Fostering a stable and inclusive financial system[1]

Excellencies, Distinguished speakers, Ladies & Gentlemen,

Good afternoon

I would like to take this opportunity to thank Governor Cetinkaya for his kind invitation to deliver a keynote address in this conference. I am honored to have this opportunity of sharing my thoughts with such a distinguished audience.

This session is centered on the topic of 'Fostering Stable and Inclusive Financial System'. In line with the broader scope of this session, I would like to speak about both *financial inclusion* and *stability* – the two objectives that have received increasingly greater attention from regulators and central banks in the last decade.

Why financial inclusion matters and where we stand

Let me start by discussing the significance of financial inclusion first. Research shows that financial inclusion, in the broader context of financial development, plays an important role in promoting long-term growth and reducing poverty. Access of finance helps reduce poverty by providing the poor a range of products and services to save and invest in.

Financial inclusion is also critical from a central bank's perspective, given its implications for both monetary and financial stability. Exclusion of people and firms from a formal financial system significantly weakens the monetary policy's transmission to the economy. Interest rate, as a monetary policy tool, can be more effective, the more inclusive a financial system is. And from financial stability standpoint, an inclusive financial system can help banks achieve a wider deposit base and a more diversified credit portfolio, thus strengthening financial sector resilience.

Notwithstanding these benefits, the state of financial inclusion in many countries suggests that a vast segment of the population is still either underbanked or completely unbanked. According to World Bank's data on financial inclusion, around 2 billion people or 38% of the world's adult population have no access to formal financial services. Particularly left out are the poor, women, youth, and people living in rural areas. Cost of opening and maintaining an account, onerous documentations and physical distance are

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[1] Keynote Speech delivered by His Excellency Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait at the OIC Conference held on 22nd September, 2017, Istanbul, Turkey.

some of the key constraints in access to finance. In Muslim countries, some people also opt out of conventional banking system for religious reasons.

Financial inclusion also varies substantially, both across the regions and income levels. For instance, in low-income countries, inclusion stands at 28% while it is around 91% in high-income countries. Regionally, account ownership is highest in East Asia and Pacific and lowest in the Middle East.

It is pertinent to mention that Kuwait has a fairly high degree of financial inclusion by global standards. Around 73% of the population above the age of 15 years in Kuwait has an account with a formal financial institution. Compare this to the Middle East region in general where account penetration stands at a meager 14%.

How technologies are helping increase access to finance

Thankfully, modern technologies are helping provide formal financial services to the millions of unbanked customers around the globe. In a world where the poorest 20% of the population is more likely to have access to a mobile phone than to clean water and sanitation, mobile banking has tremendous potential to promote financial inclusion.

According to GSMA, the global association of mobile network operators, two third of the world population currently has a mobile subscription. Capitalizing on this opportunity, Tanzania has more than doubled the percentage of adults with transaction accounts, from 17.3% in 2011 to 39.8% in 2014 largely through e-money services. In Kenya, 'M-Pesa', a small-value electronic payment system that is accessible from ordinary mobile phones, is now serving over 20 million customers; half of the Kenya's adult population uses 'M-Pesa' to transfer funds, pay bills, and purchase mobile airtime.

Secondly, the growing use of mobile phones and internet is generating huge amount of data, offering opportunities to better understand customers' needs and provide tailored services. By effectively using the digital trails of individuals' payments and transfers like airtime top-ups and utility bill payments, fintechs are developing credit histories of individuals and SMEs, paving the way for extension of credit to such borrowers.

Thirdly, biometric technologies are creating the possibility of using agent based banking models and opening of accounts in distant locations. In India alone, digital IDs have helped add 200 million new bank accounts. Tech based face and voice recognition are helping verify new customers in novel ways, while reducing the burden of onerous documentation in opening low-value accounts.

What are the implications from financial stability standpoint?

Notwithstanding the unprecedented opportunities that fintechs offer for financial inclusion, we should also recognize the challenges that financial innovations can pose to the overall financial stability. Let me briefly point out a few such issues.

First, consider the case of fintechs which have unbundled parts of finance value chain and are offering some of the financial services directly to the customers. Banks have long relied on such firms to help them serve their customers better. But now fintechs are engaging in direct competition with banks. Probably it was under these competitive pressures that three major US banks allowed instant payments, a market that has been largely captured by Apple Pay and PayPal's Venmo. Likewise, Competition and Markets Authority in the UK has required British banks to share, from 2018, their customers' data with third parties who can then advise how much could be saved using other lenders. Once implemented, this would further enhance competition in the banking sector with implications for financial stability.

Second, some observers reckon that the growing use of blockchain may reduce the role of banks as financial intermediaries. The technology even has the potential to eliminate the role of central depositories. Given its decentralized nature, distributed ledgers may relegate banks to a position of insignificance, unless banks adopt the platform early on and to their advantage.

Third, fintechs are moving part of the banking business to shadow banking which remains lightly regulated, if at all. Likewise, tech-enabled peer-to-peer lending and crowdfunding may exacerbate procyclicality and the scale of shadow banking.

Fourth, we may witness the emergence of new systemically important digital financial firms. The tech world already reflects a winner-takes-all phenomenon as few firms like Google and Apple enjoy huge presence in their respective areas; greater role of these firms in providing financial services may create a completely new set of unregulated too-big-to fail institutions with their own unique risks.

Fifth, cyber security risk is becoming an increasingly major part of banks' operational risk profile. As various hacking episodes illustrate, now fraud can be perpetrated swiftly, remotely and on a massive scale. Just a few weeks back, critical personal information of around 143 million US customers was stolen from Equifax, a leading credit reporting firm. And last year, Yahoo announced that accounts of around 1.5 billion users were affected by two separate hacks during 2013-14. Though such occurrences are still somewhat infrequent, the impact is massive, both in financial and reputational terms.

What regulators can potentially do?

Against this backdrop, regulators face a daunting task of keeping financial systems safe and stable while continuing to ensure the convenience and efficiency that modern technologies offer. Indeed, it is a delicate balance to achieve, as we want neither to stifle innovation nor to undermine financial stability. The dilemma is that the very technologies that promise enhanced access to finance also pose the risks to financial stability, if not managed well.

At the same time, we also need to recognize that ensuring '100% security' is not practically possible. As Gene Spafford, a security expert put it, 'the only truly secure system is the one that is powered off'. For anything else which is fully functional 24/7, potential for some glitches here and there would always remain and can only be minimized.

At the CBK, our approach in regulating innovations is both *enabling* and *proportionate*, as we aim to use a tiered process of introducing rules in accordance with the risks involved. That is why we have adopted a 'regulatory sandbox' approach to provide a safe testing place for innovative products or services. The approach will help harness the potential of innovative technologies but without exposing the entire financial system during the early stages of development.

To conclude, in a dynamically changing business environment, we, the regulators, need to remain agile, adaptive and proactive, similar to when navigating unfamiliar domains. We need to be , as Churchill said , awake 'to the tips of our fingers'.

Thank you for your attention.