrepreneurial party; for instance, equity financing limits for individual fund seekers may be at a lower value (either as an absolute limit or as a percentage limit to total

capital) than for groups of investees, or MSMEs. This treatment recognises that the financing needs for groups of fund-raisers and MSMEs are typically larger than those of individuals.

237. The regulatory authority will also consider the type of deposits mobilised by the service provider, and a PSIA-based funding structure is likely to enjoy more relaxed conditions on investment limits than a funding structure based mainly on demand deposits and term deposits.

238. Another factor for due consideration is the availability of credit enhancement via various Sharī'ah-compliant mechanisms for the investee entity. However, Sharī'ah has specific guidelines and conditions for credit enhancement for equity financing contracts, as discussed in section 5.4.7 of this TN.

5.4.5 Exit Plan and Redemption

239. The TN requires all equity financing activities by service providers in financial inclusion to have clear exit plans and withdrawal conditions specified in the contract and duly signed by the investee entity and the service provider (or fund providers, as applicable).

240. This plan will spell out the terms of ownership and withdrawal conditions for all parties involved, including methods for the sale of either party's ownership share (if capital is contributed by both parties, as is the case in *mushārakah* financing). Clarity on this is particularly important for equity-based financing transactions, where many considerations, including current valuations of the business entity, are important to enable an amicable and appropriate exit benefiting all the parties involved.

241. The redemption plan is also subject to Sharī'ah conditions, in accordance with the rights and responsibilities of the contracting parties, based upon the original contract upon which the equity financing facility was provided to the investee.

5.4.6 Equity Losses and Liquidity Arrangements

242. In contrast to credit financing activities, which are based upon a structured repayment plan consisting of regular payments by instalment, equity financing is not necessarily packaged with a structured and reliable cash-flow plan. A true equity financing transaction is subject to actual business performance; hence, the cash flows are also subject to the economic and financial liquidity conditions of the fund-raising entity or individual.

243. Given the nature of risk undertaken (i.e. equity investment risk), the TN requires the service providers to implement a fair-value recognition and accounting treatment system for any losses that are realised in the equity position of the equity financing portfolio. Depending

upon the type of deposit¹¹⁴ used to finance this portfolio, the losses may either pass through the profit and loss account of the service provider and/or be absorbed by PSIAs, if applicable.

244. The potentially irregular nature of cash flows from equity financing transactions also poses challenges for sound liquidity risk management. Not superseding the guidelines in section 4.3 of this TN, the service providers are expected to pre-emptively have in place appropriate arrangements for raising emergency liquidity in the event of a missed cash flow from equity financed accounts that were previously expected to perform.

245. The exact treatment of equity losses and/or emergency liquidity arrangements is likely to vary between countries, depending upon their local regulations and accounting standards. In all circumstances, the service provider is expected to review its total equity exposures and assess changes in riskiness as frequently as every month, and to make appropriate adjustments to equity valuations in its assets. The service provider should also send to the supervisory authority its schedule of total equity exposures, showing the adjustments made (or to be made) for realised losses. This reporting to the supervisory authority must occur at least once every three months, although a different frequency may be adopted by the authority depending upon the size, nature and complexity of the service provider, including the type of deposits mobilised. The supervisory authority may also have in place other mechanisms (e.g. on-site supervision) as and when it feels appropriate.¹¹⁵

5.4.7 Credit Enhancement Mechanisms

246. Shari'ah has clear rules in relation to equity financing contracts, including that the entrepreneur/agent cannot guarantee either the principal or the profits to the investing party in *muḍārabah*, *mushārah* and *wakālah* contracts. The only situation when the capital is guaranteed is if it is proven that the entrepreneur/agent was negligent or has carried out misconduct in his or her duties, resulting in a financial loss.

247. Based on the above, the only credit enhancement mechanism available for equity financing contracts is through third-party guarantees. Normally for financial inclusion activities, the government provides the guarantees through its specialised agencies or even specific ministries, which step in to provide guarantees related to projects of national interest or priority (e.g. for women, agriculture, SME finance, technology finance, etc.).

¹¹⁴ See the discussion in section 5.4.1 of this TN. Regarding the profit and loss distribution method for PSIAs, the IFSB is in the process of issuing a working paper, *Profit-Sharing Investment Accounts: A Cross-Country Analysis*, which will provide insights regarding the treatment of losses on financing made using PSIA funds.

¹¹⁵ Discussed further in section 5.5. The discussions in sections 3.4 and 4.4 are also relevant.

248. As a result, when such a guarantee is available from a reliable third party, the TN recognises that the service provider will no longer have to comply with prudential regulations from an equity investment perspective; rather, it will implement and comply with prudential regulations from a credit risk perspective based on the credit quality and rating of the third-party guarantor.

249. Aside from the above, third-party guarantees may also be given by members other than the fund-raiser if the scheme is based on group-financing practices, whereby an equity financing facility to an individual fund-raiser is secured by other members in his or her group – usually close relatives, associates, and fellow residents in villages and communities.

5.4.8 Resolvability and Insolvency

250. The issues and guidance provided in section 3.3.6 of this TN are equally applicable to investment activities and, hence, are not repeated.

251. See also the discussion on recourse options for the financial inclusion consumers in section 6.1.4 of this TN.

5.5 Supervision

252. The discussion of supervision in sections 3.4 and 4.4 is also relevant here. There are some additional issues, however, from the perspective of equity financing activities that are discussed below.

253. The extent of supervision will depend upon the type of deposits utilised to support equity financing activities. In general, the TN recommends utilising PSIA deposits for funding equity financing transactions – in particular, restricted PSIA (RPSIA), in which case supervision will mainly be for regulatory compliance with non-prudential regulations for these investment activities.

254. However, in the event that other types of deposits are utilised for equity financing transactions, much more stringent supervision will be required and the service provider will have to comply with the full set of prudential and non-prudential regulations, including frequent supervisory reporting.

255. In all circumstances, the supervisor has to reasonably satisfy itself that the service provider has effective risk management systems in place for the ongoing review and assessment of total equity exposures on a monthly basis, and with appropriate adjustments

made in the financial books to recognise equity position losses (if any) when realised. The supervisor must also have backing from relevant law and regulations, giving it the authority to collect supervisory reporting templates on equity investments by the service provider, as well as the right to intervene and conduct on-site inspections when necessary (see also specific guidance in paragraph 245).

256. The supervisor must also assess the competence of the service provider to undertake equity investments on behalf of various fund providers, and, if necessary, intervene with sanctions and corrective actions if it finds any violations in its corporate governance practices and fiduciary responsibilities, or any risks of independence of its governing board or executive committee, as applicable.

SECTION 6: NON-PRUDENTIAL REGULATION

257. Non-prudential regulations are mainly focused upon the operations of a service provider with the overarching objective of protecting the consumer and maintaining the integrity of the financial system. These sets of regulations have been gaining particular prominence over the past two decades or so, due to various global events ranging from corporate scandals involving fraudulent practices to political issues related to money laundering and terrorism financing.

258. In the sphere of financial inclusion, consumer protection is generally a bigger concern since a material share of the target market involves the low-income segments with limited or no financial literacy. There are also criticisms against the financial inclusion service providers in some jurisdictions for engaging in exorbitant rate-charging practices. These types of issues also fall under the mandate of non-prudential regulations.

259. As has been mentioned earlier in the TN, non-prudential regulations are usually applicable equally to both deposit-taking and non-deposit-taking institutions providing financial services. However, the diverse set of service providers operating in this market sector requires some consideration of proportionality in regulations to avoid excessive regulatory costs and/or other barriers to entry. Further consideration is in the context of digital financial inclusion service providers, which may require some additional non-prudential measures – for instance, adequate cyber security to prevent unauthorised access to private information through hacking. Premised on such, this section outlines the various non-prudential guidelines applicable, in particular, to service providers engaged in serving the financial inclusion segment.

260. The guidelines in this section aim to address gaps (if any) in non-prudential regulations for financial inclusion service providers. However, the TN clarifies that they are not meant to replace any existing guidelines or recommendations of other IFSB standards and/or more stringent practices as adopted by national RSAs, particularly if the service provider is a regulated institution in the financial sector, which is usually under a more holistic regulatory framework. As such, the guidelines are intentionally skewed more towards service providers that may not be regulated and/or are institutions under the mandate of non-financial sector regulators.

6.1 Consumer Protection

261. Aside from safeguarding financial stability, most regulatory and supervisory authorities also enlist the protection of consumers as one of the fundamental objectives in their mandate. In general, the standards for consumer protection should be consistent regardless of the type of institution providing the product; however, some differences between institutions may be in the actual implementation of guidelines that are intended to achieve the consumer protection objectives. For instance, a commercial bank may have a much more detailed product disclosure sheet commensurate with the complexity of its financing product as compared to an NGO, which may offer a relatively small-sized financing product to a low-income client.

262. In the following subsections, the TN recommends core guidelines that are particularly relevant for upholding consumer protection in activities related to achieving financial inclusion objectives.

6.1.1 *Discrimination/Affirmative Action*

263. The TN encourages the adoption of non-prudential guidelines that prohibit discrimination against the marginalised segments of society. Service providers in financial inclusion activities must have transparent criteria regarding the eligibility of specific products and without any bias towards, for instance, women (gender-based criteria), or based on race, caste, religion or ethnicity. Islamic finance, while addressing the issue of religious exclusion for Muslims, does not discriminate against the members of other religions. Sharī'ah-compliant financial products and services are available to all so as long as the activities of the contracting parties do not contravene the principles of Sharī'ah.¹¹⁶

264. The TN also acknowledges the role of affirmative action policies that endeavour to address the gaps in financial exclusion of the marginalised segments. Financial inclusion objectives often prioritise specific segments that are particularly vulnerable or largely excluded from the formal financial system. Hence, regulations may require, for instance, mandatory provision of a certain percentage of services to a targeted group (e.g. 20% of all microfinancing to female clients).

265. For affirmative action and regulatory prohibition of discrimination to be effective, support is often needed in the form of supply-side policies and fiscal incentives. For instance, to enable more women to avail themselves of financing, specialised government-backed credit agencies could step in as guarantors of transactions to address the issue of limited or no

¹¹⁶ See the discussion of principles in section 2.2 of this TN.

collateral held by this segment. The TN in its various sections has duly discussed options for credit guarantees and collateral mechanisms in Islamic finance for the purposes of supporting financial inclusion activities.

6.1.2 Financial Literacy and Disclosure Requirements

266. Financial literacy of the particularly vulnerable segments is a primary consumer protection issue in financial inclusion activities and potentially requires more attention in Islamic finance, where there are additional rules relating to product structures and the varying rights of contracting parties (as per the underlying contracts) as guided by Sharī'ah. While financial literacy itself is not a regulatory topic per se, adequate disclosures and information transparency are non-prudential regulatory requirements that can, to a certain extent, help in mitigating financial illiteracy and information asymmetry challenges.

267. The TN recommends that all service providers within a jurisdiction have in place standardised product disclosure sheets regarding the common financing, deposit and investment products offered as part of their financial inclusion activities. The inter-agency coordination committee¹¹⁷ may take the lead in coordinating the various authorities in order to develop a common format for this product disclosure sheet that provides clear, yet concise, information about the financial inclusion products and services, as well as about the underlying Sharī'ah contract, with a particular emphasis on the repayment terms and pricing mechanisms. For example, a standard disclosure sheet on opening deposit accounts through agent banks would list the facilities available to customers and the different charges payable by them to utilise this service. A standard disclosure sheet for financing products may, for instance, duly clarify the methodology to calculate pricing of the financing facility.

268. The product disclosure sheet – or its terms and conditions, at a minimum – should indicate the financial responsibility of the client in relation to the product being signed up for, including terms of regular instalment payments, profit/fee/commission to be charged by the service provider, any financial risks (e.g. for investment products), punitive measures in the event of non-payment, and dispute resolution mechanisms should differences arise. Where available, the product, in its disclosure sheet or its terms and conditions for financial inclusion, should also indicate the support or recourse options available to clients in the event of any grievances or lack of clarity about matters related to the financial product. These options may be referrals to purposefully established government-led tribunals or dispute resolution

¹¹⁷ See the discussion in section 2.3.2 of this TN.

avenues, or industry/NGO-led associations that act as neutral parties to provide guidance and welfare support to the financial inclusion-tagged clients.¹¹⁸

269. The TN also recommends that RSAs (or relevant ministries and other bodies) conduct financial awareness campaigns – for instance, through TV commercials/programs or training team visits to targeted rural areas/specified segments – in order to improve upon the financial understanding and capability of the targeted groups. Where such campaigns are run regularly, the product disclosure sheet or its terms and conditions for financial inclusion in the jurisdiction should require the client to indicate their prior knowledge and participation in such financial literacy building campaigns. This requirement acts as an initial signal concerning the client's understanding and financial readiness to utilise the product.

6.1.3 Profit Rate Control

270. A common criticism in financial inclusion initiatives, at least in terms of microfinance activities, has been the comparatively high rates of interest charged by the conventional microfinance institutions. The criticism draws upon the fact that the high rates are charged to low-income consumers, the segment most vulnerable and in need of financing to get itself out of the poverty region. However, the service providers counter that the administrative efforts and costs involved in processing small loans (particularly to those in remote areas and those inaccessible for formal financial institutions) are significant, and that any lowering of rates will make microfinancing unsustainable and therefore unavailable.

271. The argument of administrative costs is also applicable to service providers engaging in Sharī'ah-compliant financial inclusion activities, although the pricing structure of the financing activities is not based on interest rates but on the underlying Sharī'ah-compliant contracts.¹¹⁹

272. A regulatory option is to introduce rate caps that restrict service providers in financial inclusion financing activities from charging beyond a certain threshold. Such caps can prevent service providers from charging exorbitant rates for the purposes of profit maximisation. However, the challenge is to identify a reasonable rate cap that is sufficient to cover the unavoidable higher administrative costs involved in financial inclusion activities. The presence of different types of institutions involved in financial inclusion activities may also make it difficult to identify a “sustainable” rate that is applicable to all of them, given their different cost structures, market segments, business models, etc.

¹¹⁸ See further discussion of recourse options in section 6.1.4 of this TN.

¹¹⁹ See the discussion in section 3.2 of this TN.

273. As an alternative to introducing rate caps, this TN recommends that the relevant authorities introduce schemes that lower the financing costs for financial inclusion clients without eroding the normal profitability of the service providers. This may be achieved by introducing either credit enhancement schemes that favour the targeted population groups (so as to reduce their credit risks and lower the rates offered), or subsidy schemes that partially absorb the costs of the financing facility to the targeted group. The authorities may also support, via supply-side policies, and give incentives for service providers to invest in, for instance, technology that results in improving operational efficiencies and lowering of costs for the service providers in delivering the financial products and services. The TN further clarifies that these authorities are not expected to be the financial sector regulators, but rather government ministries and other specialised bodies that have a mandate to support financial inclusion initiatives (e.g. SME finance, agriculture finance, unemployment support, FinTech and entrepreneurship development, etc.)

274. A further alternative to support the lowering of rates charged is for subsidies to be provided by Islamic social finance institutions through, for example, *waqf*, which mobilise funds to support social and charitable causes. Based upon the deed and intention of the contributing parties, funds could be used to support lowering the debt burden on the eligible clients of financial inclusion products.¹²⁰

6.1.4 Dispute Support/Grievances Recourse

275. Having effective mechanisms for addressing complaints and disputes is an integral and essential component of consumer protection in the financial sector. These mechanisms serve to uphold confidence and encourage the financially excluded to reduce any perceived mistrust of the financial services providers and to partake in utilising the formal financial services sector. However, clients in financial inclusion activities are often the low-income and less financially savvy segments; given their small-sized transactions, judicial recourse is not a viable option for seeking redress of issues (if any) with the financial services providers. As a result, the focus for financial inclusion activities needs to be on alternative mechanisms that can provide sufficient recourse options to the target audience.

276. The TN strongly encourages jurisdictions to have in place recourse options specifically for financial inclusion clientele. These may be special tribunals or dispute resolution bodies

¹²⁰ Islamic social finance institutions and their role in financial inclusion activities are discussed in detail in Section 7 of this TN.

established by the regulatory authority¹²¹ or by relevant ministries in the jurisdiction. They may also be established as an industry association and/or be supported by NGOs to provide guidance and welfare support to financial inclusion-tagged consumers. Non-prudential regulations will play an important role in raising consumers' awareness of these options by requiring service providers to list them in both the product disclosure sheet and the product's terms and conditions that are made available to the consumer, either prior to or at the time of signing the contract.¹²² The same regulations must also ensure the independence of these tribunals from the contracting parties (service providers and the clients) to avoid any potential conflict of interest in the arbitration process.

277. The recourse mechanisms must be designed to include simple processes and easily understood language, to avoid intimidating the consumers. They must also be made available to the targeted consumers at little or no cost. Where applicable due to illiteracy, assistance needs to be offered to consumers in filling out and submitting written complaint forms. The independence of the mechanism from the service providers must also be highlighted to the consumers to instil confidence and trust in the redress system.

278. An essential concern in financial inclusion activities is the ease of access to support for the aggrieved parties, given that some consumers may be based in remote and rural areas with limited accessibility to city offices/complaint desks. Hence, consumers should have other options for accessing support, such as dedicated phone lines, or digital platforms if FinTech was utilised to provide financial access to these targeted segments.

279. The TN also encourages the concerned supervisory authorities to regularly review complaints and grievances data filed at the tribunals/dispute resolution bodies to identify frequent dispute issues in financial inclusion activities. This review will serve as an important feedback mechanism to further improve upon consumer protection regulations and practices in financial inclusion activities on an ongoing basis.

6.2 Conduct of Business

6.2.1 Financing and Debt Collection

280. Financial services providers must be fair in their dealings and avoid abusive "selling" practices. Such practices include taking undue advantage of the lack of financial literacy and

¹²¹ In most countries, the regulatory and supervisory authorities normally do have in place an ombudsman that acts as an independent body to investigate and mediate consumer grievances. The ombudsman for financial inclusion clientele, however, needs to have some additional characteristics, as elaborated further in this subsection of the TN.

¹²² See the relevant discussion in section 6.1.2 of this TN.

understanding of the clients and signing them up for products they do not need or understand. Financial services providers must engage in responsible financing activities so as not to create an “over-indebtedness” situation resulting in repayment issues for clients that push them into the “debt trap”.

281. Service providers’ debt collection practices must also be fair and ethical, and not employ abuse or intimidation. Some informal moneylenders are known to resort to criminal intimidation strategies that force clients to take extreme measures to repay their debts. Related criticisms have also been raised against group-based lending practices, where social intimidation by the service provider and the group’s peer pressure has led to overburdening societal pressures, causing consumers who default to “lose face” or result in more worse outcomes.

