BASEL III, DERISKING, DIGITAL FINANCIAL SERVICES AND SMALL & MEDIUM ENTERPRISES (SMEs)

WHAT'S HAPPENING IN THE MARKETS TODAY?
HOW SHOULD WE RESPOND?

Bill Haworth
February 1, 2017

Introduction

- **IFC believes that SMEs are essential for economic development and job creation**
- **However, Basel rules and KYC/AML rules are causing a pull-back by Global Banks from smaller EMs – This is potentially threatening international clearing and settlement activities, correspondent banking networks and Trade Finance**
- **In addition, Basel rules seem poised to require higher risk weights on SMEs and Trade and this seems to be suppressing access to finance for SMEs**
- **This combination of higher capital, higher KYC/AML costs, and reduced network effects seems poised to reduce SME access to credit, or greatly increase the price and reduce demand**
- **This problem is much admired, but is there something we can do about it?**

Two Questions:

1. **Do you agree this is a problem in your market? Capital weights? AML/KYC? Reduced correspondent network? Increased transaction costs?**
2. **What might IFC do to help resolve these problems? With International Regulators? With Local regulators? As correspondents?**

The Financial System Is Facing Structural Changes Driven by 5 Fundamental Forces…

1. **Re-regulation** following the financial crisis aimed at reducing risks and **increasing capital** cushions and lowering leverage. This is **reducing profitability** for the entire regulated industry

2. **Increased scrutiny and costs** related meeting regulatory requirements around Know your Customer **(KYC),** Anti-money laundering **(AML),** Combatting the Financing of Terrorism **(CFT),** and dealing with offshore financial centers – this is raising costs for the entire industry and also **reducing profitability**

3. Increased use of **digital currencies** and the move away from cash – this is increasing inclusion and opening opportunities for Fintech Companies with mixed impact on banks and other FIs. Technology is reducing entry barriers in banking, but it is also increasing the strategic penalties from lock-in and creating tension between high cost branches and low cost internet delivery approaches. Adding to the complexity, are issues around differential adoption rates in different segments in different countries. In the end, Citibank estimates that we should expect a 30% decline in core revenues, and a 44% market share shift over the next 10 years. This is significant, and there will be clear winners and losers from this disruption.

… Financial System Is Facing Structural Changes Driven by 5 Fundamental Forces….

4. The emergence of **thousands of Fintech companies** that offer a wide array of both disruptive and complementary products and services that can dramatically change the product and delivery economics for customers and FIs – this is eroding margins in banks and other FIs, but also offers cost reduction opportunities that will enable some FIs to become clear cost leaders in their chosen fields.

5. The proliferation of **Big Tech "platform business models"** that are changing channels and distribution economics in radical ways that also effect finance – this is providing a potential substitute to many FI functions. Looking at the evolution of Alibaba and Ant Financial in China, this seems to be the most fundamental threat to incumbent FIs and Fintechs, and this is just starting…

We believe that these trends are likely to accelerate and that this will lead to a **significant consolidation of banks and other FIs and globally and to the emergence of new financial players** particularly in the Big Tech space and to a lesser degree in the Fintech space going forward. **We think this process will be very disruptive and will lead to a redrawing of the map of the global financial system. This is already underway.**

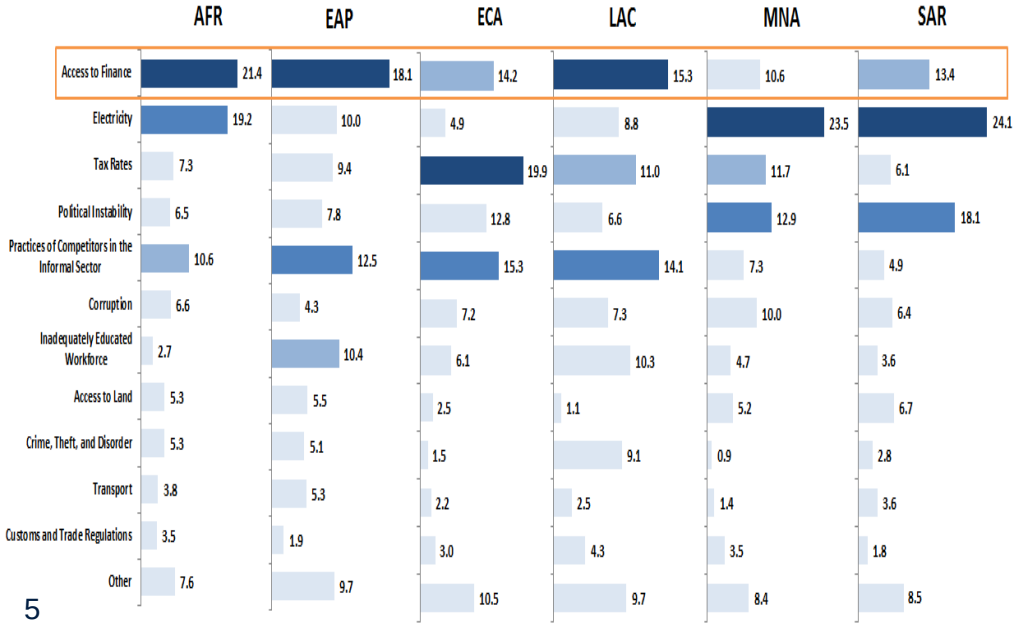
SMEs: Crucial to development, lacking access to finance

SME growth is directly linked to **job creation, poverty reduction and shared prosperity**

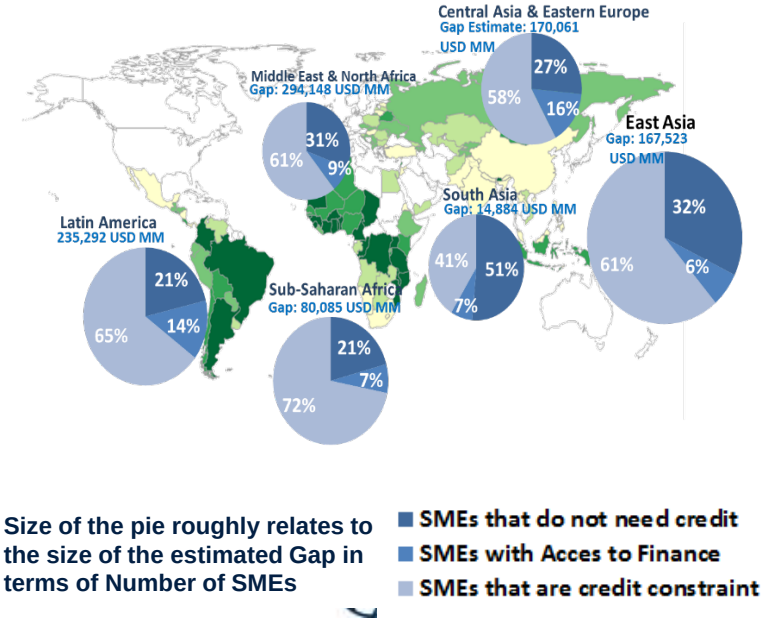
SMEs account for:

- ✓ **over 90% of formal jobs** in lower income countries
- ✓ **80% of new formal jobs** in emerging markets

SMEs LACK ACCESS TO FINANCE:
biggest obstacle for SMEs in over 70% of countries



SMEs ARE UNDERSERVED: 60% of formal SMEs are underserved globally



Sources: World Bank Enterprise Survey; IFC Enterprise Finance Gap Database (2011)

How Digital Financial Services (DFS) can help SMEs

Digital finance could increase the GDPs of all emerging economies by 6 percent, or a total of $3.7 trillion, by 2025

McKinsey&Company | Source: McKinsey Global Institute analysis

Digital finance could provide access to **1.6 billion** unbanked people, more than half of them women, increasing markets for SMEs.

Expanding customer base could sustainably increase deployable deposits by as much as **$4.2 trillion**.

Governments could gain **$110 billion** per year by reducing leakage in public spending and tax collection with digital vs paper currency.

An additional **$2.1 trillion** of loans to individuals and SMEs could be made sustainably, as providers gain newfound ability to assess credit risk for a wider pool of borrowers quicker, cheaper, and more effectively.

IFC International Finance Corporation WORLD BANK GROUP

What DFS Can Bring

TRANSPARENCY	ID numbers, biometrics and distributed ledgers can make personal identity, asset identity, transactions records, and validation cheap, easy and effective
SECURITY	Encryption and distributed information can ensure privacy, reliability and redundancy (backed-up, immutable records). Digital currency is safer than cash
STANDARTIZATION	Technology requires standardization and this drives interoperability, efficiency and reinforces transparency. Digital currency is easier to transfer
INFORMATION	• Digital Financial information available for lenders/investors • Assets and liability records available for lenders • Links to credit bureaus and collateral registries decrease risks and increase credit quality
ACCESSIBILITY	Web-based applications can make different levels of data available to different users at different security levels, everywhere
SPEED & ACCURACY	Rules based decisions and artificial intelligence can greatly reduce processing times and focus human intervention on only critical decision points –reducing costs, increasing accuracy and speeding decisions
COMPETITION	With transparency, security, standardization and accessibility, competition can increase and the supply of capital available to SME can surge

Areas Where Technology Can Help SMEs

SME AND SME OWNER IDENTIFICATION

- Individual owner/shareholder IDs
- Company IDs linked to individual Biometrics
- Meeting KYC/AMC transparency standards

DIGITAL BUSINESS RECORD ACCESSIBILITY

Registrations, Tax IDs, ownership, management, operating locations, asset locations, credit information

BUSINESS PERFORMANCE VALIDATION

Financial records can be available on-line and can be audited and/or cross-validated with supply-chain data on purchases, sales, inventory levels, payables, etc. This will increase business partners and lender confidence, reduce risks and increase supply of credit