282. The TN requires jurisdictions to have in place regulatory guidelines on fair and ethical financing and debt collection practices to be followed and implemented by registered service providers in financial inclusion, regardless of the type of institution (e.g. non-banks, NGOs, cooperatives, etc.). Importantly, the guidelines must reflect the local cultural norms in their definition of “fair” and “ethical” treatment. For instance, “saving face” in public is a much more critical human need in some countries than in others – hence, the approach taken to debt collection in those countries must try to avoid publicly naming and shaming defaulters.

283. The guidelines must also include some levels of assessment of the client’s instalment payment ability. In the absence of a reliable credit reporting system for the financial inclusion segment,¹²³ the service providers will need to undertake a simple cash-flow and instalment payment assessment of the client and advise them accordingly on the product they are signing up for and its terms and instalment payment schedule. The regulatory guidelines must also include provisions on an appropriate product disclosure sheet to be provided by the service provider that lists the recourse options available to the client in the event of a dispute.¹²⁴

¹²³ Normally, clients in this segment are the financially excluded and with no prior credit history. However, it is encouraged that a centralised credit database is in place to record the credit history of specific financially included clients so as to ensure that service providers obtain records to assess the over-indebtedness of individuals (e.g. by clients not fully disclosing other microfinance products they have availed themselves of from other service providers).

¹²⁴ See related discussions on consumer protection in section 6.1 of this TN.

284. The TN recommends that supervisory authorities¹²⁵ have in place a mechanism to periodically collect financial performance statistics¹²⁶ of the service providers which includes indicators of financing sizes, the number of rescheduling and default cases treated in a Shari'ah-compliant manner,¹²⁷ and the number of dispute references filed by clients against a service provider. Such supervisory data are essential to guide the authorities on any strategic response and regulatory updates required to address frequent patterns of issues in existing financial inclusion activities.

285. The TN also encourages concerned supervisory authorities to undertake a fact-finding study on the effectiveness of group-based¹²⁸ financial inclusion activities (if practised in their jurisdictions) from a consumer protection perspective – and with a particular focus on mechanisms of debt collection. Based on the findings, and if required, the supervisory authorities must respond with corrective actions to improve upon the financing and debt collection practices, as well as the overall conduct of business of the service providers in relation to group-based mechanisms. The TN further suggests that this study is periodically undertaken in the medium to long term (e.g. every 10 years) to ascertain the impact of evolving developments in market practices and to update policies and initiate correction measures (as necessary).

6.2.2 Marketing and Branding

286. All service providers must refrain from publishing any misleading advertisements, and the nature and scope of their marketing and branding activities in Islamic financial inclusion (including their claim to Shari'ah compliance) must genuinely comply with various guidelines on permissible and impermissible activities as provided in the various sections of this TN.

287. The TN recommends that jurisdictions have in place regulatory guidelines that require service providers to disclose in their advertisements the necessary laws/Acts under which they

¹²⁵ These authorities may not necessarily be financial sector supervisors, but may include other ministries and bodies that have the mandate to register and oversee service providers engaged in financial inclusion activities. The jurisdiction's inter-agency coordination committee may undertake the role to facilitate the development of an appropriate and consistent supervisory template that collects somewhat harmonised data from the different types of service providers. Such harmonised supervisory data will enable a coordinated national financial inclusion strategic response to any identified patterns of problems in existing practices.

¹²⁶ Discussed further in section 6.2.3 of this TN under "Financial Reporting and Disclosures".

¹²⁷ Making a reference to the number of rescheduling and default cases treated in a Shari'ah-compliant way does not mean that cases of rescheduling and default cases that are not treated in a Shari'ah-compliant way should not be included; rather, they should be included as well.

¹²⁸ While group-based mechanisms are widely celebrated to minimise default issues and encourage performance between members (since these groups typically comprise friends, relatives, community members or work colleagues who know each other), risks to consumer protection arise when service providers charge exorbitant financing rates – indebting an individual in the process – and then combine this with social and peer pressure to force the individual to maintain repayments without due regard to his or her ability to repay.

are licensed, including their entity's specific registration number as issued by the licensing authority.

288. While it may not be feasible for the supervisory authority to vet and review every signage and advertisement, due to the large number of service providers in financial inclusion, the TN recommends regulations to put the ultimate responsibility for ensuring accuracy upon the service provider itself, and any marketing found to be in breach of the overall encompassing regulatory framework will initiate legal and/or regulatory action against the violating service provider.

289. The TN further recommends that authorities require the service provider to list in their promotion materials (e.g. websites, brochures, pamphlets, etc.) the recourse options available to consumers to register complaints and/or comments about the service provider. This may be direct office addresses, phone numbers or email addresses of the complaints cell at the service provider itself and also those of the third-party entity.¹²⁹

6.2.3 *Financial Reporting and Disclosures*

290. The TN recommends that supervisory authorities have in place regulations that require all service providers (including non-deposit-taking providers) to engage in regular financial reporting and non-prudential disclosures to their licensing/supervision authorities. This type of reporting will include updates to basic institutional information when necessary (e.g. operating locations, key personnel involved, types of activities undertaken, legal status, etc.) as well as regular reporting on financial performance¹³⁰ (e.g. financial statements and indicators of scale and portfolio quality).

291. The non-prudential disclosures will include information on the characteristics, terms and costs of the products being offered, as well as the number of rescheduling and default cases treated in a Shari'ah-compliant manner,¹³¹ including dispute references filed by clients against a service provider. Specifically for Islamic finance, the service provider will also provide details of the due processes that are in place to ensure the Shari'ah compliance of its products, and highlight any updates or changes to these, as and when they are implemented.

292. The periodic collection of such data will enable the authorities to monitor the financial inclusion activities being undertaken in the jurisdiction. Also, by including all types of service

¹²⁹ See the related discussion on third-party arbitration entities in section 6.1.4 of this TN.

¹³⁰ The actual extent of financial reporting will differ based on the type of institution – the regulated financial services providers will have more stringent financial reporting requirements than those that are non-regulated (e.g. not-for-profit organisations).

¹³¹ See footnote 127.

providers, the authorities will have access to information and practices by even those that are not prudentially regulated. The non-prudential disclosure requirements should also be harmonised¹³² as much as possible between the different types of institutions (and, hence, different sets of regulators) involved in financial inclusion activities. Such harmonised supervisory data will enable a coordinated national financial inclusion strategic response to any identified patterns of problems in existing practices.

293. The TN also recommends a proportionate approach to reporting between the prudentially regulated and non-prudentially regulated service providers; the latter category may include a much larger number of smaller-sized service providers, including those located in far and remote locations where efficient supervision by the supervisory authority is difficult. For those service providers that are not prudentially regulated, the TN encourages authorities to consider introducing a framework for shared centralised services for financial reporting and non-prudential disclosures. Such a framework will involve one professional services entity being the representative for many different small service providers, and in this process assuming their accounting, auditing, corporate and Sharī'ah governance, and other legal and regulatory functions. The service providers will each pay a lower professional services fee to the entity in order to benefit from its expertise than if they had each established their own separate functions to meet the regulatory requirements.

294. The professional services entity will also be the contact point for the supervisory authority and will provide supervision data for each of its members. Any supervisory enquiries about a service provider will also be directed to this entity, saving time and effort, rather than engaging separately with individual service providers.

295. However, while allowing centralised shared services, regulations must also bind the entities providing these services to strict confidentiality rules to ensure that information about the different service providers that are availing themselves of the facility is not leaked or used in any unauthorised manner.

6.2.4 Governance Framework

296. In general, governance frameworks are of equal concern to all institutions offering financial services, both conventional and Islamic. However, for the purposes of this TN, there are two important considerations: (a) the Sharī'ah governance requirements for activities in

¹³² The jurisdiction's inter-agency coordination committee may undertake to facilitate the development of an appropriate and consistent supervisory template that collects somewhat harmonised data from the different types of service providers.

financial inclusion; and (b) the proportionate application of governance requirements for the non-prudentially regulated service providers.

297. In essence, the guiding principles on Sharī'ah governance systems for IIFS are provided by the IFSB in its standard no. 10 (IFSB-10¹³³), and this TN broadly benchmarks the minimum governance requirements to it. However, specifically for the purposes of Sharī'ah governance requirements for activities in financial inclusion, this TN has recognised certain exceptions and allowed proportionate regulatory flexibilities, and takes precedence over IFSB-10 only for such specified activities (i.e. financial inclusion activities as defined in this TN). This, however, does not override any existing guidelines and/or more stringent practices as already adopted by national RSAs, particularly if the service provider is a prudentially regulated institution under a national/central Sharī'ah governance framework of the jurisdiction.

298. As a result, and based on the guidance in the above paragraph, the supervision on Sharī'ah governance framework for service providers in financial inclusion will be in line with the requirements as established in this TN.

299. In terms of corporate governance for IIFS, the IFSB has established these requirements in its standard no. 3 (IFSB-3¹³⁴), and this TN broadly benchmarks the minimum corporate governance requirements to it. IFSB-3 recognises that many bodies that are concerned with the promotion of good corporate governance have issued codes of corporate governance best practices that have been widely accepted as the international standards, and would be relevant and useful for IIFS.

300. Hence, in line with IFSB-3, this TN does not intend to “reinvent the wheel” by proposing a wholly new corporate governance framework for Sharī'ah-compliant financial inclusion activities. Rather, the TN endorses any sound corporate governance mechanisms as practised in the conventional financial inclusion, and subject to ensuring the compliance with Sharī'ah rules and principles at all times. This includes implementation of, and conformity with, Sharī'ah governance systems, as discussed earlier. Importantly, it also includes upholding the fiduciary responsibilities the service provider has towards investment account holders that have provided funds to it on a profit-sharing and loss-absorbing basis.¹³⁵

301. For both Sharī'ah and corporate governance functions, as introduced in section 6.2.3, the TN recognises a proportionate approach for non-prudentially regulated service providers

¹³³ Available at: <https://www.ifsb.org/download.php?id=4366&lang=English&pg=/published.php>

¹³⁴ Available at: <https://www.ifsb.org/download.php?id=4359&lang=English&pg=/published.php>

¹³⁵ When funds are raised through PSIA, fiduciary risk arises when the service provider fails to act with due care when managing investments, resulting in the risk of possible forgone profits or even losses to the PSIA holders. See the related discussions on PSIA in sections 5.4.1 and 5.4.2 of this TN.

in financial inclusion, particularly those smaller-sized entities that may utilise shared centralised services. This proportionality would involve outsourcing the corporate and Sharī'ah governance functions to a professional services entity in exchange for a fee. The service provider will benefit from the entity's expertise while saving on the costs of having in-house corporate and Sharī'ah governance functions. Specifically for Sharī'ah governance, an option to reduce the costs of operations may be for each smaller service provider to rely on a single Sharī'ah adviser, or for a number of such providers to collectively engage one adviser or a Sharī'ah consultancy firm. An additional modality may be when voluntary Sharī'ah services may be offered by Sharī'ah advisers, Sharī'ah advisory firms or Sharī'ah boards of firms (e.g. Islamic banks) to smaller service providers as part of their social solidarity/CSR efforts.

302. The professional services entity will also be the contact point for the supervisory authority and will provide supervision data for each of its members. Any supervisory enquiries about any of the service providers will also be directed to this entity; as a result, the supervisory agency saves time and effort by not engaging separately with individual service providers.

303. However, regulations, while allowing centralised shared services, must also bind the entities providing these services to strict confidentiality rules to ensure that information about the different service providers availing themselves of this facility is not leaked or used in an unauthorised manner.

6.2.5 Ownership and Management

304. The TN does not have any specific additional criteria on ownership and the management structure of the service providers involved in Sharī'ah-compliant financial inclusion activities, and these may continue to conform with the prevailing local regulations and licensing/registration requirements.

305. The TN, however, recommends that for those wishing to offer Sharī'ah-compliant products, at least one key personnel in a senior position of the service provider must have an accredited certification in the basics of Islamic finance.¹³⁶ The regulatory authority is to identify a list of recognised certification programs that meet this regulatory requirement. The certification program may be offered locally or by an overseas entity through classroom-based learning, or remotely by an e-learning platform.

¹³⁶ This recommendation, however, does not override any existing regulatory requirements and/or guidelines in other IFSB standards concerning the qualification requirements and "fit and proper" criterion for the board of directors/management of Islamic financial institutions. The recommendation is more for those small service providers that are currently not being regulated in terms of the Islamic finance qualifications of their owners/trustees.

306. In relation to the “fit and proper” criterion for experts within the Sharī‘ah body,¹³⁷ IFSB-10: *Guiding Principles on Sharī‘ah Governance Systems*¹³⁸ provides this under Part II, “Competence”.

307. In some countries, the law requires that shareholders/owners of financial inclusion service providers are not entitled to receive returns from the activities; that is, all profits generated by financial inclusion activities must be ploughed back into the business/organisation. The drawback of such a policy is that it limits attracting capital injections into the sector and discourages new entrants/expansion of existing service providers.

308. The TN encourages authorities to permit diverse organisational formats in the financial inclusion space – for instance, limited liability companies, cooperatives, NGOs, etc. – and in the case of for-profit entities, enables regulations that allow for distribution of dividends to shareholders. Such a policy encourages relatively larger capital injections by potential shareholders/owners into the financial inclusion sector.

6.3 Anti-Money Laundering/Countering Financing of Terrorism

309. AML/CFT is one of the key non-prudential regulatory areas that, since the 2000s, has attracted the widespread attention and focus of policymakers globally. The Financial Action Task Force is the international standard-setting body responsible for protecting the integrity of financial systems by preventing financial crime, particularly through standards and guidance on AML/CFT. Over 190 jurisdictions¹³⁹ around the world have committed to implement the FATF’s recommendations against money laundering and terrorist financing.

310. In the context of financial inclusion activities, the FATF Recommendations allow for proportionality in the implementation of AML/CFT rules. Otherwise, high costs of regulatory compliance may discourage microfinance and informal financial services providers from entering the regulatory ambit. It is asserted that without access to the formal financial system, unserved or underserved customers will resort to cash and unregulated channels, which limits transparency and increases the risk of crime and money laundering. This would be counterproductive to one of the key objectives of enhancing financial inclusion, which is to reduce money laundering and terrorism financing risks.

¹³⁷ This may be an individual Sharī‘ah scholar, a Sharī‘ah board comprising three or more scholars, or an external Sharī‘ah advisory firm. See the discussion in section 2.2.3.

¹³⁸ Available at: <https://www.ifsb.org/download.php?id=4366&lang=English&pg=/published.php>

¹³⁹ See: www.fatf-gafi.org/countries/

6.3.1 FATF Recommendations

- *Guidance Paper on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion (2011)*¹⁴⁰

311. In a 2011 guidance paper entitled *Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion*, FATF recognised the relevance of financial inclusion as a means to mitigate the money laundering and terrorist financing risks of financial exclusion. The guidance paper provided support to countries and their financial institutions in designing AML/CFT measures that meet the national goal of financial inclusion, without compromising the measures that exist for the purpose of combating crime.

312. The main aims of the document were to develop a common understanding of the FATF standards that are relevant when promoting financial inclusion, and to lay out the flexibility that the standards offer – in particular, regarding the risk-based approach (RBA), thus enabling jurisdictions to craft effective and appropriate controls.

313. The 2011 version of the guidance paper was developed within the framework of the 2003 version of the FATF standards. It reviewed the different steps of the AML/CFT process (customer due diligence [CDD], record-keeping requirements, reporting of suspicious transactions, use of agents, internal controls), and for each of them presented how the standards can be read and interpreted to support financial inclusion. A revised version of the guidance paper was issued in 2013 to reflect the adoption of the new FATF recommendations issued in 2012 (as discussed below).

- *Revised FATF Recommendations (2012)*¹⁴¹

314. Given the unintended consequences of inflexibility in AML/CFT requirements on financial inclusion, the FATF introduced a risk-based approach to AML/CFT regulation and supervision in its revised recommendations issued in 2012. The RBA, which becomes a key element of the international AML/CFT standards¹⁴² is intended to pursue a financial-inclusion-friendly AML/CFT regime by offering jurisdictions a degree of flexibility to tailor regulations and policies commensurate with the specific nature and types of financial services providers and the level of the risks identified in the respective markets.

¹⁴⁰ Financial Action Task Force (2011). *Guidance on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion*.

¹⁴¹ Financial Action Task Force (2012). *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation – The FATF Recommendations*, updated November 2017.

¹⁴² The FATF recommendations allowed, but did not explicitly require, countries to implement a risk-based approach prior to the 2012 revision.

315. Despite the wide variability of countries' AML/CFT capacity and experience, as well as potential exposures to money laundering and terrorist financing, the RBA enables countries to make decisions on how to allocate their own resources in the most effective way to achieve the balance of financial integrity and financial inclusion.

316. The cornerstone of the RBA in the revised FATF recommendations lies in the assessment of risk undertaken both at the country and financial institution levels. The revised FATF recommendations clearly distinguish the circumstances where "higher risk" and "lower risk" of money laundering and terrorist financing could potentially exist. The ground rule used is that, where the risk of money laundering and terrorist financing is pronounced, regulators should require financial institutions to undertake enhanced measures to adequately address such risks. On the other hand, in the event of lower risks, simplified measures may be permitted under certain conditions.

317. The concept of simplified measures may have greater practical contributions in the effort of establishing AML/CFT regimes that complement the global financial inclusion agenda. For instance, with respect to CDD, the offering of financial products that are properly defined and limited to certain types of customers for the purpose of promoting financial inclusion can be classified as a lower-risk scenario, and hence be subject to simplified CDD measures.¹⁴³

- *Revised Methodology for Assessment of Compliance with the FATF Recommendations (2012)*¹⁴⁴

318. The FATF revised its assessment methodology for assessing a jurisdiction's compliance with the FATF recommendations in 2012. By incorporating, for the first time, assessment of the effectiveness of a respective country's AML/CFT regime in addition to the existing technical assessment component, the revision of the FATF's compliance assessment has significant ramifications for financial inclusion by allowing assessors to consider the potential adverse impacts of financial exclusion in their evaluations. For instance, the effectiveness of a country's AML/CFT regime will be assessed poorly if assessors find that applied AML/CFT measures could discourage the legitimate use of the formal financial services in that country.

¹⁴³ Examples of simplified CDD measures include the following: (i) verifying the identity of the customer and the beneficial owner after the establishment of the business relationship; (ii) reducing the frequency of customer identification updates; (iii) reducing the degree of ongoing monitoring and scrutinising transactions based on a reasonable monetary threshold; and (iv) inferring the purpose and intended nature from the type of business relationship established, instead of collecting specific information or carrying out specific measures.

¹⁴⁴ Financial Action Task Force (2012). *Methodology for Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems*, updated November 2017.