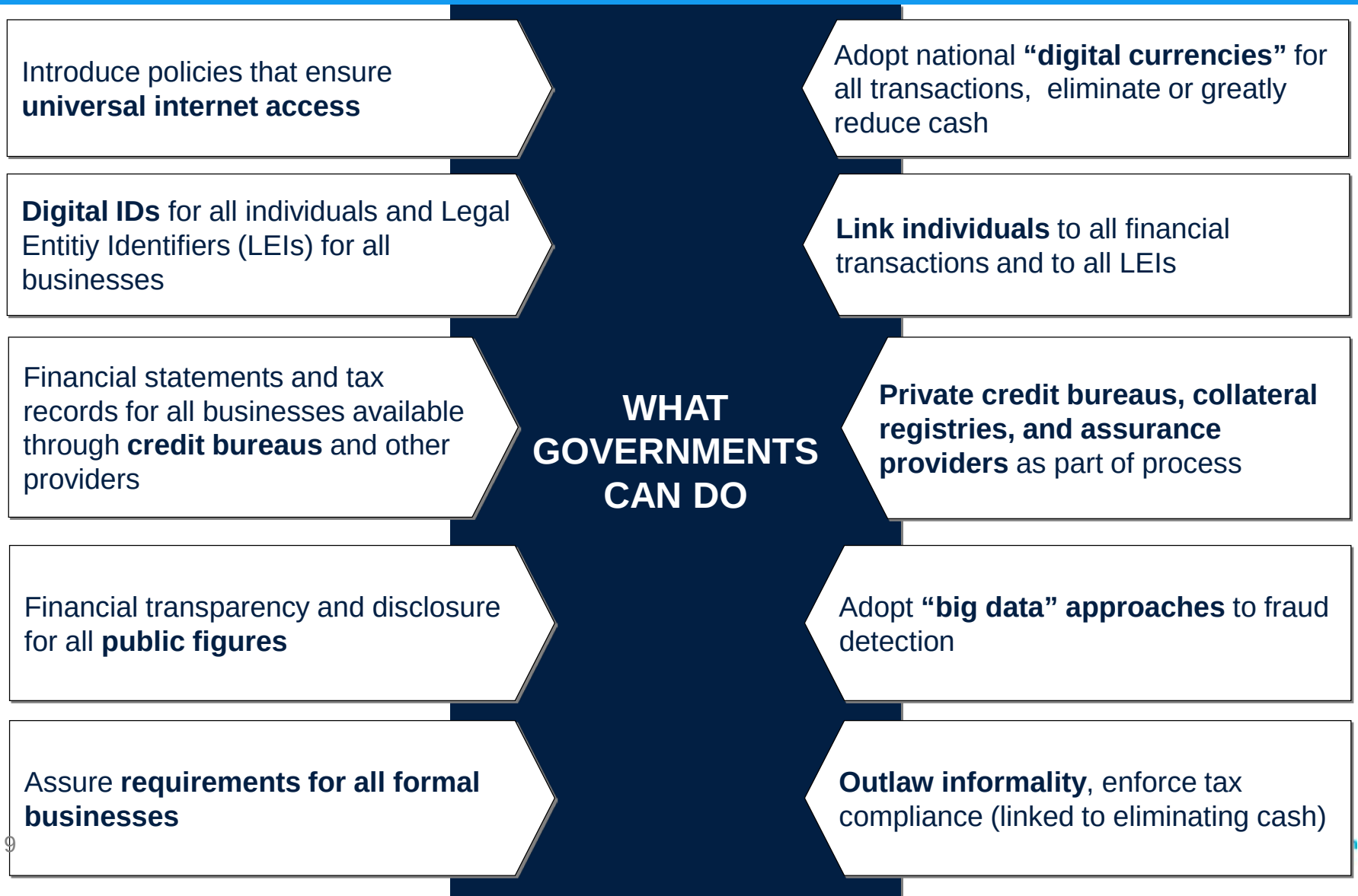
TRANSACTION RECORD ACCESSIBILITY AND OWNERSHIP

- Can make secured transaction processing much cheaper, faster and more reliable
- “Block chain or :distributable ledgers”
- Technology can support asset trading and transfer

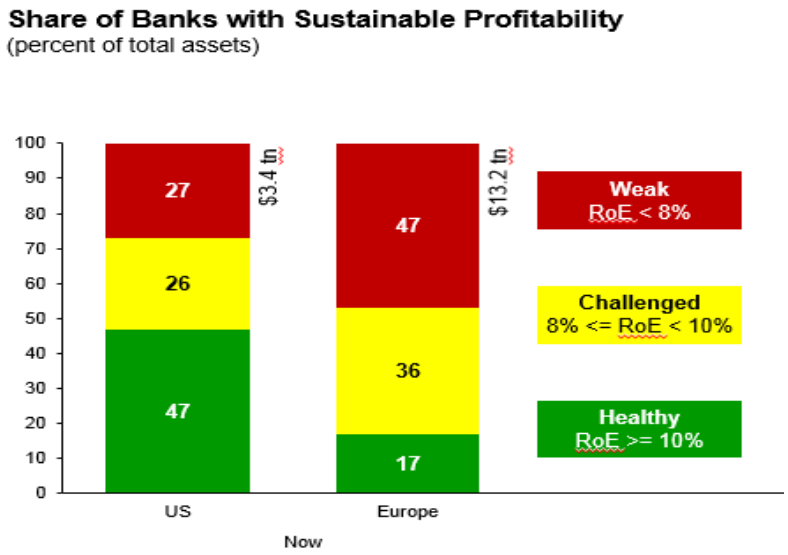
FINANCIAL TRANSPARENCY

- Linked to tax compliance, insurance, payrolls, etc.
- Meet global KYC/AML standards

Role of Governments



Long Predicted, the Decline of Branch Banking May Finally Be at Hand… Except in Africa and Asia…



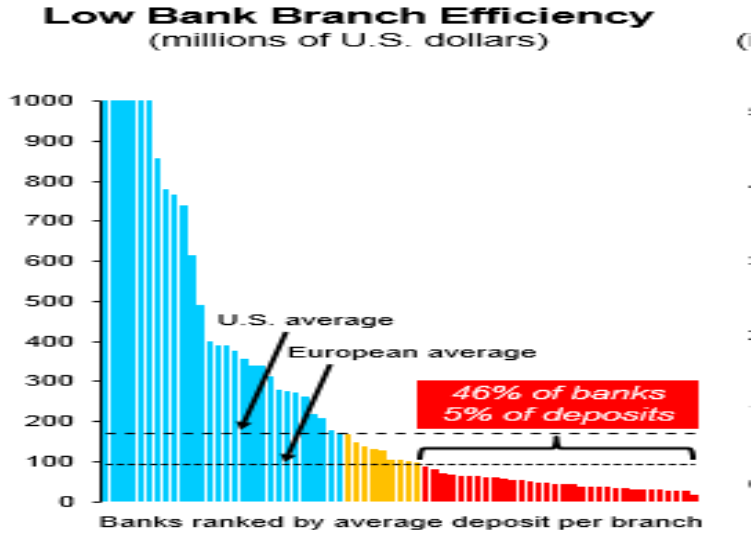


Figure 63. Traditional Bank Channels by Region per 100k People

		Developing			
	OECD (High Income)	Sub-Sahara Africa	LatAm	Europe/Central Asia	East Asia
ATMs	75.8	5.2	43.3	52	23
Bank Branches	25.6	3.9	19	21.4	9.5
Total	101.4	9.1	62.3	73.4	32.5

Source: Citi Research, World Bank

Sources: IMF Global Financial Stability Report (Oct 2016); Citgroup GPS Digital Disruption Report (Mar 2016)

Fintechs Attack Weaker Service Points….

Bank Profits

Figure 22. Global Banks Profit Breakdown By Product and Customer Segments

	Payments	Savings and Investment	Lending	Capital Markets	Overall
Personal/SME	4%	12%	29%	1%	46%
Corporate	3%	6%	21%	5%	35%
IB/Markets	0%	3%	6%	10%	19%
Overall	7%	21%	56%	16%	100%

Source: Citi Research Estimates; Based on the banks under Citi coverage; The profit split by customer segments are based on company reports or analyst estimates; the profit is then allocated across products; the profit splits by product segments is estimated base on selected banks that discloses revenue splits by products.