319. The following immediate outcomes (1, 3 and 4) are identified in the revised assessment methodology indicating the effectiveness of a country's AML/CFT regime as having a certain degree of relevance to financial inclusion:

- *Immediate outcome 1:* ML/FT risks are understood and, where appropriate, actions are coordinated domestically to combat money laundering and the financing of terrorism and proliferation.
 - *Immediate outcome 3:* Supervisors appropriately supervise, monitor and regulate financial institutions and defined non-financial businesses or professions (DNFBPs) for compliance with AML/CFT requirements commensurate with their risks.
 - *Immediate outcome 4:* Financial institutions and DNFBPs adequately apply AML/CFT preventive measures commensurate with their risks, and report suspicious transactions.
- *Revised Guidance Paper on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion (2013)*¹⁴⁵

320. In 2013, FATF published a revised guidance paper on the application of AML/CFT measures in the financial inclusion context, in collaboration with the World Bank and the Asia/Pacific Group on Money Laundering. Updating the first guidance paper issued in 2011, the 2013 paper reflects the changes made to the revised FATF recommendations issued in 2012 – in particular, the reinforcement of the RBA.

321. The application of the RBA will help countries and financial institutions to understand, identify and assess risks and apply mitigation and management measures that are risk-sensitive. This may include low risks, which could benefit from an exemption, and lower risks, which could apply simplified AML/CFT measures.

322. The 2013 guidance paper also highlighted that the main challenges in enforcing financial integrity, in line with the financial inclusion mandate, relate to the lack of reliable identity documentation and data verification of potential customers. In doing so, the 2013 guidance paper also reviews how different steps in the AML/CFT process – CDD, record-keeping requirements, report of suspicious transactions, use of agents and internal control – can be interpreted and applied in support of financial inclusion.

¹⁴⁵ Financial Action Task Force (2013). *Guidance on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion*.

- *FATF Guidance on AML/CFT Measures and Financial Inclusion, with a supplement on Customer Due Diligence (2017)*¹⁴⁶

323. In 2017, FATF issued a supplement to the 2013 guidance paper that provides country examples of CDD measures adapted to the context of financial inclusion. Those examples illustrate how a simplified set of CDD measures or alternative forms of identity verification – for example, the use of e-identity tools – can support financial inclusion, while appropriately mitigating the ML/TF risks.

6.3.2 IFSB Guidelines

324. The IFSB, at this stage, takes the position that activities in Islamic finance do not pose any different money laundering and terrorism financing risks beyond those that are potentially posed by the conventional financial sector.¹⁴⁷

325. Sharī'ah rules demand high ethical standards and conduct from the IIFS, and mandate an absence of activities that would result in fraud and criminal activity. Hence, money laundering and terrorism financing are non-Sharī'ah-compliant by their very nature, being fraudulent and criminal-based activities. Consistent with international standards, IIFS are to report to the relevant authorities suspicious activities involving cases of potential money laundering and the financing of terrorism.

326. The IFSB has previously addressed AML/CFT requirements for Islamic banking under its CPIFR 33 on “Abuse of financial services” in its IFSB-17: *Core Principles for Islamic Finance Regulation – Banking Segment (CPIFR)*.¹⁴⁸ More recently, the IFSB has published a joint working paper on AML/CFT Issues in Islamic finance in partnership with the Arab Monetary Fund (AMF).¹⁴⁹

327. In view of the above, this TN endorses the FATF recommendations and their proportionate application (as discussed in section 6.3.1) for AML/CFT regulations in Sharī'ah-compliant financial inclusion activities. The TN further recommends authorities to duly understand ML/TF risks and consider the findings and recommendations of the joint AMF–IFSB *Working Paper (WP-12) on Money Laundering and Financing of Terrorism Risks in*

¹⁴⁶ Financial Action Task Force (2017). *Guidance on AML/CFT Measures and Financial Inclusion, with a supplement on Customer Due Diligence*.

¹⁴⁷ This view was expressed in IMF Working Paper WP/16/42, issued February 2016, which states: “There is no evidence that the ML/TF risks in Islamic finance are any different from those posed by conventional finance. Rather, the choice of conventional or Islamic financial institutions to launder the proceeds of crimes or finance terrorism would appear to be dictated by convenience and opportunity rather than by inherent differences between them.”

¹⁴⁸ Available at: <https://www.ifsb.org/download.php?id=4373&lang=English&pg=/index.php>

¹⁴⁹ Available at: <https://www.ifsb.org/download.php?id=5509&lang=English&pg=/index.php>

Islamic Banking when designing AML/CFT rules for Islamic finance. The TN also encourages regulators and the Islamic finance industry market players to develop a better understanding of the ML/TF risks faced by the industry. As indicated by the FATF guidance on financial inclusion, improving the understanding of ML/TF risks in Islamic finance will allow effective implementation of preventive measures tailored to the characteristics of their products and services.

328. Proportionate application of AML/CFT regulations for financial inclusion activities will apply equally to both Islamic and conventional products. The risk-based approach to AML/CFT regulation responds to the need to bring the financially excluded into the regulated financial sector, while at the same time maintaining effective safeguards and controls against ML/TF risks. It offers jurisdictions a degree of flexibility to tailor regulations and policies commensurate with the specific nature and types of financial services providers and the level of the risks identified in the respective markets. The simplified measures resulting from proper application of an RBA may contribute to establishing AML/CFT regimes that complement the global financial inclusion agenda.

6.4 Digital Finance

329. Non-prudential regulatory issues are increasingly gaining prominence for digital financial services as these evolve from simple “transfer” and “payment” mechanisms into more “intermediation” and “investment-based” platforms. The latter involves at least some levels of credit, market and equity risk undertaking by the funds contributing consumers. Given the often intersectoral relationships between service providers, financial institutions, mobile network operators (MNOs) and others in digital financial inclusion services, there are some specific considerations relating to non-prudential regulations for digital financial inclusion¹⁵⁰ Supervisory authorities need to keep abreast of the latest technological developments and periodically monitor any related shifts in digital financial platforms.

6.4.1 Web-based Platforms

330. Digital finance includes a number of service providers that may not necessarily have a physical office location or a strong branch network; rather, they operate solely online through the web and/or mobile applications – for instance, some crowdfunding platforms or payment service providers. Hence, non-prudential issues of consumer protection, conduct of business and AML/CFT become a much more severe regulatory concern for these virtual platforms

¹⁵⁰ The specific considerations from a prudential regulations perspective were duly addressed in Sections 3, 4 and 5 of this TN. Relevant preliminary discussion on digital finance is also included in section 2.3.4.

since they cannot be tracked to a physical office or location. These platforms can also easily circumvent jurisdictional borders and enable consumers from across borders to participate in the financial activities offered. Virtual platforms, both within financial services and in other sectors, are also increasingly in the spotlight due to cases of fraud, manipulation, personal data theft, deceptive marketing and other challenges associated with non-prudential regulatory issues.

331. The TN strongly recommends that all supervisory authorities regularly update and publish a public list of all “approved” digital financial inclusion service providers in their jurisdiction to enable consumers to verify the legality of any service provider found on the web/mobile app. The TN also recommends that supervisory authorities have in place regulations that require digital financial services providers to provide their regulatory registration details on their website/mobile app, including the types of activities they are permitted to undertake, eligibility criteria, financing and/or investment limits. The website/app must also give sufficient contact details to enable consumers to initiate recourse actions should an issue arise from utilising the services offered by the service provider.

332. The TN further recommends that the supervisory authorities follow the above initiative by running public awareness campaigns against the risk of online scams in financial services, as well as to encourage consumers to duly verify service providers against the “approved” list published by the authority. Where any anomaly or a non-licensed service provider is identified, the authorities must encourage the public to duly report such websites/mobile apps to the concerned departments for investigation and regulatory action. As such, the public awareness campaigns run by the authorities must also provide the regulatory contact details for consumers to report any unlawful activities found on digital finance platforms.

333. Where digital finance service providers in a jurisdiction belong to different economic sectors and are under different supervision authorities, the TN encourages the national financial inclusion inter-agency coordination committee¹⁵¹ to take the lead in implementing the above recommendations.

6.4.2 Agents/Branchless Banking

334. Third-party agents (e.g. retail shops, mobile airtime resellers, etc.) are an essential feature of digital finance/branchless banking, since they enable the financial services providers (including banks) to expand their outreach to various locations with minimal capital and operating costs, as opposed to setting up bricks-and-mortar bank branches. In this process,

¹⁵¹ See guidance on the inter-agency coordination committee in section 2.3.2 of this TN.

third-party agents are a core component of the customers' experience and inherently assume the responsibility of "trust" over people's money.

335. This TN recommends that supervisory authorities introduce certain non-prudential regulations to oversee the behaviour of third-party agents involved in supporting financial inclusion activities. These regulations¹⁵² will apply to the financial services provider itself, who will act as an "intermediary" in implementing the regulations set by the authority to regulate the behaviour of the third-party agents.

336. This TN stipulates that all financial services providers that wish to utilise the services of third-party agents must obtain "regulatory approval" from the concerned RSA, prior to marketing and operating third-party mobile money/banking services to the general public. This regulatory approval will require, at a minimum, that the financial services provider conducts appropriate due diligence on its potential agents, including collecting copies of company registration records if the agent is registered as a company and/or identity and verification documents of the owner(s) if the agent is a sole proprietorship/partnership business. The financial services provider must also verify and validate the physical address and location of the agent's business/shop (e.g. through copies of utility bills in the shop's name, a local municipal authority approval letter for the business, etc.).

337. The financial services provider must also have in place a documented due process for selecting and approving third-party agents, and it must submit this process for information and record-keeping by the concerned supervisory authority, prior to beginning the process of selecting its agents. This due process must include appropriate training programs for potential agents that cover topics such as the financial services provider's digital finance/branchless banking products and services, as well as basic AML/CFT, information technology, user-interface and other relevant aspects necessary for operating a sound and stable platform. Such training is required because, by way of delegation, the agents are undertaking to carry out some of the regulatory requirements on behalf of the financial services provider (e.g. requiring identity documents from clients to comply with AML/CFT requirements). These trainings are to be carried out on a regular basis.

338. The training for agents may also include some basic instruction regarding the Sharī'ah governance mechanisms in place at the level of the service provider to ensure the Sharī'ah

¹⁵² The prudential regulations will apply directly to the financial services providers, as discussed in Sections 3, 4 and 5 of this TN, and without an immediate impact on third-party agents. Nonetheless, the financial services providers, on their own initiative, may require third-party agents to place a "security deposit" for obtaining agency rights. However, given the often small scale of these third-party agents, requiring cash funds as a deposit is not a viable option; hence, emphasis needs to be placed upon non-prudential measures, as discussed in this specific subsection of the TN.

compliance of its products and services. The third-party agent itself, however, is not required to have any Shari'ah governance mechanisms in place at its premises.

339. The financial services provider must also maintain records of its “approved agents” and regularly update this list to capture any new additions/deletions and/or updates to existing ones. During the normal cycle of supervisory reporting, these records need to be duly submitted by the financial services provider to the supervisory authority.

340. Finally, the financial services providers must have appropriate systems in place to capture real-time information about the activities being undertaken by the third-party agents. This is essential to ensure that the service provider is able to, in a way, aptly “supervise” its agents’ activities and initiate corrective actions when necessary. Where any major breach or suspicious activity is observed, the service provider must duly report this to the supervisory authority for their further investigation and action. (An example might be when agents process transactions involving large amounts without including the client’s personal information, thus breaching AML/CFT requirements.)

6.4.3 Mobile Network Operators

341. In contrast to the use of third-party agents, which may number several hundred or more, MNOs are normally few in number, depending on how many telecom operators are in business in a jurisdiction. They are also usually well regulated (although, admittedly, not from a financial services perspective) under the telecommunications authority, which will have in place rules regarding the conduct of business, consumer protection, anticompetitive behaviour and, recently, anti-terrorism initiatives.

342. Telecommunication authorities globally are increasingly requiring customers to be “registered” with full identification and address details (including biometric fingerprints data) as a means to prevent crime that may involve phone calls using mobile phones. This has also resulted in millions of mobile phone SIM cards being disconnected, as well as hefty fines being imposed upon MNOs due to non-compliance with identity registration requirements.

343. This TN recognises and endorses the regulatory requirements by non-financial sector regulatory bodies that support the objectives of financial regulation. For instance, registration of SIM cards will automatically comply with the basic KYC requirements of financial sector regulations. Also, the use of PIN numbers in mobile phones can provide security against identity theft for financial transactions conducted over mobile networks. MNOs also normally have SIM usage records in storage for a specific time period, and this technology and storage facility can be leveraged upon to record and store financial transactions digitally.

344. Premised on the above, this TN encourages authorities, ideally via the inter-agency coordination committee,¹⁵³ to explore effective ways to leverage existing cross-sectoral regulations to facilitate financial inclusion activities. For instance, opening mobile money bank accounts can be simple and efficient if the digital finance providers collaborate with MNOs to utilise the customer identity details provided at the time of SIM registration. The role of the inter-agency coordination committee is also particularly essential in the case of MNOs, to ensure there is sufficient clarity on the part of telecommunication regulators concerning their mandate and legal authority to intervene should they identify any issues with MNOs that are against the interests of mobile-based financial services users – for instance, MNOs charging excessive fees to the users of mobile-banking services.

345. As with the use of agents, the MNOs are not required to have any Sharī'ah governance mechanisms in place at the MNO level; instead, the responsibility lies with the financial services provider to ensure that the products and services offered over mobile networks are Sharī'ah-compliant.

6.4.4 Data Protection and Cyber Security

346. The risk of data theft is much more prominent on digital platforms (e.g. through hacking or phishing) compared to hard-copy filing and storage of personal information in bricks-and-mortar offices. Hence, robust security measures need to be in place to protect the integrity of the digital system so that information about customers is collected, stored, viewed and used only in proper ways by designated people.

347. The TN strongly recommends authorities to have in place regulations that require service providers in digital finance to implement robust online security measures that ensure the effective protection of clients' confidential data as well as stored monetary values. This security system must protect data against hacking attempts, the spread of malware and spam, and the theft of proprietary values, and have in place effective antivirus safeguards to protect the servers of the service provider, as well as the clients/users accessing the website/mobile app, against infection.

348. The regulations must also ensure that all third parties who gain access to confidential or sensitive information digitally (e.g. MNOs, third-party agents in branchless banking, etc.) duly comply with the data confidentiality agreements and do not disclose or leak such information. In addition, for third-party agents, the primary responsibility for data protection and cyber security lies with the service provider, who must have an effective digital system

¹⁵³ See guidance on the inter-agency coordination committee in section 2.3.2 of this TN.

with the requisite safeguards in place. However, in the case of MNOs, the primary responsibility may lie with the operator, who must ensure that its network is safe and secure.

349. In general, the issue of cyber security and data protection goes beyond the realm of just financial sector regulators and requires a broader, jurisdiction-wide policy concerning online privacy and data protection issues. For instance, the multimedia and telecommunications authority may be in a better position than a central bank to provide guidance on relevant online security systems to protect against the ever-evolving cyber security risks.

350. Premised on the above, the TN further encourages the supervisory authorities with a mandate over digital financial inclusion service providers to leverage upon digital security expertise available through different authorities in the jurisdiction and to introduce necessary regulations that reflect upon this expertise. Periodic vulnerability assessments also need to be carried out to review and address any changes or new risks in data protection.

351. A particular challenge regarding digital security systems for financial inclusion service providers is the costs involved in buying/designing such systems. In this regard, the TN considers a proportionate approach where the non-deposit-taking service providers, and those that are not prudentially regulated, may opt to outsource their IT management and security systems to an external shared centralised services firm that is a professional in this field. This approach will involve one IT solutions entity assuming responsibility for designing, maintaining and updating the digital system supporting the financial inclusion activities, as well as having in place robust security measures to protect against any unauthorised access to the data and stored proprietary values (i.e. intangible financial assets, including mobile-based money, app-based financial credits, etc.). The entity will provide similar services to many different digital financial inclusion service providers in exchange for fee payments by each. The service providers will benefit from the expertise of the professional services entity at a reduced cost by virtue of availing themselves of shared centralised services, as opposed to each having established its own separate security system.

352. However, regulations that allow centralised shared services must also bind the entities providing these services to strict confidentiality rules to ensure that information provided by the different service providers using the facility is not leaked or used in an unauthorised manner.

SECTION 7: ISLAMIC SOCIAL FINANCE

7.1 Relevance for Financial Inclusion

353. “Islamic social finance” in this TN refers to all those Sharī‘ah-compliant financing activities that are undertaken for “non-profit” and/or “societal welfare” purposes; that is, the underlying intention of the financial activity is to support charities, social causes and/or other welfare projects that do not contravene the principles of Sharī‘ah.¹⁵⁴ Social finance activities in Islamic finance may be broken down into two interrelated components: (i) social solidarity instruments, and (ii) social finance institutions.

7.1.1 Social Solidarity Instruments

354. “Social solidarity instruments” are at the level of “contracts” and, in this TN, the term refers to those Sharī‘ah-compliant mechanisms through which social finance activities can be undertaken. There are a number of social solidarity instruments defined in Sharī‘ah, including *sadaqah*, *waqf* and *qarḍ hasan*.

- **Sadaqah:** Charitable contributions to protect the rights of the poor and needy in society.
- **Waqf:** This is a voluntary endowment of assets or properties to a trust, whose usufruct is earmarked for charitable purposes specified by the founder of the trust.
- **Qarḍ:** Money extended to an individual without any obligation to repay an amount in excess of the loaned principal (i.e. a benevolent loan without interest).

355. The above instruments are in widespread use by Muslims globally, which are voluntary in nature, while *waqf* beneficiaries are those specified by the endower. For the other two, there are no restrictions on the recipients.

356. This TN recognises that social solidarity instruments in Islamic finance can play a major role in supporting financial inclusion initiatives. In terms of extending financing, *qarḍ hasan* is an ideal instrument for supporting financial inclusion as it enables the deserving segments to borrow funds at no cost.

357. Among the other instruments, the TN notes that *sadaqah* can be utilised for a variety of purposes in financial inclusion activities, including in supporting debt alleviation of genuinely defaulting clients. Alleviating the burden of debt on a debtor is a very notable virtue in Sharī‘ah;

¹⁵⁴ For a discussion of Sharī‘ah specificities, see section 2.2 of this TN.

hence, *sadaqah* funds can be a source of financial assistance to clients of Sharī'ah-compliant financial inclusion activities.

358. *Waqf* is the most versatile instrument since, subject to the stipulations in the *waqf* deed (i.e. trust deed), the returns generated by a *waqf*'s principal fund could be used for all of the above purposes. For instance, *waqf* returns may be utilised to extend financing if the *waqf* deed as stipulated by the founder allows this. (For instance, the *waqf* deed could stipulate that a portion of its returns may be used to support aspiring Muslim entrepreneurs.) *Waqf* returns can be utilised in supporting debt alleviation of genuinely defaulting clients and to subsidise financing costs if the *waqf* deed stipulations include financially supporting debtors who have defaulted due to no fault of their own and supporting entrepreneurs by partially absorbing some of the financing costs incurred by them.

359. In all cases, the actual modality and specifics of implementing social solidarity instruments in support of the above financial inclusion initiatives will need to comply with Sharī'ah guidelines. This compliance of modality may be affirmed by seeking either (i) the approval of a centralised approval authority on Sharī'ah where available (e.g. a centralised Sharī'ah board), or (ii) an approval of the modality by a Sharī'ah body.¹⁵⁵

7.1.2 Social Finance Institutions

360. "Social finance institutions" are at the level of "institutions" and, in this TN, the term refers to those non-profit entities that are established for the particular purpose of undertaking social finance activities. The IFSB survey¹⁵⁶ carried out to support the preparation of this TN identified several countries with Islamic social finance institutions that utilised Islamic social solidarity instruments to raise funds to support their activities. These institutions included *waqf* institutions (i.e. institutions set up as *waqf*), Islamic foundations, and other types of charitable organisations/NGOs that collected funds by means of a social solidarity instrument.

361. The TN recommends that RSAs explore the role and importance of these Islamic social finance institutions in supporting the various financial inclusion initiatives. Quite often, a *waqf* institution is under the direct care, operation and supervision of a government authority (e.g. *Waqf* Ministry, Religious Affairs Ministry, etc.). These institutions, by virtue of their donor-based funds, have an easier disbursement mechanism for eligible individuals from the *waqf* returns based on the conditions of the endower (as opposed to commercial service providers'

¹⁵⁵ This may be a Sharī'ah board comprising three or more scholars, or an external Sharī'ah advisory firm, or an individual Sharī'ah scholar. See the discussion in section 2.2.3.

¹⁵⁶ The survey exercise was conducted from October to December 2017.

risk-based mechanisms) and are in a position to address many of the limitations and challenges of financial inclusion activities.

362. Importantly, in line with the discussion in section 7.1.1, Islamic social finance institutions (*waqf* and *sadaqah* institutions) can disburse funds to defaulting debtors to alleviate their debt burden resulting from financial inclusion activities. If this is done regularly for specific target groups, the ex-post disbursements of Islamic social finance funds to eligible recipients can have similar effects as an ex-ante credit guarantee because it reduces the risk of losses for the financial inclusion service provider. Islamic social finance institutions (*waqf* institutions) can also provide the support required to lower financing costs for financial inclusion clients – for instance, through earmarked direct payments to eligible recipients to lower the burden of the financing costs charged by the financial inclusion service provider.

363. Islamic social finance institutions that raise funds through cash *waqf* may also themselves take part in financial inclusion activities by extending *qard hasan* to individuals directly, or through direct payments to eligible recipients for the specific purpose of the reduction of the costs of financial inclusion services provided this is specified in the *waqf* deed.

364. Islamic social finance institutions, particularly those based on *waqf*, may also be in a position to support financial inclusion by placing funds with deposit-taking service providers on the basis of profit-sharing investment accounts, provided this is specified in the *waqf* deed. This arrangement will help financial inclusion service providers in the form of relaxed prudential regulatory and supervision regimes.¹⁵⁷

365. In order to ensure Sharī'ah compliance in the implementation of the practices discussed above, the Islamic social finance institutions may (i) rely on their own internal Sharī'ah expertise,¹⁵⁸ or (ii) leverage Sharī'ah approvals already in place at the level of the service providers. If the first two options are not available, Islamic social finance institutions may validate the Sharī'ah compliance of their practices by seeking either (iii) approval of a centralised approval authority on Sharī'ah where available (e.g. a centralised Sharī'ah board), or (iv) an approval of the modality by a Sharī'ah body.¹⁵⁹

366. The TN further acknowledges that, in some jurisdictions, Islamic social finance institutions may not be present, or may be very few in number. In such an event, the TN recognises that conventional social finance institutions (those that do not implement a Sharī'ah

¹⁵⁷ See the related discussion in section 5.4.1 of this TN.

¹⁵⁸ Since these are Islamic social finance institutions, they are very likely to have their own in-house Sharī'ah governance systems.

¹⁵⁹ This may be an external Sharī'ah advisory firm or an individual Sharī'ah scholar. See the discussion in section 2.2.3.

governance system or claim to be Sharī'ah-compliant) may provide support for Sharī'ah-compliant financial inclusion activities subject to the conditions and proportional flexibilities accorded in this TN in its various guidelines.¹⁶⁰

7.1.3 *Gaps and Opportunities*

367. The potential of Islamic social finance for serving financial inclusion objectives is largely untapped and underutilised. This underutilisation is partly due to the perception that social finance is only for religious and/or charitable purposes and may not be utilised for related productive activities.

368. In the IFSB survey conducted as part of the preparation of this TN, an overwhelming majority of the RSAs surveyed indicated that Islamic social finance activities fell outside the regulatory ambit of the financial sector RSAs in their jurisdiction. In the same survey, some RSAs also suggested that these institutions were not established from a financial inclusion perspective, but more for charity/donation purposes; hence, they did not require financial sector regulations.

369. In the contemporary Islamic economy, social finance activities have largely been excluded from the commercial Islamic financial services industry, aside from the usual CSR initiatives. However, an integration of social finance with commercial activities can nurture the entrepreneurial spirit, which is key to enabling segments of society to climb out of the poverty trap. This draws a parallel to the classical quote: "Give a man a fish and you feed him for a day. Teach him how to fish and you feed him for a lifetime."

370. Islamic social finance institutions have an important role to play in supporting initiatives in financial inclusion, as has been discussed in this TN. The TN envisions that the integration of Islamic social finance, which aims to support financial inclusion initiatives, into the commercial finance industry can improve socio-economic well-being, financial inclusion and overall financial stability by bringing both social and social solidarity activities within the regulatory ambit.

371. In this regard, some initiatives have already been undertaken in a few countries to integrate Islamic social finance within the commercial IFSI as a means to promote financial inclusion. This trend is still relatively new, with only a few practical cases. Nonetheless, these developments mark an important direction of regulatory interest, since the traditional regulations in place have not actively considered the role of Islamic social finance in the

¹⁶⁰ For example, see the exceptions to Sharī'ah requirements discussed in sections 2.3.5 and 3.3.5.

commercial IFSI. Hence, appropriate regulatory guidelines are needed to ensure the smooth and stable functioning of this integration.

7.2 Modality for Commercial Integration¹⁶¹

372. The TN proposes that Islamic social finance can be integrated into the commercial IFSI via two mechanisms: (i) direct utilisation of Islamic social solidarity instruments “on-balance sheet” to raise funds by the financial services providers; and (ii) partnerships with Islamic social finance institutions to support financial inclusion activities by the financial services providers. The TN also discusses a third modality, where there is a reversal in integration: in this modality, the commercial IFSI is instrumental in supporting the Islamic social finance institutions in their activities, which may include, among other objectives, supporting financial inclusion.

7.2.1 Direct Integration

373. Direct integration entails the commercial financial services provider utilising Islamic social finance “on-balance sheet” and earmarking these funds for specified financial inclusion activities. This would involve the service provider offering and marketing accounts where funds may be placed on the basis of *sadaqah*, *waqf* and *qard hasan*. These accounts¹⁶² would be made available to the members of the general public, including individuals, institutions, corporates, NGOs and any other registered bodies/entities. The Islamic social finance institutions can also participate by placing funds into these accounts.

¹⁶¹ Due to the essence of this TN, which is dedicated to financial inclusion, the discussions in this subsection consider only how Islamic social finance can support financial inclusion activities by IIFS. However, in reality, Islamic social finance can support any Shari’ah-compliant welfare activities through integration with the commercial IFSI, beyond financial inclusion activities.

¹⁶² It is important to note that funds placed on the basis of *sadaqah* do not need to be repaid to their contributors. This is discussed further in section 7.3.3 of this TN. As a result, the contributing parties forfeit their right over the use and withdrawal of these funds and give full discretion to the IIFS to use these funds as per pre-specified social purposes. Hence, from this perspective, *sadaqah* placements are, in fact, not banking deposits, which attract a liability upon the IIFS for repayment.

Table 7.2.1.1: Direct Integration of Islamic Social Finance within a Commercial IIFS

ASSETS	FUNDING PROFILE
Cash	Current accounts
Financing	Investment accounts
Investments	Other remunerative accounts
Others	
Financial Inclusion Portfolio (<i>murābahah</i>, <i>mushārakah</i>, <i>qarḍ</i>, <i>ijārah</i>, etc.)	Islamic Social Finance Funds (<i>waqf</i>, <i>qarḍ</i>, <i>sadaqah</i>)
Long-term investments	Long-term funding
Fixed assets	Equity and reserves

374. The IIFS is encouraged to support financial inclusion by undertaking financing activities in line with the objectives and targets of the national financial inclusion strategy (where available). The IIFS is not restricted to using only Islamic social finance funds to extend financial inclusion financing; rather, the IIFS is free to use all available funds in its funding profile.¹⁶³ However, the Islamic social funds will be instrumental in supporting the financial inclusion portfolio by way of risk management, as well as easing of prudential regulatory requirements.¹⁶⁴

375. The funds raised in *sadaqah* accounts can be used to support debt alleviation. For debt alleviation, the funds collected in *sadaqah* accounts can be disbursed to a defaulting client and, hence, facilitating a positive decision towards his or her application. To prevent any wilful default, it is suggested that clients not be informed about the availability of *sadaqah* funds to alleviate their debt should they be unable to repay it.

376. For the above-mentioned source of Islamic social finance accounts (*sadaqah*), an important consideration is whether to invest any surplus funds available with the IIFS for generating returns. Leaving aside the regulatory concerns (which are discussed in section 7.3), in general there are no restrictions on doing so, provided that the funds are only invested in Sharī'ah-compliant opportunities and that the profit generated is used solely for social activities. That is, the profits are added back into the pool of funds available to support the financial inclusion portfolio.

377. In contrast to the above source, cash *waqf* deposits need to be invested and only the profits generated from these funds are to be utilised for social activities. That is, IIFS could offer *waqf*-based deposits and specify that any returns generated may be dedicated, either

¹⁶³ For a better understanding of the utilisation of deposits for financial inclusion activities, see the related discussion in sections 4.1 and 4.2 of this TN.

¹⁶⁴ Regulations for Islamic social finance are discussed in more detail in section 7.3 of this TN.

wholly or partially, to various financial inclusion supporting activities – including debt alleviation, lowering of financing costs, and the extending of *qarḍ hasan* microfinancing. Cash *waqf* can be placed either in perpetuity or as temporary placements for a certain time period provided the endower has stipulated these in the *waqf* deed.¹⁶⁵

378. As with the earlier recommendations, when cash *waqf* returns are available to alleviate the debt burden of genuine defaulters, this facilitates a positive decision towards his or her application. To prevent any wilful default, it is encouraged that clients are not informed about the availability of the *waqf* returns to alleviate their debt should they be unable to repay it. In the case of utilising these returns as subsidies to lower financing costs, there is no restriction on providing this information to the client, who will be asked to indicate his or her interest in this facility by “opting in” at the time of submitting an application for financing.

379. Finally, in relation to *qarḍ hasan*, IIFS are known to normally attract current accounts on the basis of *qarḍ* even outside the financial inclusion space. However, due to their nature, which requires repayment in full to the contributors, they attract both prudential and non-prudential regulations; hence, they are not as attractive a source to support financial inclusion activities as the other social solidarity instruments (*ṣadaqah* and returns on cash *waqf*). Nonetheless, the IIFS may consider extending *qarḍ hasan* financing, packaged with the support of the other social finance deposits as a means to mitigate default risks, as well as to cover its direct and actual administrative costs incurred in processing and managing the *qarḍ hasan* financing portfolio. The end-result is that the client gets the required financing at zero cost, while the IIFS is secured against default risks and is able to collect some of its direct and actual administrative costs through these social finance deposits.

380. In all cases, the actual modality and specifics used to implement social solidarity instruments within an IIFS in support of the above financial inclusion initiatives will need to comply with Sharīʿah parameters. Based on the proportionate guidelines of this TN, this compliance of modality may be affirmed by seeking either: (i) the approval of a centralised approval authority on Sharīʿah where available (e.g. a centralised Sharīʿah board), or (ii) approval of the modality by a Sharīʿah body.¹⁶⁶ However, where an IIFS is a prudentially regulated institution, it is expected to have option (ii) in place. When this IIFS is in a jurisdiction that has a centralised Sharīʿah board, it will also be required to comply with option (i).

¹⁶⁵ There is a difference in Sharīʿah opinion regarding the permissibility of temporary *waqf*. The mechanism of temporarily endowing wealth is based on an opinion proposed by Maliki jurists, who are of the opinion that permanency is not a condition for the validity of *waqf*. As a result, the proposals regarding temporary cash *waqf* are applicable to all those jurisdictions where Sharīʿah opinions allow this practice.

¹⁶⁶ This body may be a Sharīʿah board comprising three or more scholars, or an external Sharīʿah advisory firm, or an individual Sharīʿah scholar. See the discussion in section 2.2.3.

7.2.2 Third-party Integration

381. A third-party integration occurs when a commercial financial services provider does not hold social finance deposits on its balance sheet, but rather leverages upon support extended by third parties (i.e. Islamic social finance institutions). This model would involve unencumbered commitments by Islamic social finance institutions to support the financial inclusion portfolio of an IIFS. For instance, Islamic social finance institutions (*waqf* institutions) may provide subsidies for lowering financing costs for female clients, or support with PSIA¹⁶⁷ funds equity-based partnerships with aspiring entrepreneurs.

Table 7.2.2.1: Third-party Integration of Islamic Social Finance within a Commercial IIFS

ASSETS	FUNDING PROFILE
Cash	Current accounts
Financing	Investment accounts
Investments	Other remunerative accounts
Others	
Financial Inclusion Portfolio <i>(off-balance sheet) Islamic social finance guarantee and subsidies receivable</i>	RPSIA for Financial Inclusion
Long-term investments	Long-term funding
Fixed assets	Equity and reserves

382. The main advantage of third-party integration modalities is that an IIFS is able to leverage upon its experience in assessing clients' creditworthiness to screen and identify deserving and aspiring recipients for financial inclusion support. It also abstains from additional administrative and governance procedures should it begin raising social finance funds on its own balance sheet from a large number of contributors (individuals, corporates, NGOs, social finance institutions, etc.).¹⁶⁸

383. The Islamic social finance institution, in turn, focuses on its fund-raising activities and leverages upon the wide and extensive branch network of IIFS (including through agent and branchless banking) to reach out to the low-income segments who are interested in financial inclusion, as opposed to receiving cash handouts for subsistence purposes. The end-result is that the IIFS focuses on its core competence of undertaking financing activities, while the raising of social funds is left to the Islamic social finance institutions that are well versed in this.

¹⁶⁷ See the related discussion in section 5.4.1 of this TN.

¹⁶⁸ IIFS may, however, become intermediaries in collecting funds on behalf of Islamic social finance institutions – but the management, governance and administration of the funds will be with the Islamic social finance institutions; the IIFS will support only the collection and channeling of funds.

384. A further advantage of third-party integration is that an IIFS may not always have regular and sufficient inflow of social funds – this is because IIFS, at least presently, are not a natural host for receiving social contributions. As such, the IIFS may invariably have to undertake marketing expenditure to attract these types of funds and build a pool from scratch. For instance, sufficient time needs to elapse before *waqf* funds would have generated enough returns enabling IIFS to start supporting financial inclusion activities. The Islamic social finance institutions, on the other hand, are a natural host for collecting social funds. By virtue of their having been in operation for many years, they would have generated a sufficient pool size to undertake support for financial inclusion activities.

385. In order to ensure the Sharī'ah compliance of the practices discussed above, the Islamic social finance institutions may (i) rely on their own internal Sharī'ah expertise,¹⁶⁹ or (ii) leverage upon Sharī'ah approvals in place at the level of the IIFS. If the first two options are not available, Islamic social finance institutions may validate the Sharī'ah compliance of their practices by seeking (iii) the approval of a centralised approval authority on Sharī'ah where available (e.g. a centralised Sharī'ah board), or (iv) the approval of the modality by a Sharī'ah body.¹⁷⁰

386. The TN further acknowledges that, in some jurisdictions, Islamic social finance institutions may not be present, or may be very few in number. In such an event, the TN recognises that conventional social finance institutions (those that do not implement a Sharī'ah governance system or claim to be Sharī'ah-compliant) may provide the necessary support for Sharī'ah-compliant financial inclusion activities subject to the conditions and proportional flexibilities accorded in this TN in its various guidelines.¹⁷¹ These conventional social finance institutions are also permitted to place funds on the basis of RPSIA, in line with the rules and principles of Sharī'ah.

7.2.3 Reverse Integration

387. From a different perspective, the commercial IFSI itself can also be instrumental in integrating with the Islamic social finance activities. At the most basic level, the IIFS can channel its own charitable funds (e.g. *sadaqah* as CSR funds or even *gharāmah*¹⁷²) to Islamic social finance institutions, particularly those that are engaged in supporting financial inclusion

¹⁶⁹ Since these are Islamic social finance institutions, they are very likely to have their own in-house Sharī'ah governance systems.

¹⁷⁰ This may be an individual Sharī'ah scholar or an external Sharī'ah advisory firm. See the discussion in section 2.2.3.