Fintech Investments

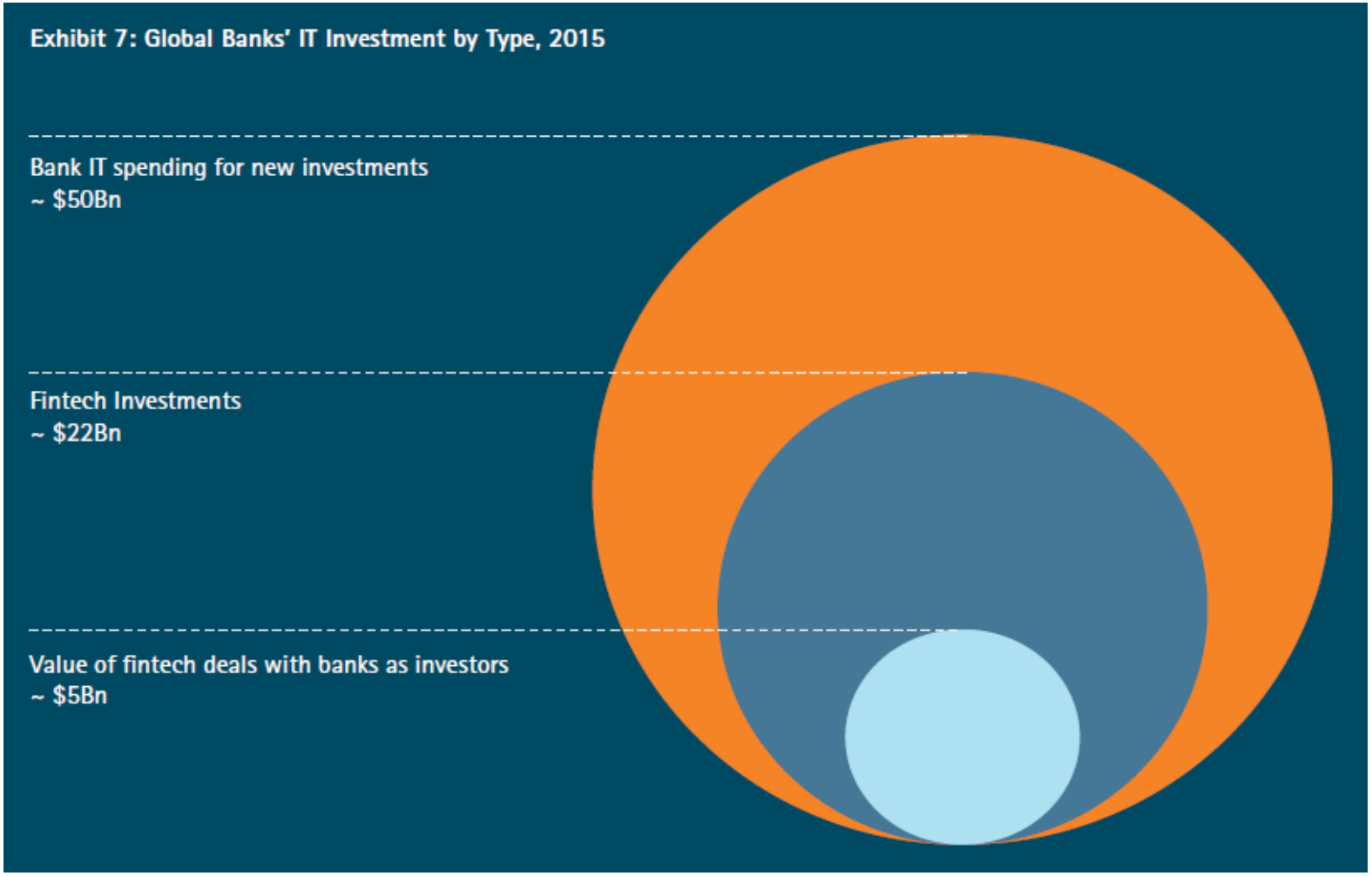
Figure 15. Dollar Invested in Private FinTech Companies By Product and Customer Segments

	Payments	Savings and Investment	Lending	Capital Markets	Insurance	Overall
Personal/SME	26%	10%	47%	0%	10%	92%
Corporate	3%			0%		4%
IB/Markets				4%		4%
Overall	29%	10%	47%	5%	10%	100%

Source: CBInsights, KPMG, Crunch Base and Citi Research; Based on ~120 private companies from CBInsights FinTech Periodic table Dec 2014; KPMG's top 50 most prominent FinTech innovators Dec 2015; Valuation based on Crunch Base Total Equity Funding for private companies and exit value for acquired companies

Source: Citgroup GPS Digital Disruption Report (Mar 2016)

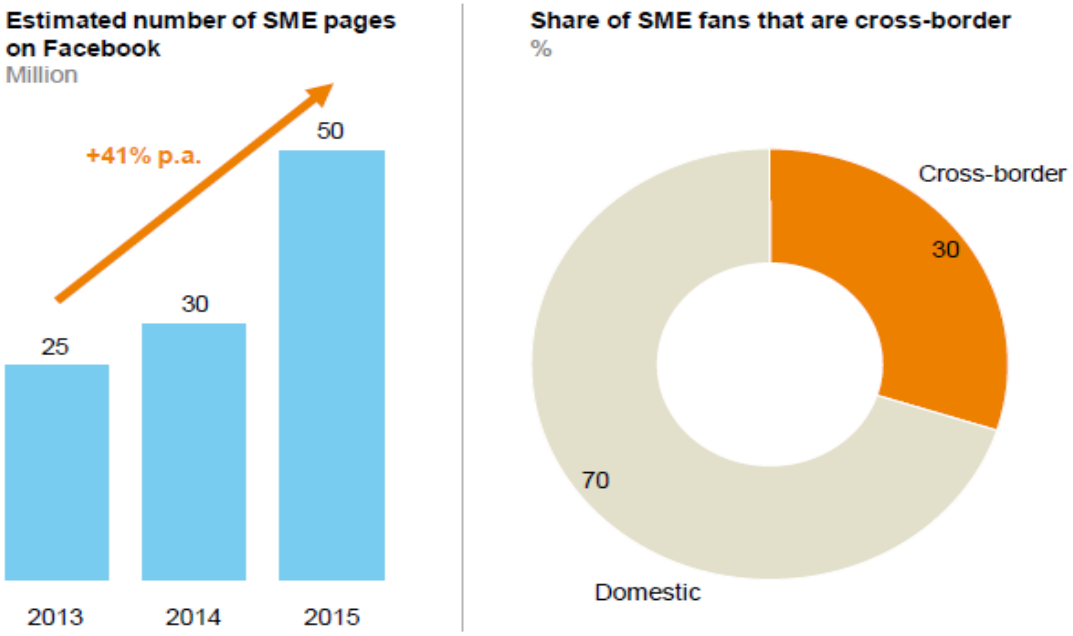
75% of Fintech Investments Come From Outside Banking… While Banks Spend 10 Times More on Legacy Systems…