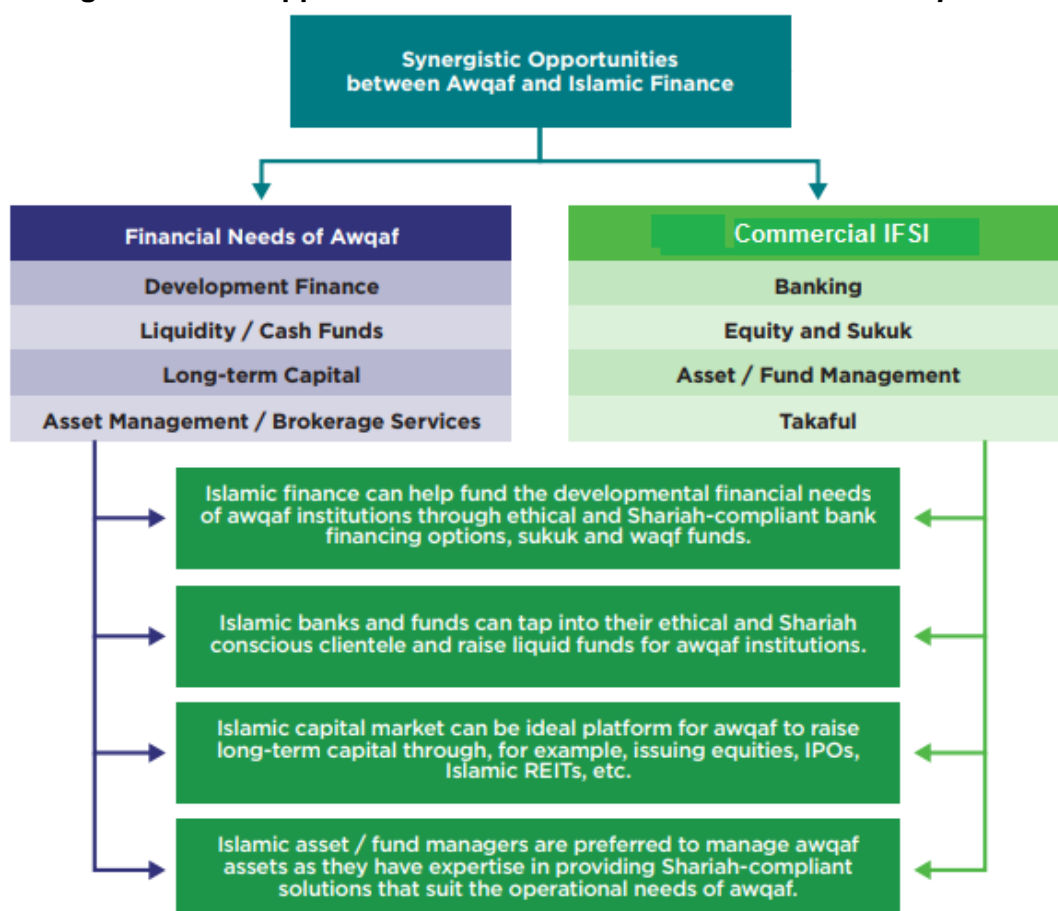
¹⁷¹ For example, see the exceptions to Sharī'ah requirements discussed in sections 2.3.5 and 3.3.5.

¹⁷² *Gharāmah* is the late payment penalty charges imposed by Islamic banks upon their customers. The rules of Sharī'ah entail that these charges collected must be diverted to charity and cannot be used by the IIFS for any purpose that directly benefits itself.

activities. The IIFS can offer to become an “intermediary” for collecting funds on behalf of Islamic social finance institutions.

388. *Waqf* is a particular sector where the commercial IFSI as a whole, particularly the Islamic capital markets, can be instrumental in supporting its development and expansion, enabling it to undertake further welfare activities within the economy. The *waqf* sector offers manifold opportunities for the commercial IFSI to expand its market share given the synergies between the two sectors (see Figure 7.2.3.1).

Figure 7.2.3.1: Opportunities for the Commercial IFSI in the *Waqf* Sector¹⁷³



Source: KFH Research, MIFC

¹⁷³ One of the earliest and most notable Islamic financing examples in this category is the *musharakah sukuk* issued by the Islamic Religious Council of Singapore (MUIS) whose proceeds were used to develop two *waqf* properties – namely, the Bencoolen Mosque Project (a serviced apartment block, a four-storey commercial complex and a mosque) and the 11 Beach Road Project (a six-storey office building). The rental returns generated by the commercial portion of the projects helped to pay off the *sukuk* obligations, following which, the *waqf* would be able to utilise the returns for its own administration costs as well as for further welfare activities. Another example is that of Yayasan Dakwah Islamiah Malaysia (YADIM), or the Islamic Dawah Foundation Malaysia, which issued 14 million units of *waqf* shares or certificates that were bought by interested individuals for MYR 1 each. The proceeds were raised to fund the construction of a new training centre, whose cost had been estimated at about MYR 14 million. Subsequently, the purchased shares were endowed in their entirety to the *waqf*, with YADIM acting as a trustee in charge of utilising the collected funds for the designated investment purpose. In such an arrangement, henceforth, the shareholders are not entitled to any financial return from their participating in the fund (known as the YADIM Training Centre Waqf Fund).

389. Overall, the integration between the commercial IFSI and Islamic social finance has great potential to address poverty alleviation and an economy’s financial inclusion objectives. The TN has provided some practical measures through which this integration can be achieved for supporting various financial inclusion initiatives. In the following subsection, the TN highlights some of the regulatory considerations that will need to be addressed and implemented in order to ensure a smooth and stable functioning of this integration.

7.3 Regulation and Supervision

390. The integration of Islamic social finance represents a new regulatory direction for the financial sector RSAs. This TN proposes some basic guidelines that will be helpful in setting up an appropriate framework for its regulation and supervision.

7.3.1 Regulatory and Legal Clarity

391. At the onset, the TN recommends that a jurisdiction provide regulatory and legal clarity about whether the commercial and prudentially regulated IIFS is permitted to utilise Islamic social solidarity instruments on-balance sheet, and/or whether it may recognise guarantee and subsidy support of Islamic social finance institutions. This clarity is important to ensure that an IIFS undertakes only permissible activities, and that it has the necessary approvals/clearance to engage in introducing and launching products to the wider public.

392. The IFSB survey for this TN identified that most RSAs presently do not have any provisions in law and regulations/guidelines on Islamic social solidarity instruments. Some RSAs added that this was out of their regulatory purview. Those that had answered “Yes” were asked to provide their areas of coverage. One RSA stated that Islamic banking regulations included provisions on *zakāh*, while another highlighted that the applicable law on charitable activities included an instruction on “Islamic finance operations effected by Islamic credit institutions”. Those RSAs that had answered “Yes” to having laws and regulations/guidelines on Islamic social solidarity instruments were further asked whether these guidelines permitted IIFS to integrate Islamic social solidarity instruments (e.g. *waqf*, *sadaqah*, etc.) into Islamic financial products. Only two RSAs responded positively to this question, with each indicating the initiatives as listed in Table 7.3.1.1.

Table 7.3.1.1: Do Regulations Allow Integration of Islamic Social Solidarity Instruments?
RSA 1: These social solidarity instruments are not excluded.
RSA 2: Not specifically mentioned, although this may be done.

Source: IFSB Survey for TN-3 – October to December 2017

393. Based on the above, the TN encourages authorities in a jurisdiction to undertake high-level consultations among the relevant stakeholders and, accordingly, proposes that appropriate revisions be made to the relevant statutes/Acts to enable IIFS to integrate Islamic social solidarity instruments. Once the permissibility is ascertained, the RSAs must then undertake public awareness campaigns to facilitate the growth and development of this concept.

7.3.2 Credit Ratings

394. In terms of debtor relief schemes and subsidies support by Islamic social finance institutions to IIFS under the third-party integration approach, another important regulatory consideration is the “reliability” and “credibility” aspects of these commitments.

395. In traditional banking regulations, third-party guarantees are subject to risk weights based on the credit rating of the guarantor (in the standardised approach) or an internal-ratings approach carried out by the IIFS. Islamic social finance institutions are normally not rated institutions, nor is there at present any known internal-ratings mechanism for assessing the creditworthiness of these institutions.

396. The TN recommends that those Islamic social finance institutions that are under the control, operation and supervision of government authorities (e.g. *Waqf* Ministry, Religious Affairs Ministry, etc.) should be accorded a risk weight equivalent to that of the supervising government authority or its peer. For instance, if the *Waqf* Ministry does not have a credit rating, the sovereign rating may be used instead for prudential regulatory purposes and be applied to the Islamic social finance institution.

397. For the other types of social finance institutions that are not under a government authority, the TN suggests the following three approaches: (i) if the commitment is based on unencumbered assets that are already marked and set aside by the social finance institution, then the risk weight shall be 20% of the total commitment for prudential regulatory purposes; (ii) if the commitment is based on partially unencumbered assets that represent 50% or more of the total committed amount, then the risk weight shall be 50% of the total commitment for prudential regulatory purposes; and (iii) if the commitment is based on partially unencumbered assets that represent 20% or more of the total committed amount, then the risk weight shall be 100% of the total commitment for prudential regulatory purposes.

398. The TN does not recognise debtor relief schemes that are not backed by unencumbered assets for social finance institutions that are not under the direct care, operation and supervision of a government authority.

7.3.3 Prudential Regulations¹⁷⁴

Direct Integration Approach

399. For IIFS that are prudentially regulated, the financial inclusion portfolio on the assets side will not attract any prudential regulations if they are fully backed by the two sources of Islamic social finance accounts (*sadaqah*, *waqf*). This is because these sources of funds do not need to be repaid to their contributors. As a result, there will be no credit risk charge or operational risk charge for this financing portfolio. For the deposits themselves, there will be no liquidity risk charge.

400. In the more likely event that the financial inclusion portfolio on the assets side is only partially backed by the two sources of Islamic social finance accounts (*sadaqah*, *waqf*), the total financial inclusion portfolio exposure will be reduced by the social finance amounts available and committed to support this portfolio. The remaining net financial inclusion exposure will attract the necessary credit and operational risk charges as per the applicable prudential regulations upon the IIFS. For the deposits themselves, however, there will still be no liquidity risk charge.

401. In the case of a temporary cash *waqf* deposit, the principal amount needs to be repaid; hence, the deposit itself needs to be considered for liquidity risk management purposes as per the applicable prudential rules (and the assets funded by the temporary cash *waqf* deposits will attract relevant credit and market risk charges). Another component is the returns generated by the cash *waqf* that can be used to support the financial inclusion portfolio: this portion of the *waqf* returns earmarked for financial inclusion activities does not need to be repaid, and hence, is absolved from the liquidity risk requirements.

402. In the case of cash *waqf* accounts that are placed perpetually and do not need to be repaid, these funds can be excluded from any liquidity risk requirements as they take on the feature of equity. The assets funded by perpetual cash *waqf* accounts (the principal and its returns) will also not attract any prudential regulations – although, given the normal intention to preserve the *waqf* capital long-term, the IIFS must take sound and prudent financial decisions when utilising *waqf* funds to support deserving recipients. The treatment of returns generated by cash *waqf* is the same as discussed in the paragraph above (regardless of whether placement is perpetual or temporary).

¹⁷⁴ The prudential regulations discussed in Sections 3, 4 and 5 of this TN remain applicable to prudentially regulated IIFS. This subsection addresses only those specific aspects of Islamic social finance that need additional consideration.

403. In summary, *sadaqah* and perpetual cash *waqf* funds for distribution by the IIFS do not attract liquidity risk requirements; for temporary cash *waqf* deposits, only the principal amount attracts liquidity risk requirements, while its returns earmarked for social finance activities do not. In terms of the funds earmarked for financial inclusion, the portion of financing supported by *sadaqah*, perpetual cash *waqf* and returns of cash *waqf* do not attract any capital charges, while any remaining net financing exposure will attract capital charges as per the prudential regulations applicable to the IIFS.

Third-party Integration Approach

404. The recognition of debtor relief schemes and subsidies by Islamic social finance institutions under the third-party integration approach¹⁷⁵ will be as per the guidelines provided in section 7.3.2 of this TN.

405. Where Islamic social finance institutions place *sadaqah* and *waqf* funds in restricted PSIA with IIFS to support financial inclusion activities, these funds, due to their conditions as per the rights and responsibilities of contracting parties, do not require liquidity risk regulations; nor are credit, market and equity investment risks chargeable on portfolios financed by them. However, such portfolios would attract operational risk charges, as the RPSIA contributors do not bear responsibility for financial loss if the IIFS was negligent in its duties or has engaged in misconduct.

*7.3.4 Non-prudential Regulations*¹⁷⁶

406. While many of the prudential regulations do not apply to Islamic social finance deposits, non-prudential regulations are still applicable to ensure that use of these social finance funds is transparent and fair, in line with the objectives specified and agreed upon by the contributors.

407. The TN requires that IIFS have in place strong governance mechanisms to ensure that social finance funds are used only for pre-specified types of financial inclusion activities and that they are not co-mingled or used for any purpose other than that specified at the time of the funds being raised. This also includes prohibition of any self-benefiting practices by the IIFS – for instance, overcharging potential microfinance clients to forcefully collect subsidies from social finance deposits in the guise of reducing financing costs to the clients.

¹⁷⁵ See the related discussion in section 7.2.2 of this TN.

¹⁷⁶ The non-prudential regulations discussed in Section 6 of this TN are also applicable in the context of Islamic social finance activities by IIFS. This subsection addresses only some specific aspects of Islamic social finance that need additional consideration.

408. The IIFS must ensure that the social finance funds are not used to earn any unjust commercial benefits for itself, and that it upholds its integrity in discharging its fiduciary duties. Where an IIFS has raised RPSIA deposits, it must undertake to ensure strong compliance with non-prudential regulations¹⁷⁷ relating to, for instance, fiduciary responsibilities and comprehensive and credible corporate and investments governance practices.

409. The IIFS must also uphold compliance with Sharī'ah rules and principles in line with the guidance provided in the TN in its various sections. Where exceptions are allowed in this TN, they must be implemented strictly according to the conditions under which such an exception is permitted.

410. Where an IIFS decides to invest any surplus funds collected as social finance deposits (*sadaqah* and cash *waqf* funds), it must ensure that these are invested only in Sharī'ah-compliant opportunities, and that the profits generated by these investments are used solely for the activities specified at the time of the funds being raised.

7.3.5 Supervision

411. In general, the discussion on supervision in sections 3.4, 4.4 and 5.5 is also relevant here. However, a specific consideration for the supervision of Islamic social finance activities is the need for appropriate knowledge by the supervisors.

412. Since social finance activities are a new regulatory area with evolving guidelines, the examiners may need comprehensive training on their regulatory treatment. This will require a material allocation of time and resources by the concerned supervisory authority.

413. Also, due to a lack of precedence of past supervision, this may involve, at least initially, some differences in deriving sound interpretations and judgments by the different examiners when undertaking supervision of Islamic social finance activities. Hence, the supervisory authority has to be vigilant to ensure consistency in the supervision assessment of different IIFS.

414. There is also likely to be a lot more coordination efforts required, since, for the first time, integration is bringing Islamic social finance institutions into direct involvement with commercial financial services providers. Hence, financial RSAs will need to collaborate closely with the registration/licensing authorities of social finance institutions to identify and fill any gaps in regulations and practices.

¹⁷⁷ Discussed in Section 6 of this TN.

SECTION 8: OTHER CONSIDERATIONS

8.1 Financial Stability

415. Policymakers need to be cognisant of any potential impact on financial stability when developing and implementing financial inclusion guidelines. Recent studies¹⁷⁸ have indicated that financial inclusion increases economic growth up to an optimal point beyond which marginal costs may outweigh the marginal benefits due to the economic principles of diminishing returns. This principle is particularly true for the developed economies, where financial inclusion is already more prevalent than in the developing economies.

416. In general, increasing financial inclusiveness is expected to improve financial stability, as previously unchecked and informal transactions would now be under regulatory purview. Reducing income inequalities will also be beneficial for the economy in the long run. However, there is also a counterbalancing argument that enhancing financial inclusion is in fact an expansion of credit access in the economy, and that too rapid credit expansion without proper supervision can lead to financial instability risks.

417. Based on the above, the TN recommends that the concerned authorities coordinate policies at a higher level to ensure that financial inclusion initiatives do not disturb the macroeconomic balance in an economy and there is an appropriate mechanism to identify any systemic-risk activities in the jurisdiction. The TN requires that objectives of financial inclusion in an economy must be achieved in an orderly manner and without compromising on financial stability.

8.2 Financial Inclusion Data

418. Following on from the above subsection, the development and implementation of stabilising macroeconomic policies invariably requires feeding into the framework credible economic and financial data. In the context of this TN, the authorities must have credible statistics on financial inclusion activities in order to assess the impact upon the macroeconomy following implementation of financial inclusion initiatives. As such, the TN encourages authorities to duly consider including financial inclusion activities in their macropudential surveillance framework.

¹⁷⁸ For instance, see IMF Staff Discussion Note SDN 15/17, "Financial Inclusion: Can It Meet Multiple Macroeconomic Goals?" (September 2015).

419. The TN also recommends that supervisory authorities periodically collect financial inclusion data from the various service providers, in line with the supervision guidelines of this TN. Importantly in this context, the TN recommends moving towards separate data collection templates for Islamic and conventional financial inclusion activities. The IFSB survey for this TN identified that most RSAs that periodically collected financial inclusion data were currently not segregating this data, and that Islamic and conventional financial data were therefore co-mingled. Separating this data will enable the RSAs to respond appropriately with policies that account for the specificities of Islamic finance and based on patterns observed in the market.

8.3 National Strategies

420. The TN further recommends that authorities have in place financial inclusion strategies at a national level to enable a strong and consistent coordination among the various stakeholders in the jurisdiction. The national financial inclusion objectives must be clearly specified in terms of measurable targets, along with the timeline by which these targets are to be achieved. This will enable the authorities to monitor progress made and to gauge the effectiveness of the policies put in place to achieve those targets. The financial inclusion strategies must include ongoing review mechanisms in order to take corrective actions or make adjustments to existing policies in line with the issues/patterns observed in the market.

421. National strategies also serve as a clear signal in terms of the political willingness of the government to address financial exclusion and to work towards eradicating poverty and income inequalities. This may be achieved by specifying targeted groups in the strategy's policy priorities whose economic condition the government wishes to improve (e.g. marginalised societies, women, youth, MSMEs, etc.). Clear identification of the targeted groups is also essential in order to fairly implement proportionate regulatory treatment and the special exemptions that have been discussed in various policy guidelines of this TN.

422. The TN further encourages the national strategies to clearly identify specific mandates of various stakeholders (e.g. central banks, capital markets, ministries, government-led corporations, etc.) involved in achieving the financial inclusion objectives. This includes a division of policy areas and implementation of strategies relevant to each organisation's regulatory ambit (e.g. bank deposit and financing targets with the central bank, while enhancing retail investment and facilitating capital market access with the capital market authority). This approach is to prevent overlaps in mandate, as well as to address any gaps identified. It will also enable specific authorities to make any necessary revisions in the statutes/Acts to explicitly include the financial inclusion mandate (e.g. to include financial inclusion as an objective of the central bank).

423. The TN also strongly recommends that RSAs invest appropriate time and resources in national financial literacy campaigns. Improved financial literacy can potentially address many of the consumer protection issues in the marketplace, as well as some involuntary financial exclusion issues (e.g. due to lack of understanding). The TN also suggests that RSAs specifically initiate literacy and awareness campaigns for the targeted groups in the national financial inclusion strategy. For instance, RSAs may conduct awareness campaigns on Sharī'ah-compliant financial products and services tailored for marginalised Muslim societies that are excluding themselves from the formal financial sector.

424. Finally, the TN encourages authorities to supplement regulations for IIFS by specific Sharī'ah guidelines for financial inclusion activities at a national level to enable easy implementation by the various financial services providers. While the TN has given a number of options for achieving Sharī'ah compliance for financial inclusion-tagged products and services, national guidelines on, for instance, plain-vanilla microfinance products can ensure consistency in practice.

APPENDICES

A-1: Islamic Financial Institutions and Financial Inclusion by Country

Economy	Religiosity and financial inclusion				Islamic financial institutions (IFIs)			
	Religiosity ^a (%)	Account at a formal financial institution (%, age 15+)	Adults with no account due to religious reasons ^b (%, age 15+)	Adults with no account due to religious reasons ^b (thousands, age 15+)	Number of IFIs	Islamic assets per adult ^c (\$)	Number of IFIs per 10 million adults	Number of IFIs per 10,000 km
Afghanistan	97	9.0	33.6	5,830	2	—	1.1	0.03
Albania	39	28.3	8.3	150	1	—	4.0	0.36
Algeria	95	33.3	7.6	1,330	2	—	0.8	0.01
Azerbaijan	50	14.9	5.8	355	1	—	1.4	0.12
Bahrain	94	64.5	0	0	32	29,194	301.6	421.05
Bangladesh	99	39.6	4.5	2,840	12	14	1.2	0.92
Benin	—	10.5	1.7	77	0	0	0	0
Burkina Faso	—	13.4	1.2	98	1	—	1.1	0.04
Cameroon	96	14.8	1.1	114	2	—	1.7	0.04
Chad	95	9.0	10.0	573	0	0	0	0
Comoros	97	21.7	5.8	20	0	0	0	0
Djibouti	98	12.3	22.8	117	0	0	0	0
Egypt, Arab Rep.	97	9.7	2.9	1,480	11	146	1.9	0.11
Gabon	—	18.9	1.5	12	0	0	0	0
Guinea	—	3.7	5.0	279	0	0	0	0
Indonesia	99	19.6	1.5	2,110	23	30	1.3	0.13
Iraq	84	10.6	25.6	4,310	14	98	7.4	0.32
Jordan	—	25.5	11.3	329	6	1,583	15.4	0.68
Kazakhstan	43	42.1	1.7	126	0	0	0	0
Kuwait	91	86.8	2.6	7	18	28,102	87.2	10.10
Kyrgyz Republic	72	3.8	7.3	272	0	0	0	0
Lebanon	87	37.0	7.6	155	4	—	12.4	3.91
Malaysia	96	66.2	0.1	8	34	4,949	16.8	1.03
Mali	95	8.2	2.8	218	0	0	0	0
Mauritania	98	17.5	17.7	312	1	76	4.7	0.01
Morocco	97	39.1	26.8	3,810	0	0	0	0
Mozambique	—	39.9	2.3	189	0	0	0	0
Niger	99	1.5	23.6	1,910	0	0	0	0
Nigeria	96	29.7	3.9	2,520	0	0	0	0
Oman	—	73.6	14.2	78	3	—	14.4	0.10
Pakistan	92	10.3	7.2	7,400	29	40	2.5	0.38
Qatar	95	65.9	11.6	64	14	13,851	86.5	12.08
Saudi Arabia	93	46.4	24.1	2,540	18	1,685	9.2	0.08
Senegal	96	5.8	6.0	411	0	0	0	0
Sierra Leone	—	15.3	9.9	287	0	0	0	0

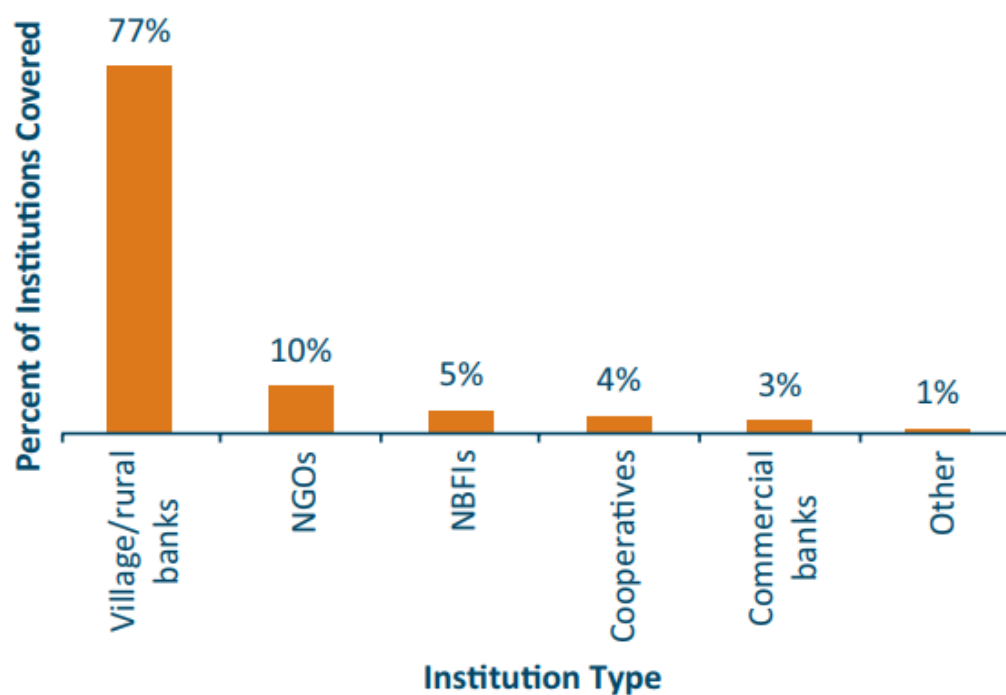
a. Percentage of adults in a given country who responded affirmatively to the question, "Is religion an important part of your daily life?" in a 2010 Gallup poll.

b. Number of adults and percentage of adults that point to a religious reason for not having an account at a formal financial institution.

c. Islamic assets per adult (\$)/Size of Islamic assets in the banking sector of an economy per its adult population.

Source: World Bank–Islamic Development Bank (2016), “Islamic Finance: A Catalyst for Shared Prosperity”

A-2: Institutions Offering Islamic Microfinance Products



N = 255 for the total number of institutions in the breakdown shown in the figure.

NGOs = non-government organisations; NBFIs = non-bank financial institutions.

Source: CGAP Focus Note No. 84, "Trends in Shari'ah-Compliant Financial Inclusion", March 2013

A-3: Application of Proportionality in Practice

425. Proportionality is defined in several Financial Stability Institute (FSI) publications¹⁷⁹ as the tailoring of international standards, or the developing of alternative rules, to reflect the size, complexity, risk profile or other characteristics of individual financial institutions or banking systems. Hence, the concept entails application of simplified rules for small or non-complex institutions to avoid excessive compliance costs.

426. In relation to financial inclusion, the G20 in its Toronto Summit of 2010 issued nine principles for Innovative Financial Inclusion¹⁸⁰ as an initiative for improving access to financial services for poor people through the safe and sound spread of new approaches. Among these nine principles was “proportionality”, which calls for the building of a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services, and is based on an understanding of the gaps and barriers in existing regulation.

427. Accordingly, several countries are beginning to implement proportionate policies and regulatory frameworks for supporting financial inclusion activities that encourage growth and innovation while also ensuring a safe and sound financial system. These efforts are in due recognition of the fact that overly conservative policies may have the unintended consequence of adversely impacting financial inclusion.

A-3.1 *Proportionality in Practice Case Studies*¹⁸¹

Key Findings

428. A few countries articulated their general approach to and interpretation of proportionality with regard to financial inclusion and global standards. For these countries (Bhutan, Malaysia and Peru), proportionality is a regulatory approach that promotes stability and integrity, yet still encourages the development of innovative financial inclusion solutions.

429. Most case studies demonstrated the application of proportionality in the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) regulations, towards advancing financial inclusion through the means of digital financial services and agent banking. Indeed, the Risk-Based Approach (RBA) as stated by the Financial Action Task Force (FATF)

¹⁷⁹ For instance, see FSI Insights on Policy Implementation No. 11 (November 2018).

¹⁸⁰ Available at: <http://www.g20.utoronto.ca/2010/to-principles.html>

¹⁸¹ These case studies are based on findings of the Global Standards Proportionality Working Group (GSPWG) of the Alliance for Financial Inclusion (AFI), which is a member of this IFSB Task Force that has guided the development of TN-3. It is important to note that the Sharī'ah board did not review this appendix. Therefore, the case studies mentioned within it may not necessarily be Sharī'ah-compliant since they are describing the financial inclusion initiatives in certain jurisdictions and it is not the function of the Sharī'ah board to comment on what certain jurisdictions are doing.

40 Recommendations, is adopted for know-your-customer (KYC) verification requirements. Specifically:

- In Bangladesh's National Risk Assessment (NRA), financially inclusive products have been recognised as products with low money laundering and financing of terrorism (ML/FT) risks. As such, banks and financial institutions adopt an RBA and apply a simplified KYC process for such products to support financial inclusion. For example, a simplified KYC process was introduced to promote MFS. Recognising the gender gap in financial inclusion, this simplified process was applied on financially inclusive deposit products to encourage women's easy access into the financial sector.
- Bank Indonesia has introduced a regulation to support digital financial services (DFS) and Laku Pandai (agent banking), which covers AML/CFT policies. The regulation states that a simplified KYC process can be applied when the ML/FT risk is low and for opening accounts associated with government programs that seek to improve welfare and alleviating poverty. Under the regulation, the various financial services (i.e. e-money unregistered, e-money registered and basic banking services) are subject to differentiated transaction limits and KYC requirements.
- In Malaysia, the Agent Banking Regulatory Framework was established in 2012 to govern the use of agents or third-party intermediaries by financial institutions in the provision of financial services. To mitigate risks that may arise in facilitating the opening of accounts at the agents: (i) the roles of agents in facilitating KYC functions are demarcated based on types of agents; and (ii) banking services offered at the agents are differentiated based on the outcome of KYC verification.
- In Peru, three KYC regimes have been adopted – namely, simplified, general and reinforced. The simplified regime is applied for clients and products with low ML/FT risks. There are two ways in which the simplified regime can be considered: (i) a financial services provider (FSP) can freely develop a product or service and seek the regulator's approval to use the simplified regime if the ML/FT risk is low; and (ii) an FSP develops a product or service as defined in the regulation (which sets out clear thresholds to ensure low ML/FT risk), and hence, can use the simplified regime without the regulator's prior approval. Thus far, basic deposit accounts, simplified electronic money accounts and some insurance products have been defined in the regulations.
- In promoting MFS, Tanzania has adopted a proportionate regime that allows mobile network operations (MNOs) to use agents to perform several critical functions and

implement tiered consumer due diligence (CDD) process. Under this model, agents are responsible for facilitating cash withdrawals and deposits, registering users, and performing initial due diligence of new customers. They are required to comply with the MNOs' AML/CFT policies and are trained to follow specific procedures in case of suspected fraud or money laundering. A four-tiered CDD process is adopted, with transaction limits for each tier corresponding with risk mitigation measures, such as KYC verification requirements and controls for governance and management information system (MIS).

430. Proportionality is also applied in the prudential regulation on non-bank financial institutions, as observed in Malaysia and Russia.

- In Malaysia, the regulatory and supervisory framework for development financial institutions (DFIs) is aimed at ensuring the institutions' financial and operational soundness, without impeding their ability to effectively achieve development mandates. In this regard, DFIs are not yet subject to the Basel II and III requirements that are applied to banks.
- With the amendment to the legislation on consumer loan and microfinance activities, Bank of Russia (CBR) now regulates four categories of professional creditors (banks, credit cooperatives, microfinance organisations and pawnshops). These institutions are subject to a different set of requirements and scope of activities, taking into consideration potential risks associated with deposit-taking activities. For e-money service providers, regulations applied to them (e.g. authorised capital) are less stringent in comparison to banking institutions.

431. Other forms of proportionality in practice include “test and learn” and phased regulatory approaches.

- Bhutan has adopted a phased approach in creating an enabling regulatory environment to improve financial access for the poor and low-income population. The regulation for micro-loans institutions was first introduced in 2014 to bring non-government organisations (NGOs) and entities engaged in lending activities into the formal financial system. Subsequently, Bhutan embarked on the formulation of regulations on agent banking in 2016. More recently, in 2017, Bhutan implemented regulations on deposit-taking microfinance institutions and e-money issuers.

- In Malaysia, the agent banking regulatory framework was first introduced in August 2012 to facilitate the implementation of agent banking in a reliable, safe and sustainable manner, while enhancing the access to basic banking services in unserved areas. The regulatory framework was subsequently enhanced in April 2015, with policy objectives expanded to include enhancement in convenience, accessibility and usage of banking services, as well as to increase customer satisfaction. Under the 2015 enhanced framework, agents can now facilitate financial institutions in opening savings accounts (previously, activities were limited to accepting deposits, facilitating withdrawals, fund transfers, bill payments and financing repayments).
- In Russia, progressive steps have been taken to strengthen the regulatory and supervisory framework to deal with potential systemic risks, including from non-bank financial entities (shadow banks). In mid-2013, CBR became the mega regulator and was empowered with a regulatory and supervisory mandate over non-bank financial entities. The National Financial Stability Council, a high level inter-agency body chaired by the First Deputy Prime Minister of the Russian Federation, was also set up. In 2014, the Financial Stability Committee was established within the CBR to, among other things, monitor and assess the risks of the financial system. Efforts are also under way to implement a unified data-reporting standard for non-credit financial institutions. This standard would enhance data quality and consistency, and promote transparency and data accessibility to market participants.
- Tanzania adopts a “test and learn” regulatory approach in promoting MFS. The approach has allowed the regulator to test the deployment of the service and monitor its developments. In this regard, the role of the regulator has been to support rather than stifle innovation, through understanding the risks inherent in such innovations and establishing the necessary risk controls.
- In Uganda, biometric identification technology was adopted as a crucial first step towards promoting financial inclusion. Progressive financial inclusion initiatives have subsequently been undertaken, including the development of guidelines on consumer protection and mobile money services. The Bank of Uganda is also in the final stages of drafting regulations to support agent banking.

432. A few countries indicated that the adoption of proportionality had yielded positive financial inclusion outcomes, as evidenced through quantitative and qualitative results. Some countries expressed difficulty in attributing progress within financial inclusion to proportionality, as the regulations’ implementation is still too recent to yield outcomes.

- In Tanzania, more than 58% of adults now use mobile money accounts, and access to MFS has reached over 98%. In comparison, only 11% of adults used formal financial services when MFS first came into use in 2008.
- For Malaysia, access to financial services has significantly increased since the introduction of agent banking in 2012. As at end-June 2015, there were five participating financial institutions with a combined network of 6,507 banking agents nationwide. The total number of transactions exceeded 45 million, with a total value of USD 1.1 billion. Malaysia has achieved numerous targets set under the Maya Declaration. As of end-2014, 95% of sub-districts, with a population of more than 2,000, have at least one financial access, exceeding the 90% target one year ahead (end-2011:46%; end-June 2015: 96%). The 100% target for state legislative assemblies has also been achieved (end-2011: 73%).
- Since the regulation on micro-loan institutions was implemented in Bhutan to bring entities engaged in lending into the formal system, three entities have registered with the Royal Monetary Authority of Bhutan (RMA) as micro-loan institutions.
- In Peru, AML/CFT regulations (including application of a tiered KYC regime) was first introduced in 2011 and further fine-tuned in 2015. As such, it is still too early to see the impact. Volume-wise, there is less than one million simplified e-money accounts, but the numbers are increasing. Informal evidence derived from the regulator's engagement with services providers suggests that simplified accounts have contributed towards attracting new clients. Encouraging results have been observed in the insurance market, with about 70% of existing insurance policies based on the simplified regime.
- In Bangladesh, women's participation in MFS and agent banking is still comparatively low, but initiatives have been undertaken to address the financial inclusion gap. Of the 21 million registered MFS account holders, only 18% are women. Less than 3% of banking agents are women. While the factors impacting women's access to financial services in Bangladesh are complex, it was recognised that resources and market players are available to bridge this gap.

433. Some countries highlighted several challenges in implementing proportionality in practice, including the need for operational enhancements for KYC verification. A few countries also indicated that there is scope for enhanced data collection to facilitate monitoring and to better regulate non-bank financial institutions (shadow banking).

- For Indonesia, the pilot implementation of proportionate KYC rules in government aid disbursement revealed that individual registration for complete CDD procedures was a major hurdle, given the considerable amount of time required. For the reason that the social welfare ministry has already previously validated the identity of recipients, bulk registration can speed up the process while still keeping the risks low. Flexibility should also be implemented in the acceptance of valid ID documents for KYC verification. Other ID documents issued by government institutions, such as the social welfare ID, should be recognised the same as the national ID.
- In Peru, FSPs were unclear about using the RBA for KYC processes, with some firms highlighting difficulties in developing a rating system to score their clients. The FSPs also faced challenges in integrating analysis for KYC, especially when the assessment involved multiple risk factors for the same client.
- In Cambodia and Mozambique, the lack of information on shadow banking is a major challenge. It affects the ability of the regulator to assess the build-up of risks and to deploy the necessary regulatory measures, and thus, to apply proportionality accordingly.

434. Sudan provided an interesting perspective from the de-risking phenomenon. Stringent KYC measures, when not applied in a manner that is proportionate to risks, may lead to the loss of correspondent account relationships and greatly undermine access to financial services.

435. To further support the adoption of proportionality in practice and ensure effectiveness, some countries highlighted the need for other complementariness to be put in place.

- Peru recognised the importance of effective communication and dialogue with FSPs. Such engagements should take place during the formulation of regulations, as well as throughout the implementation stage.
- Malaysia and Bhutan highlighted the importance of ongoing efforts to enhance financial literacy, to allow the public to make informed financial decisions.
- Malaysia also recognised the need to continuously conduct surveillance (including mystery shopping) by financial institutions and the central bank, to support the effective implementation of the agent-banking framework.

Bangladesh

436. Over the past few years, Bangladesh has seen a theatrical expansion in financial inclusion, driven by many government initiatives to promote inclusive and sustainable finance for financial and social stability. Given that women comprise 50% of Bangladesh's population, their participation in the financial sector can have a great impact on economic development. However, women's participation in the institutional economic sector is inadequate, and the rate of women entrepreneurs is very low, compared to male entrepreneurs. In fact, there are many obstacles affecting women participation in the mainstream economy, although the degree of integrity, attention, creativity and expertise is very high.

437. The strategic move for widespread financial inclusion initiatives has led to enhanced opportunities for a much-desired inclusive growth. The government has taken initiatives to empower women by broadening the base of financial access through several types of financial institutions. Along with the formal banking sector, non-banking financial institutions (such as cooperatives, microfinance institutions, and other government and non-government financial institutions) provide different financial services to women. Several types of products and services have been introduced in the last few years to encourage women's easy access to the financial sector.