Source: Accenture Fintech Report (2016)

Big Techs May be the Greatest Threat of All

50 million SMEs use Facebook to find customers, and 30 percent of their fans are from other countries



SOURCE: Facebook; McKinsey Global Institute analysis

[52] Amazon.com company facts, corporate website; Jack Ma, "America's online sales opportunity in China," *The Wall Street Journal*, June 8, 2015.
[53] 2015 third-quarter financial results, Etsy.
[54] Khrystyna Kushnir, Melina Laura Mirmulstein, and Rita Ramalho, *Micro, small, and medium enterprises around the world: How many are there, and what affects the count?* World Bank/IFC, 2010.

- Big Tech Platforms have proven to scale rapidly at low capital costs
- Alibaba and Ant Bank now have nearly $1Tr in float to manage and have established a bank to do this
- The Platforms have huge data management systems advantages and can use this data to make better faster credit judgements that banks
- The question is do others follow Alibaba and get squarely into the banking business?

Source: McKinsey Digital Globalization Report (Feb 2016)

IFC International Finance Corporation WORLD BANK GROUP

DFS/Fintech Disruption is real and is accelerating globally

Digitalization of Money

- Drivers: ecommerce, convenience, government action, transport, money transfer
- Main opportunities: ASPs, CCNs, regulatory work, like payments regulation,
- Where: Everywhere, populous countries first
- Investment thesis: Massive concentration of power to few / one player
- Examples: Ant Financial, PayTM, bKash, mPesa

1.5 billion wallets / 6 yrs

Digitalization of Invoicing

- Drivers: business need and possibility, government push for transparency and even tax base,
- Opportunities: e-invoicing companies, factoring, supply chain finance,
- Where: regional and cross border
- Investment thesis: few large regional and global players. Accelerated concentration within 5-7 yrs
- Examples: invoinet, eFactor, FIT, Trulia

Over US$1T p.a. in LAC alone

Digitalization of Origination

- Drivers: market need for efficient origination, consumer demand for transparency, financial advice
- Main opportunities: Originators, marketplaces, PFAs
- Where: large markets, regions;
- Investment thesis: Massive market concentration into few/one players
- Examples: CompareAsia, ComparaOnline, BankFacil, Kabbage,

Globalization of Payments

- Drivers: Global trade, ecommerce, business and leisure travel.
- Main opportunities: Money transfer operators, cross border payment networks, FX operators; new money;
- Where: global; main trade corridors
- Investment thesis: Rapid movement towards immediate settlement, rise of new reserve currencies.
- Earthport, Payoneer, Remittly

Digitalization of Cash Transfers

- Drivers: government efficiencies, direct policy implementations, reduction of fraud
- Main opportunities: government payment contractors;
- Where: main markets first, markets with significant cash transfer programs
- Investment thesis: Governments may unintentionally create the country's largest payment banks
- Examples: Net1, PagaTodo, Fino

Over 300M accounts

Digitalization of Identity

- Drivers: online activity, increase of remote transactions, frequent need to establish identity
- Main opportunity: non-Government Identity Service Providers; government regulation advice
- Where: country specific and global
- Investment thesis: Identity eventually to become global and totally private.

3B+ people without ID

Digitalization of Lending

- Drivers: availability of more data, automation, identity, financial literacy, convenience/
- Main opportunity: Digital Lenders, regulatory and perception work
- Where: every country; large demographics present largest opportunities
- Investment thesis: Power will shift to capital pools and shadow banking
- Examples Kreditech, Kabbage, Moni