Proportionality in mobile financial services (MFS) regulations to bridge the gender gap in access to finance

438. From an AML/CFT perspective, it is recognised that the target customer segment for financial inclusion (those with limited or no access to the formal financial system) has lower ML/FT risks. Necessary guidelines and circulars have been published by Bangladesh Bank for the special products introduced under this system. In the NRA, financially inclusive products have been identified as low-risk products. In line with the FATF Guidance on AML/CFT and financial inclusion, banks and financial institutions are required to follow an RBA and apply simplified due diligence for low-risk products to support financial inclusion. Simplified KYC is introduced to promote MFS for easy access to the financial sector. To promote MFS and women's financial inclusion, some financially inclusive deposit products have been launched, whereby simplified due diligence is applied:

	Name of the Product	Characteristics
1	Account for the garments worker	<ul style="list-style-type: none"> Account can be opened with BDT 100; Required documents are National Identification Card (NID) and Employee ID.
2	Account for Hardcore poor women	<ul style="list-style-type: none"> Account can be opened with BDT 10; Required documents are NID, Birth Certificate or Food and Livelihood Security Card issued by Department of Women Affairs Bangladesh.
3	Account for Cleaning Staff	<ul style="list-style-type: none"> Account can be opened with BDT 10; Required documents are NID and ID issued by City Corporation.
4	Account for Leather Sector Worker	<ul style="list-style-type: none"> Account can be opened with BDT 100; Required document for this account should be NID and Employee ID.

Note: No charges applicable for the above accounts.

Source: AFI Proportionality in Practice Case Studies (Volume 1)

439. The Bangladesh Financial Intelligence Unit (FIU) has undertaken some background work on MFS, where a three-tiered KYC regime has been proposed, with transaction limits for each tier. The proposal contains the simplest type of KYC, where the mobile service provider can open an MFS account with Photo ID, NID and verification. No forms are required to open an account. If the client is a female with no NID, the NID of a close relative (such as parent, husband or child) can be used to open an account.

Indonesia

440. Indonesia has promulgated a policy on digital financial services (DFS) as a key element of its national financial inclusion strategy (NFIS) to broaden financial access to those at the bottom of the pyramid. Efforts include providing a payment system and financial services to the underbanked and unbanked people through cooperation with network agents using mobile- and web-based technology. Bank Indonesia has initiated DFS through registered electronic (e) money, based on chips and servers.

441. In 2015, the Financial Services Authority (OJK) commenced the Laku Pandai program to allow the offering of a complete suite of products to the unbanked and underbanked through agents. Products offered under the program comprise: (i) savings that have characteristics similar to the Basic Saving Account (BSA); (ii) loans or financing to micro-business customers; and (iii) other financial products such as micro-insurance.

Proportionality in anti-money laundering and combating the financing of terrorism (AML/CFT) regime for DFS and Laku Pandai

442. An aspect that plays a significant role in supporting DFS and Laku Pandai is the implementation of Bank Indonesia's Regulation (PBI) No. 14/27/PBI/2012, which covers AML/CFT policies. The regulation states that simplified know your customer (KYC) can be applied when the risk of money laundering and financing of terrorism is low, and for opening accounts associated with government programs targeted at improving welfare and alleviating poverty.

443. The regulation allows the implementation of consumer due diligence (CDD) by third-party agents who represent the bank. The final responsibility for the identification and verification lies with the operator, and third-party agents have had cooperation with the bank in the form of a written agreement. The implementation of KYC in DFS and Laku Pandai are structured as follows:

Customer category	Maximum monthly transaction	Daily mobile wallet balance	Maximum transfer size (per transaction)	Risk mitigation measures: KYC verification requirements
<i>E-Money unregistered</i> (Individuals newly registered)	IDR 20 mil. (\$1,500)	IDR 1 mil. (\$75)		<i>Cash-in transactions:</i> <ul style="list-style-type: none"> Registered phone number and registered e Money account user
<i>E-Money registered</i>	IDR 20 mil. (\$1,500)	IDR 5 mil. (\$385)		<ul style="list-style-type: none"> Prerequisites for upgrading:
(Individuals who have been upgraded through verification of KYC)				<ul style="list-style-type: none"> - Acceptable ID⁸ - Registered phone number
				<i>Transfer transactions:</i> <ul style="list-style-type: none"> Registered phone number and registered mobile money account user
				<i>Cash-in transactions</i> <ul style="list-style-type: none"> Registered phone number and registered mobile money account user
				<i>Cash-out transactions:</i> <ul style="list-style-type: none"> Acceptable ID
<i>Basic savings account</i>		IDR 20 mil. (\$1500)	IDR 5 mil. (\$385)	Simplified CDD. The information should include: <ul style="list-style-type: none"> Name Address as stated in ID and current residence address Place and date of birth Occupation

Note: Maximum transaction counts should not exceed the maximum monthly transfer limit stated above; *means the number of counts of all types/nature of transactions.*

Source: AFI Proportionality in Practice Case Studies (Volume 1)

444. In addition, management information systems (MIS) and institutional governance also serve as risk mitigation measures. This includes the following:

1. MIS:
 - a. automatic system block on transactions that exceed limits;
 - b. audit trail reports of each customer's transactions;
 - c. alerts;
 - d. AML system.
2. Institutional governance:
 - a. segregation of duties and clear approval procedures that are documented;
 - b. existence of a risk mitigation unit;
 - c. AML/CFT compliance officer and reporting.

Malaysia

445. Proportionate regulation promotes stability and integrity of the financial sector, and encourages innovative financial inclusion solutions. The proportionate application of global standards for financial regulation is a critical factor in enabling innovative financial inclusion solutions, ensuring its delivery in a safe and sound manner. Proportionate regulation ensures that the costs of regulation do not outweigh the benefits of regulation and that regulation is applied commensurately to risks.

446. Malaysia has been a practitioner of proportionate regulation. Examples of proportionality in practice include the following:

1. **Agent banking:** The Agent Banking Regulatory Framework was established in 2012 to align inter-disciplinary stakeholders of agent banking to enable delivery of agent banking in a reliable, safe and sustainable manner. The regulatory framework also provides a basis for assessing risks, and implementing regulations that are proportionate to the risks identified; and
2. **Development financial institutions (DFIs):** The *Development Financial Institutions Act 2002* (DFIA), which empowers Bank Negara Malaysia to regulate and supervise DFIs,¹⁸² was enacted in 2002 to ensure that institutions perform their developmental mandate in a prudent, effective and financially sustainable manner. The DFIA provides a comprehensive regulatory and supervisory framework for DFIs to ensure financial and operational soundness of these institutions.

With respect to agent banking, Malaysia has successfully implemented proportionate regulation on the adoption of a risk-based approach in addressing anti-money laundering and combating the financing of terrorism (AML/CFT) risk

447. The expansion in agent banking was put into effect through a phased approach with a clear regulatory framework, as outlined in the policy document on agent banking. The policy document, which was first issued by Bank Negara Malaysia in August 2012 and subsequently

¹⁸² Specialised financial institutions established by the Government with specific mandate to develop and promote key sectors like agriculture, small and medium enterprises, infrastructure, maritime, export-oriented sector, capital-intensive and high-technology industries of strategic importance to the country.

revised in April 2015,¹⁸³ governs the use of agents or third-party intermediaries by financial institutions¹⁸⁴ in the provision of financial services.

448. In developing the Policy Document on Agent Banking, the following key aspects were considered:

Application of global standards	<ul style="list-style-type: none"> Generally, the regulatory framework is in line with the FATF 40 Recommendations, particularly on the application of new technologies (Recommendation 15),¹⁸⁵ whereby financial institutions that leveraged on new technology in delivering agent banking services are required to identify, assess and effectively manage the risks associated with agent banking, including AML/CFT risk.
	<ul style="list-style-type: none"> The regulatory framework is also in line with the FATF Guidance on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion, specifically on the adoption of risk-based approach of AML/CFT as follows: <ul style="list-style-type: none"> Financial institutions can engage agents to facilitate automated and real-time customer biometric identity verification, using chip-based national identity card. In mitigating the potential risks which may arise when facilitating the opening of accounts at the agents, the following controls have been put in place: <ul style="list-style-type: none"> roles of agents in facilitating know-your-customer (KYC) functions are demarcated based on types of agents; and banking services offered at the agents are differentiated based on the outcome of KYC verification performed on the customer. The rigorousness of customer due diligence (CDD) measures is based on the risks associated with individual customers and delivery channels.

¹⁸³ Published in Bank Negara Malaysia's website (<http://www.bnm.gov.my>).

¹⁸⁴ Financial institutions refer to licensed banks under the Financial Services Act 2013 (FSA); licensed Islamic banks under the Islamic Financial Services Act 2013 (IFSA); and prescribed institutions under the Development Financial Institutions Act 2002 (DFIA).

¹⁸⁵ 2 Recommendation 15 stipulates that "Countries and financial institutions should identify and assess the money laundering or terrorist financing risks that may arise in relation to (a) the development of new products and new business practices, including new and pre-existing products. In the case of financial institutions, such a risk assessment should take place prior to the launch of the new products, business practices or the use of new or developing technologies. They should take appropriate measures to manage and mitigate those risks".

Regulatory objectives	<ul style="list-style-type: none"> • The regulatory framework was introduced in August 2012 to facilitate the implementation of agent banking in a reliable, safe and sustainable manner, while enhancing access to basic banking services in unserved areas.¹⁸⁶ • With the enhancement of the regulatory framework in April 2015, the policy objectives have been expanded to further enhance convenience, accessibility and usage of banking services, as well as to increase the satisfaction level of customers.
Risk assessment undertaken	<ul style="list-style-type: none"> • Potential risks that may arise from agent banking in the Malaysian context include operational, technological, compliance, financial, legal and reputational risks, as well as user awareness risk and financial inclusion risks (access, usage and quality). • These risks are dealt with in the agent banking regulatory framework that outlines the minimum expectations to be observed by financial institutions, which (among others) include the following: <ul style="list-style-type: none"> i. financial institutions must retain the ultimate responsibility and accountability of all agent banking activities; ii. an oversight mechanism must be established to monitor agents' conduct and ensure that associated risks are managed effectively; iii. all transactions by agents, including verification of a customer's identity, must be conducted on an online, real-time basis and within the business premise of the agent; iv. a robust, reliable and secure infrastructure/system must be put in place to support agent banking activities, including a minimum two-factor authentication¹⁸⁷ system for agent banking transactions; and v. appropriate deposit and withdrawal limits must be established so that more customers can benefit from agent banking and reduce risk exposures.

¹⁸⁶ Unserved areas defined as sub-districts (mukims) with >2,000 population without any access point to both deposit and withdrawal services.

¹⁸⁷ The two-factor authentication may include verification via MyKad and Personal Identification Number (PIN) of ATM/debit card.

	<ul style="list-style-type: none"> Since the implementation of the agent banking regulatory framework in 2012, the inherent risks of agent banking have been well managed, with zero fraud incidences.
Data used to inform policy implementation	<ul style="list-style-type: none"> The data used in formulating policy/regulation, as well as in monitoring and measuring the impact of implementing agent banking in the country, include the following: <ul style="list-style-type: none"> i. percentage of sub-district with population of more than 2,000 or state assembly areas in Sabah having at least one access point;¹⁸⁸ ii. volume and types of transactions, withdrawals, loan payments, fund transfers, bill payments, cashless payments, pre-paid top-up; and iii. total number and type of agents.

Source: AFI Proportionality in Practice Case Studies (Volume 1)

449. In April 2012, the Financial Sector Assessment Program (FSAP) conducted an assessment on the concept paper of agent banking guidelines¹⁸⁹ (the Concept Paper). FSAP viewed that the Concept Paper generally applied the international best practices for agent banking. FSAP also recommended Malaysia to review certain aspects of the guidelines towards ensuring a sustainable adoption of agent banking by financial institutions, which includes: (i) lifting the limitation on locations where agents can be deployed; and (ii) permitting low-value account opening at agents, on behalf of banks. The policy document on agent banking, issued in April 2015, has incorporated FSAP's recommendations, while the liberalisation of agent location was implemented in phases, in line with the policy objectives of serving the underserved areas.

450. Recognising the need to focus on enhancing the usage and satisfaction of the customers, the agent-banking framework was expanded¹⁹⁰ in 2015 as follows:

i. Agent banking services

- In addition to existing services – namely, accepting deposits, facilitating withdrawals, fund transfers, bill payments and financing repayments – agents are

¹⁸⁸ An access point is a place of banking business that provides minimum services of accepting deposit and facilitating withdrawal of funds by customers, which include bank branches, mobile units of the financial institutions, electronic terminals and bank agents.

¹⁸⁹ The Guidelines on Agent Banking were subsequently issued on 15 August 2012.

¹⁹⁰ Revised regulatory framework formulated based on feedback from stakeholders, including the underserved communities, financial institutions and various relevant departments in the Bank Negara Malaysia.

now allowed to facilitate financial institutions in the opening of saving accounts via online real-time systems and through biometric identity verification.

ii. **Location of agent banking**

- Extended from the unserved to underserved areas. Underserved areas are sub-districts (mukims) with a population of more than 2,000, or a State Assembly Area (DUN) for Sabah¹⁹¹ having access points of five and below.

iii. **Daily cash withdrawal limit**

- Increased from USD 120 to USD 240 at sole proprietor agents to better facilitate the needs of the community.

451. Additional requirements to mitigate the risk of allowing agents to facilitate the opening of savings accounts are as follows:

- i. Adopt the risk-based approach of AML/CFT.
- ii. The following key functions of opening accounts and AML/CFT obligations to remain with financial institutions:
 - decision to approve the customer's application to open a savings account and for issuance of an ATM/debit card;
 - ongoing AML/CFT surveillance, which includes profiling of customers and reporting of suspicious transactions; and
 - conducting due diligence on customers immediately upon opening accounts.
- iii. Enhance infrastructure and capability of AML/CFT system.
- iv. Intensify customer awareness and education programs.
- v. Expand training modules on AML/CFT, data privacy and secrecy rules for agents.

¹⁹¹ Sabah is located in the East Malaysia, one of two Malaysian states on the island of Borneo and is the second largest state in Malaysia.

Peru

452. The core mission of the Peruvian regulatory and supervisory body the *Superintendencia de Banca, Seguros y Administradoras Privadas de Pensiones* (SBS) is to protect depositors' interests by ensuring the soundness and stability of the financial system. An additional responsibility, since 2007, is to prevent the abuse and misuse of supervised financial services. Thus, the Peruvian regulator faces the challenge of harmonising three objectives – stability, integrity and financial inclusion. The housing of diverse functions under the same roof, however, accords the SBS with a coordination advantage.

453. The earliest application of proportionality in Peru was possibly in 1997, when the micro-credit regulation was first issued. This regulation defines micro-credit and boundaries for risk exposure. Regulatory requirements were reduced to ease credit management for services providers and to enable financial access to micro and small firms.

454. In pursuing the stability and integrity objectives, the SBS adopts international standards, including the principles and recommendations of the Basel Committee on Banking Supervision (BCBS) and the Financial Action Task Force (FATF). The global standards are implemented in a customised way, taking into consideration Peru's context and the characteristics of its financial sector.

In developing a regulatory framework for stability and anti-money laundering and combating the financing of terrorism (AML/CFT), proportionality promotes the harmonisation of stability, integrity and financial inclusion objectives

455. The approach is aimed at ensuring measures that are commensurate with the risk level of the activities performed and the complexity of the operations of a specific supervised entity. This is in line with the recommendations by the BCBS in its 2012 *Revised Basel Core Principles for Banking Supervision*, and by the *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations*.

456. SBS adopts proportionality in the due diligence process for know your customer (KYC), which is aimed at ensuring regulations are effective without being an obstacle to financial inclusion. The approach taken by the SBS is described in the Regulation for Risk Management of Money Laundering and Terrorism Financing, issued by Resolution SBS N° 2660-2015.¹⁹² The following aspects were considered in developing the regulation.

¹⁹² First version of the approach was issued in 2011.

Application of global standards	<ul style="list-style-type: none"> The regulation is consistent with 2012 FATF Recommendations, mainly Recommendation 1, where FATF advises the use of a risk-based approach (RBA).¹⁹³
Regulatory objectives	<ul style="list-style-type: none"> The objectives are twofold: <ol style="list-style-type: none"> To increase the efficacy and efficiency of the AML/CFT system, abiding by international standards and best practices. To ease the access to financial services, especially for low-income segments of the population, without affecting the integrity of the financial system. The regulation does not target specific sectors. It affects the relationship and interaction between diverse financial services providers (banking and non-banking institutions, cooperatives, insurance brokers and private pension funds) and their clients.
Data used to inform implementation	<ul style="list-style-type: none"> To define regulatory thresholds in the Simplified Regime (described further below), data on per-capita income and expenses for different quintiles of income were useful for making inferences about the reasonable volume of transactions that are associated with diverse accounts. A survey was also extended to the insurance industry, and the results were used to inform policies for the Simplified Regime. For monitoring purposes, firms report the number of basic deposit account holders and simplified e-money accounts.
Consultative arrangements	<ul style="list-style-type: none"> The views of standard setters were indirectly taken into account through the revision of published documents. In this regard, the KYC regime is aligned with international standards and best practices. In particular, the development of the regime benefited from FATF Recommendation 10. SBS also engaged supervised entities to clearly identify sources of inefficiencies and barriers of the AML/CFT regulation to their activities, especially those serving the small and low-income customers.

¹⁹³ "To ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified". The recommendation is strong and it is suggested that an RBA "should be an essential foundation to efficient allocation of resources across the anti-money laundering and countering the financing of terrorism (AML/CFT) regime..."

457. Making the regulation proportional to risk increases efficiency in the allocation of resources for both the supervisor and the supervised entities. This avoids overburdening financial institutions with requirements when they are not needed. Increased efficiency promotes financial inclusion, as it implies lower costs for all FSPs, especially those targeting low-income people as potential customers.

458. The AML/CFT Regulation is a comprehensive document that has evolved over time, in response to the need to fine-tune the overall financial regulatory framework. This is critical to ensure that the regulation is conducive to financial inclusion.

Three regimes for KYC due diligence: simplified, general and reinforced

459. In determining which regime to adopt, an assessment of money laundering and financing of terrorism (ML/FT) risk is made, based on risk factors that are explicitly set out in the regulation.¹⁹⁴ As such, the KYC regime can be applied to diverse risks, allowing financial institutions to freely design products and services, and a regime that best fits the characteristics and risk of clients and products. This approach provides sufficient room and flexibility for innovation. The regimes mostly differ by the minimum information required to identify a client, with the subsequent verification, and by the intensity of monitoring.

460. The Simplified Regime, which applies to clients and products with proven low ML/FT risk, has the least requirements. The General Regime is applicable to most clients and products, with standardised identification, verification and monitoring. The Reinforced Regime¹⁹⁵ entails a more exhaustive and detailed KYC due diligence process.