US$34B in China

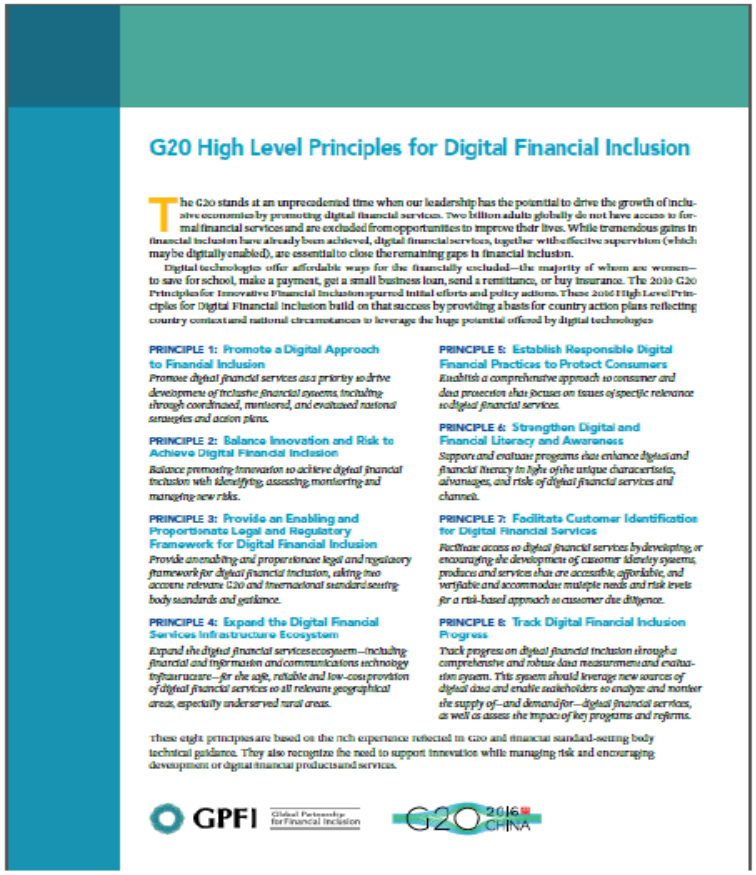
Globalization of Capital Markets

- Drivers: search for global returns
- Main opportunities: back office operations, main exchanges (stock, currency, bonds, derivatives, commodities)
- Where: Current financial market capitals
- Investment thesis: Capital markets will be global and utilities underneath will also be global utilities; players from main markets will dominate the space

Massive national, regional and global opportunities will create very few ultimate winners; exits by M&A will be important and understanding rather than trying to catch the ultimate winners is more critical;
Investment thesis should calculate M&A exits and allow for very large "jackpot" probabilities
Investments should remain along identified and approved investment themes and done on a portfolio approach

IFC International Finance Corporation WORLD BANK GROUP

G-20 High Level Principles for Digital Finance



G20 High Level Principles for Digital Financial Inclusion

The G20 stands at an unprecedented time when our leadership has the potential to drive the growth of inclusive economies by promoting digital financial services. Two billion adults globally do not have access to formal financial services and are excluded from opportunities to improve their lives. While tremendous gains in financial inclusion have already been achieved, digital financial services, together with effective supervision (which may be digitally enabled), are essential to close the remaining gaps in financial inclusion.

Digital technologies offer affordable ways for the financially excluded—the majority of whom are women—to save for school, make a payment, get a small business loan, send a remittance, or buy insurance. The 2010 G20 Principles for Innovative Financial Inclusion spurred initial efforts and policy actions. These 2016 High Level Principles for Digital Financial Inclusion build on that success by providing a basis for country action plans reflecting country context and national circumstances to leverage the huge potential offered by digital technologies

PRINCIPLE 1: Promote a Digital Approach to Financial Inclusion
Promote digital financial services as a priority to drive development of inclusive financial systems, including through coordinated, monitored, and evaluated national strategies and action plans.

PRINCIPLE 2: Balance Innovation and Risk to Achieve Digital Financial Inclusion
Balance promoting innovation to achieve digital financial inclusion with identifying, assessing, monitoring and managing new risks.

PRINCIPLE 3: Provide an Enabling and Proportionate Legal and Regulatory Framework for Digital Financial Inclusion
Provide an enabling and proportionate legal and regulatory framework for digital financial inclusion, taking into account relevant G20 and international standard setting body standards and guidance.

PRINCIPLE 4: Expand the Digital Financial Services Infrastructure Ecosystem
Expand the digital financial services ecosystem—including financial and information and communications technology infrastructure—for the safe, reliable and low-cost provision of digital financial services to all relevant geographical areas, especially underserved rural areas.

PRINCIPLE 5: Establish Responsible Digital Financial Practices to Protect Consumers
Establish a comprehensive approach to consumer and data protection that focuses on issues of specific relevance to digital financial services.

PRINCIPLE 6: Strengthen Digital and Financial Literacy and Awareness
Support and evaluate programs that enhance digital and financial literacy to fight o the unique characteristics, advantages, and risks of digital financial services and channels.

PRINCIPLE 7: Facilitate Customer Identification for Digital Financial Services
Facilitate access to digital financial services by developing, or encouraging the development of, customer identity systems, products and services that are accessible, affordable, and verifiable and accommodate multiple needs and risk levels for a risk-based approach to customer due diligence.

PRINCIPLE 8: Track Digital Financial Inclusion Progress
Track progress on digital financial inclusion through a comprehensive and robust data measurement and evaluation system. This system should leverage new sources of digital data and enable stakeholders to analyze and monitor the supply of—and demand for—digital financial services, as well as assess the impact of key programs and reforms.

These eight principles are based on the rich experience reflected in G20 and financial standard-setting body technical guidance. They also recognize the need to support innovation while managing risk and encouraging development of digital financial products and services.

GPFI Global Partnership for Financial Inclusion G20 2016 CHINA

PRINCIPLE 1:
PROMOTE A DIGITAL APPROACH TO FINANCIAL INCLUSION

PRINCIPLE 2:
BALANCE INNOVATION AND RISK TO ACHIEVE DIGITAL FINANCIAL INCLUSION

PRINCIPLE 3:
PROVIDE AN ENABLING AND PROPORTIONATE LEGAL AND REGULATORY FRAMEWORK FOR DIGITAL FINANCIAL INCLUSION

PRINCIPLE 4:
EXPAND THE DIGITAL FINANCIAL SERVICES INFRASTRUCTURE ECOSYSTEM

PRINCIPLE 5:
ESTABLISH RESPONSIBLE DIGITAL FINANCIAL PRACTICES TO PROTECT CONSUMERS

PRINCIPLE 6:
STRENGTHEN DIGITAL AND FINANCIAL LITERACY AND AWARENESS

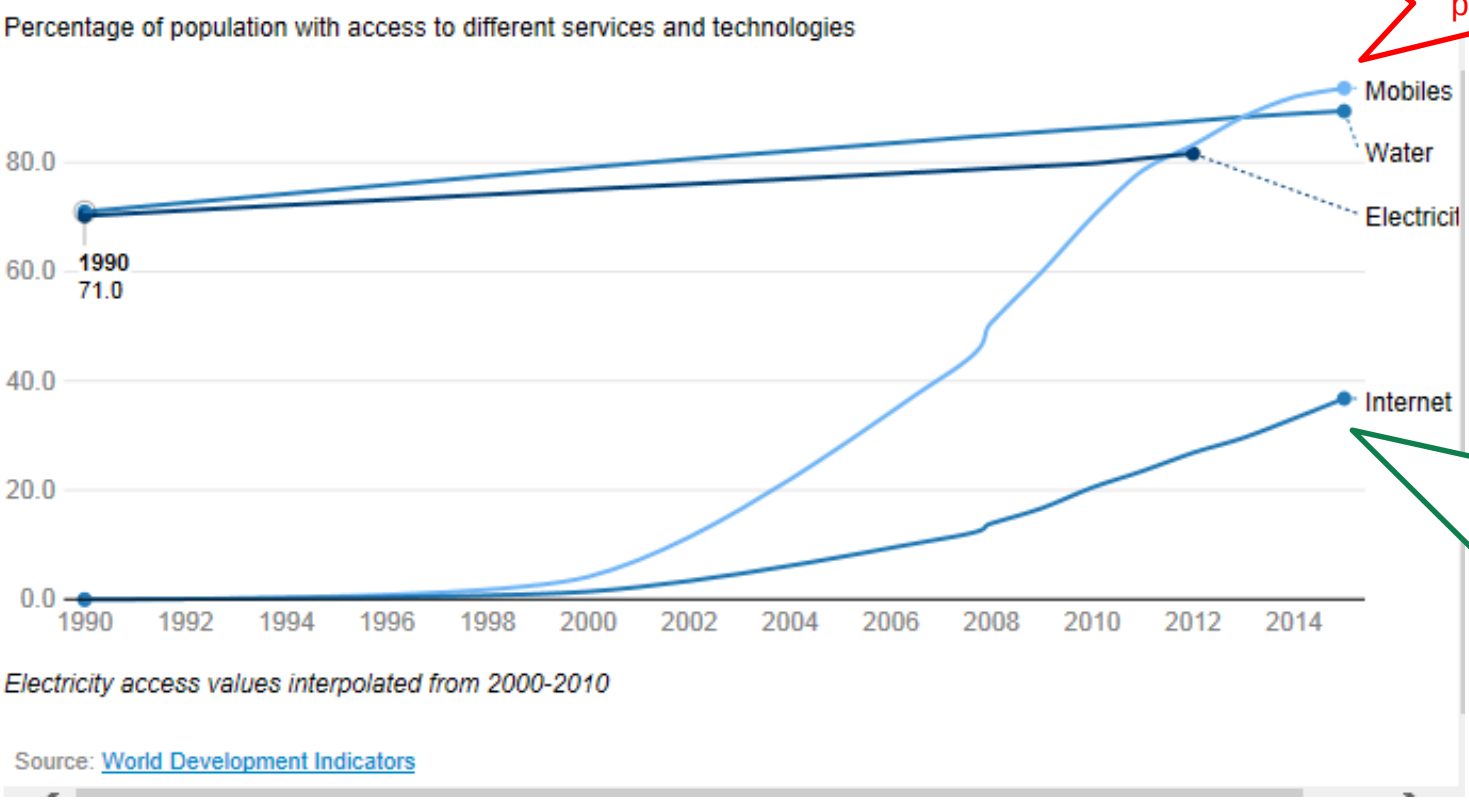
PRINCIPLE 7:
FACILITATE CUSTOMER IDENTIFICATION FOR DIGITAL FINANCIAL SERVICES

PRINCIPLE 8:
TRACK DIGITAL FINANCIAL INCLUSION PROGRESS

IFC International Finance Corporation WORLD BANK GROUP

Source: GPFI G20 High-Level Principles for Digital Financial Inclusion (2016)

We are approaching universal access to Mobile phones… Focus now needs to be on the Internet…



Well over 90% of the population now has access to Mobile phones

Internet connectivity is the next frontier in universal access – for education, finance, health care, and business

IFC International Finance Corporation WORLD BANK GROUP