As shown in Table 1, the Simplified Regime allows financial services providers to reduce the minimum information required for customer identification. Under this regime, clients are required to provide a reliable document of identification – typically, the National ID, which is used on a widespread basis in Peru.

¹⁹⁴ The client, the products and services, together with the delivery channels, and the relevant geographic region.

¹⁹⁵ It applies to all non-resident persons, trusts, politically exposed persons, persons involved in LA-TF related investigations or judicial processes, transfer recipients from countries not cooperating with FATF, among others.

Table 1: Minimum Information Required for Clients that are Natural Persons¹⁹⁶

Simplified Regime	General Regime	Reinforced Regime
<ul style="list-style-type: none"> - Full name - Type and number of ID - Address 	<ul style="list-style-type: none"> - Full name - Type and number of ID - Address - Nationality and residence - Phone number and/or email address - Purpose of relationship with the firm - Occupation and name of the employer - Identification of legal representative, if applicable 	<ul style="list-style-type: none"> - The requirements are larger than those contemplated in the General Regime. - Information collected goes beyond the client, including the spouse (or partner) and relatives, up to the second degree of consanguinity and second degree of affinity.

Source: AFI Proportionality in Practice Case Studies (Volume 1)

461. The Simplified Regime can also be applied to low ML/FT legal persons. The minimum information required is: (i) corporate name; (ii) taxpayer registration number; (iii) identification of legal representatives; and (iv) business address.

462. There are two ways in which a product or service can be considered under the Simplified Regime:

- i. Financial services providers can freely design and develop any product or service, and request the SBS's approval to use the Simplified Regime, if the product has a low ML/FT risk.
 - Financial services providers are required to provide information on the product characteristics, commercial and operative design, distribution channels, and the ML/FT risk management plan. The SBS may deny or grant approval with specific requirements.
- ii. Products or services may be defined by regulation, with established thresholds to ensure a low ML/FT risk.
 - Based on the limits specified, financial services providers may develop a suite of products and offer them without the SBS's prior approval. Thus far, basic

¹⁹⁶ Client: Resident natural person; Geographical: For contracting in the national territory only. Requirements for legal persons are also contemplated in the Regulation.

deposit accounts, simplified electronic money accounts and some insurance products have been defined by regulation, in 2011, 2013 and 2015, respectively.

- Deposit and simplified e-money accounts are defined with specific characteristics and limits (Table 2).

Table 2: Simplified Regime: Products Defined by Regulation

	Maximum Balance*	Maximum daily deposits*	Maximum accumulated deposits and Withdrawals*	Other characteristics
Basic deposit accounts	S/. 2000	S/. 1000	S/. 4000	Only one account Per person
Simplified e-money accounts ¹⁹⁷	S/. 2000	S/. 1000 (limit per transaction)	S/. 4000	

**In Peruvian Sol.*

Source: AFI Proportionality in Practice Case Studies (Volume 1)

463. In addition, after a thorough evaluation, SBS included a list of insurance products (Circular N° S-661-2016 of 20 July 2016) in the Simplified Regime. The list includes mandatory and massive insurance products, micro-insurance, group insurance, credit insurance, life insurance (with some constraints), personal accident and health insurance, and insurance contracted by employers in favour of their employees.

¹⁹⁷ Can be opened remotely, with minimum requirements and subsequent automated verification.

Tanzania

“Test and learn” regulatory approach in promoting mobile financial services (MFS)

464. Tanzania has witnessed an unprecedented level of uptake of MFS since such services came into use in 2008. These encouraging results have emerged, among others, from a conducive regulatory environment. The “test and learn” approach allows the regulator to test the deployment of the service and monitor its developments. In this regard, the role of the regulator has been to support rather than stifle innovation, through understanding the risks that are inherent in such innovations and establishing the necessary risk controls.

Proportionality in anti-money laundering and countering the financing of terrorism (AML/CFT) regime in MFS

465. Tanzania has adopted a proportionate regime that allows mobile network operators (MNOs) to use agents to perform several critical functions and implement tiered consumer due diligence (CDD). Under this model, agents are responsible for facilitating cash withdrawals and deposits, registering users, and performing initial due diligence of new customers. They are required to comply with the MNOs’ AML/CFT policies and are trained to follow specific procedures in the case of suspected fraud or money laundering. In the absence of national ID system in Tanzania, customers often use voter registration cards to validate their identity. Other valid forms of ID include pension cards, passports, employee cards, and a ward executive officer’s letter.

466. The following are key considerations in practising proportionality:

- i. **Role and potentiality of MFS in advancing financial inclusion:** MFS is considered a fundamental way to reduce financial services exclusion and informal payments. This, in turn, minimises the risks of money laundering and terrorist financing that may result from exclusion.
- ii. **Simplicity and ease of adoption of the service by the unbanked masses:** The rural and urban underserved population has easily adopted the use of mobile phones, based on the use of feature codes and the Unstructured Supplementary Service Data (USSD) technology. Such technology can be used to deliver MFS.
- iii. **Legal requirements for registration of subscriber identification module (SIM) card:** The government passed a law that made it compulsory to register all SIM cards

before use and those already in use had to be registered. Anonymous callers are also prohibited.

- iv. **Audit trail that the technology provides:** Audit trails for all transactions are required and such data must be retained for more than seven years. This requirement provides a healthy ground for law enforcement in AML/CFT intelligence and other operational risk mitigation.
- v. **Technologically imposed transaction limits and tiered customer base:** Platform-based transaction limits and structuring of customers are imposed based on the transaction limits from the system. This also allows for enforcements of such limits on a real-time basis.
- vi. **The implementation of risk mitigation measures:** All transaction limits must be based on internal risk mitigation measures of the service provider. This includes the adoption of governance and MIS controls to monitor and report suspicious transactions for AML/CFT compliance.
- vii. **Reporting institutions:** MNOs must institute AML/CFT mechanisms and report suspicious transactions to the Financial Intelligence Unit (FIU), in accordance with the *Anti-Money Laundering Act 2006 (AMLA)*.

Implementation of tiered know-your-customer (KYC) requirements

467. Transaction limits must be commensurate with the risk mitigation measures deployed by MNOs. The applicable transaction limits and corresponding KYC verification requirements are as follows:

Customer category	Transactional limits			Risk mitigation measures: KYC requirements verification	
	Maximum transfer size (per transaction)	Maximum daily transfer limit	Daily mobile wallet balance		
Tier I (Individuals) ¹⁹⁸	Tanzanian Shilling (TZS) 1 million	TZS 1 million	TZS 2 million	<i>Mobile money (e- money) transfers:</i>	• Registered phone number and registered mobile money account user
				<i>Cash-in transactions:</i>	• Registered phone number and registered mobile money account user • Acceptable photo ID
				<i>Cash-out transactions:</i>	• Acceptable photo ID ¹⁹⁹
Tier II (Individuals) ²⁰⁰	TZS 3 mil.	TZS 3 mil.	TZS 5 mil.	• Pre-requisite for upgrading: MNO to verify KYC of the customer on the MNO systems. • Documents should include: <ul style="list-style-type: none"> - Acceptable photo IDs²⁰¹ - Registered phone number and registered mobile money account user 	

¹⁹⁸ Individuals who are either newly registered or who transfer funds to unregistered customer.

¹⁹⁹ National ID; voter's registration card; employment ID; social security ID; or letter from ward/village executive.

²⁰⁰ Individuals who have been upgraded through verification of KYC by MNO through internal AML/CFT controls including micro-agents.

²⁰¹ More than one of: national ID; passport; voter's registration card; employment ID; social security ID; letter from ward/village executive; any other documentation that will assist in verification.

Tier III (Business entities, firms and institutions)	TZS 10 mil.	TZS 50 mil.	TZS 500 mil.	<ul style="list-style-type: none"> • Pre-requisite for upgrading: MNO to verify the KYC of the customer on the MNO system. • Documents should include: <ul style="list-style-type: none"> - Tax Identification Number - Business License Number - Acceptable photo IDs²⁰² - Registered phone number and registered mobile money account user
Tier IV ²⁰³	TZS 10 mil.	TZS 500 mil.	TZS 500 mil.	Same requirements as for tier III customers, and full business KYC (similar to compliance by banks)

Note: Maximum transaction counts* should not exceed the maximum daily transfer limit stated above; * means the number of counts of all types/nature of transactions.

Source: AFI Proportionality in Practice Case Studies (Volume 1)

468. In addition, management information systems (MIS) and institutional governance also serve as risk mitigation measures. This includes the following:

- i. MIS:
 - automatic system block for transactions that exceed limits;
 - audit trail reports of each customer's transaction;
 - alerts;
 - AML system.
- ii. Institutional governance:
 - segregation of duties and clear approval procedures that are documented;
 - existence of a risk mitigation unit;
 - AML/CFT compliance officer and reporting.

²⁰² More than one of: national ID; passport; voter's registration card; employment ID; social security ID; letter from ward/village executive.

²⁰³ Collection and disbursement accounts transactions of business entities and customers.

Uganda

469. The absence of a national identification card has been recognised as a key challenge for government agencies in implementing the necessary intervention strategies to bring the unbanked population into the formal financial system. Similarly, providers of formal financial services have faced difficulty in serving customers with varying identification documents.

470. Against this background, biometric technology was adopted as a more secure and reliable means of identification, prior to accessing financial services. This technology utilises specific physiological features of individuals (such as fingerprints, face and iris scans) and behavioural characteristics to determine authenticity. The technology is increasingly supporting financial inclusion, making it economically viable for financial institutions to reach poorer people.

Biometric identification system was a crucial first step in supporting financial inclusion

471. Government and the Bank of Uganda undertook the following reforms:

- i. The Credit Reference Bureau (CRB) was established under the *Financial Institutions Act 2004* to facilitate the sharing of credit information across financial institutions. Due to the lack of a unique national identification system at the time, the CRB service provider was mandated to develop a Financial Card System. The Financial Card System is an online, real-time system that captures biometric and other identification information on a financial card with built-in chip. It uniquely identifies individuals and companies for the purposes of cross-matching borrowers' credit profiles across supervised financial institutions.

As at end-June 2016, the Financial Card System was installed in 615 branches of supervised financial institutions and over 1,304,941 financial cards had been issued to borrowers. Credit extension grew by 51% between 2012 and 2014, with groups previously excluded from the financial system (such as women and youth) benefiting from greater access to credit facilities and other financial services within the country. For instance, between 2013 and 2014, loans granted to women aged between 18 and 25 years increased by 300%. During the same period, loans granted to women aged between 18 and 35 years increased by 86%. For youth, credit issued to individuals aged below 25 years increased by 525%.

- ii. The National Identification and Registration Authority (NIRA) established a national identification register and issued national identity cards. In this regard, Bank of Uganda and NIRA are discussing the prospect of utilising biometric identification data in the National ID system for financial sector purposes. It is expected that, going forward, the National ID biometric system will ultimately be the key identifier in accessing financial services and improving know-your-customer (KYC) processes. Additionally, it is envisaged that customers will be able to link their national IDs to electronic payments and receive salaries payments automatically, especially in remote areas of the country. This will, in turn, further improve access to finance for good borrowers and enhance financial inclusion. As at end-June 2016, over 17 million Ugandans had registered and accessed the national identity cards.

Various initiatives undertaken to promote financial inclusion and financial literacy

472. Efforts include the following:

- i. Between 2012 and 2015, Bank of Uganda initiated projects on financial inclusion and financial literacy that were aimed at increasing access to financial services and empowering users of financial services to make rational decisions in their personal finances. Provision of financial services in a sustainable manner remains a big challenge due to poor communications infrastructure and low levels of financial literacy. In addition, low population density renders the unbanked areas unattractive to the financial services providers, despite the evidence that the poor can also save, borrow and promptly pay their loans.
- ii. The Bank of Uganda Consumer Protection Guidelines 2011 and the Key Facts Document were issued to the financial sector in various local languages to further enhance financial literacy and increase transparency in disseminating information to consumers.
- iii. To avoid stifling innovations, Bank of Uganda further introduced guidelines to provide clarity to stakeholders on mobile money services. This was aimed at creating a flexible environment for low-cost and convenient innovations to thrive. New delivery channels, such as mobile money transfers initiated by telecommunications operators, have been fully embraced and encouraged as mechanisms to enhance financial inclusion. Bank of Uganda interacts closely and regularly with external partners, such as the Ministry of Finance, Planning and Economic Development and the Uganda Communications Commission (UCC), financial institutions, mobile network operators, and other relevant actors from the public and private sectors.

- iv. Bank of Uganda is also in its final stages of drafting regulations to support agent banking, which is a low-cost platform that promotes proximity and customers' access to financial services.

473. In conclusion, while a biometric identification system is not the only method that will address all the issues that impede financial inclusion, it is indeed a crucial first step. By making it easier to document one's identity and financial track record, biometric identification improves KYC processes and empowers wide segments of the population that were previously excluded from participating in formal financial transactions. In this regard, biometric identification is not only a starting point for innovations that will enhance financial inclusion, but also one of the biggest social experiments of our time.

Regulations on Microloan Institutions

Bhutan

474. One of the primary development objectives as enunciated in the Royal Government's vision document, "Bhutan 2020: A Vision for Peace, Prosperity and Happiness", is to ensure that "the benefits of development are shared equitably between different income groups and regions, in ways that promote social harmony, stability and unity and contribute to the development of a just and compassionate society". Consistent with this vision, the *goal of financial inclusion* in Bhutan is to ensure that the poor, the vulnerable and the marginalised segments of the population increase their financial literacy and capability, and gain access to financial services that are tailored to their specific needs. Access to financial services can, in turn, contribute towards improving their livelihoods, raising income levels, reducing vulnerability, and bringing them into the mainstream of the economy and society as economically productive citizens.

475. This goal has resulted in the adoption of proportionate regulation and the creation of an enabling legal and regulatory environment to improve access to finance by poor and low-income people. The Royal Monetary Authority of Bhutan (RMA) has actively worked to foster the development of an *inclusive financial system* that contributes to the country's goal of poverty alleviation through sustainable and equitable regional development. RMA has taken, or is in the process of undertaking, the following measures:

- i. RMA has, in 2014, put in place the **Regulation for Micro-Loan Institutions**. Under the regulation, RMA could bring non-governmental organisation (NGOs) and entities engaged in lending activities into the formal financial system, by allowing them to register with the RMA for onward lending purposes.
- ii. **Agent-Banking Regulation**, focusing on agent banking by the licensed banks, came into force in November 2016.
- iii. **Regulation for Deposit-Taking Microfinance Institution** was implemented with effect from January 2017.
- iv. **E-Money Issuers Rules and Regulations** was implemented in 2017.
- v. **Priority Sector Lending Guidelines** was implemented with effect from January 2018. This guideline is an integrated platform that will coordinate interventions from several government agencies to stimulate the cottage and small industries (CSI)

sector as an important driver of Bhutan's economic transformation, through improved access to finance.

Regulation for microloan institutions is an example of where proportionality is applied

476. Bhutan's financial sector has grown significantly over the last few years and has made substantial progress in terms of financial viability, profitability and competitiveness. However, there are concerns that it has overlooked a large segment of the population comprising the poorer and weaker sections – especially those living in rural areas.

477. "Proportionality" refers to an approach where regulation is proportional to the benefits and costs of the regulatory intervention, which implies that different risks are regulated differently. It is typically based on an understanding of the gaps and barriers in the existing regulation. In the case of micro-loan institutions, the following requirements apply proportionality in practice:

Reporting	<ul style="list-style-type: none"> • Every quarter, micro-loan institutions shall submit to RMA details of their loan portfolios and donors with details of the funds received. The information shall be submitted in the manner prescribed by RMA. • The accounts of the micro-loan institutions shall be audited at the end of each financial year. • Micro-loan institutions should seek RMA's approval in the event that there is a change in management and significant owners.
Consumer protection	<ul style="list-style-type: none"> • Micro-loan institutions shall make adequate efforts to educate their clients on important terms and conditions of all their loan products. • While making a complete disclosure of the lending rates of all their loans and any other charges in the contract/documents signed with their clients, relationship officers of the micro-loan institutions shall also read these terms aloud to their clients.
Complaint procedures	<ul style="list-style-type: none"> • Micro-loan institutions shall set up effective procedures that allow Micro-loan clients to submit complaints.
Inspections	<ul style="list-style-type: none"> • Continuous surveillance shall be carried out by the RMA through inspection/examinations on the micro-loan institutions. • Whenever the circumstances warrant, such inspections shall be extended to agents, partners, and service providers or outsourced entities of the micro-loan institution, in view of their participation in the micro-lending business.

In developing the Regulation for Micro-Loan Institutions, the following key aspects were considered:

Application of global standards	<ul style="list-style-type: none"> • In developing the regulation, RMA has incorporated certain minimum standards set out in the <i>Core Principles for Effective Supervision</i> and other standards published by the Basel Committee on Banking Supervision (BCBS). • RMA expects that the regulation will facilitate the implementation of prudent practices and effective risk management techniques by micro-finance institutions. • The regulation will also promote a level playing field for all market players, including transparency, accountability, corporate governance and fair competition.
Regulatory objectives	<ul style="list-style-type: none"> • The regulation specifically targets the poor and people with low income, who are excluded from the mainstream formal financial system – namely, smallholder farmers; unemployed youth; self-employed artisans; those engaged in small -scale production, processing and marketing of agricultural products; and micro- and small enterprise operators. • This allows for the weaker sections of society to gain access to basic financial services. Thus far, only micro-lending is covered under this regulation.
Risk assessment undertaken	<ul style="list-style-type: none"> • The main risks considered for the implementation of this regulation include operational and credit risks. • Risk mitigation mechanisms include the following: <ol style="list-style-type: none"> 1. Transparency and public disclosure by the micro-loan institutions are important to monitor their behaviours and affordability. 2. Accurate disclosure and comparable information on the products and services would help consumers to make informed choices. 3. Standardised information on financial and social performance of micro-loan institutions would help regulators to assess potential risks and the level of affordability, in line with the objective to meet financial sustainability.

Data used to inform implementation	<ul style="list-style-type: none"> • Data submitted by the financial institutions (banks and insurance companies) were used for the implementation of this regulation. • While the available data are patchy, there was some evidence that only a minority of the population in rural areas has access to formal financial services. For example, while the agriculture sector (mostly rural) accounts for more than 17% of GDP as at end-June 2015, loans to the sector comprised less than 5% of the total loan portfolio of the financial sector.
Consultative arrangements	<ul style="list-style-type: none"> • Technical assistance was sought from the Asian Development Bank in developing the regulation. • The draft regulation was also posted on the RMA's website for one month for public consultation.

Source: AFI Proportionality in Practice Case Studies (Volume 1)