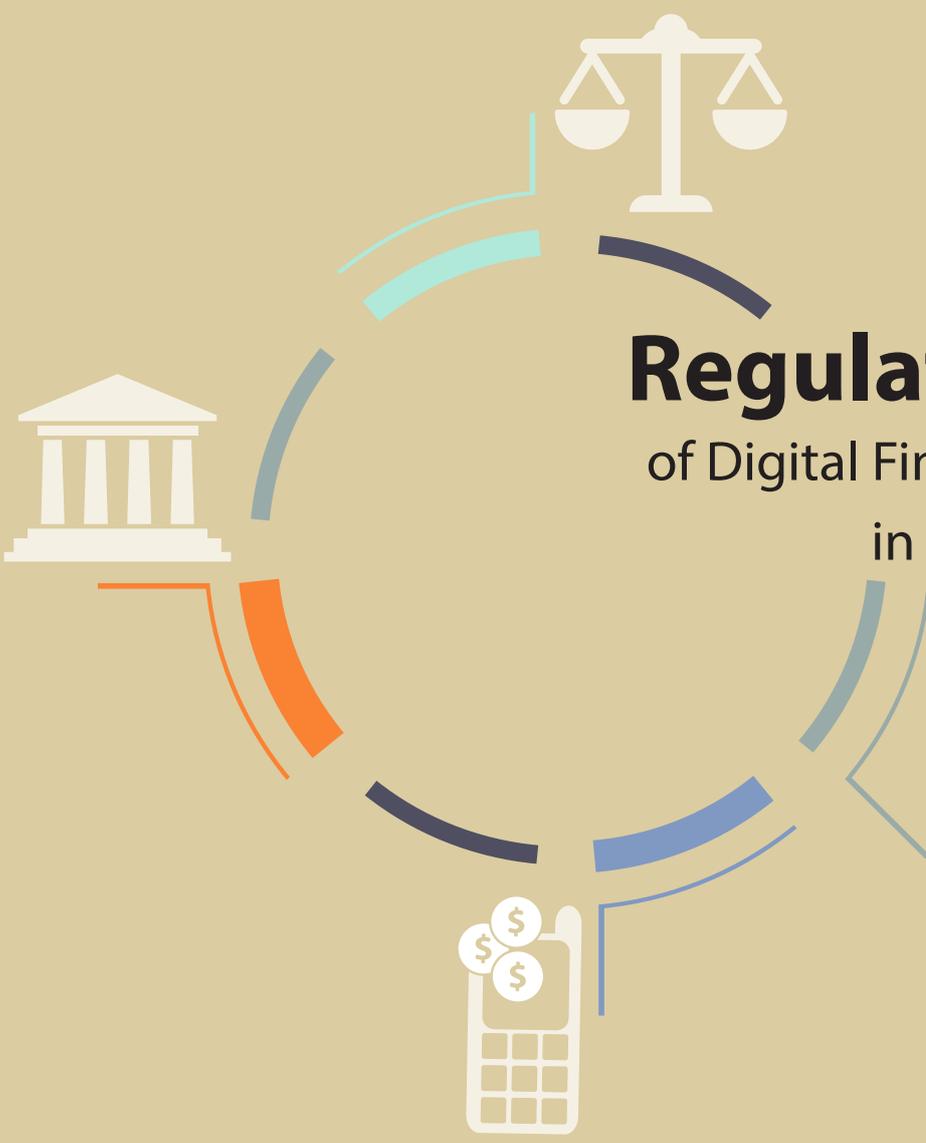


# Regulation and Digital Financial Services



## Regulating the Use of Digital Financial Service Agents in Developing Countries

By the Digital Financial Services team\*  
Law Faculty, UNSW Australia

# Introduction

Digital financial services (DFS) provided by banks and mobile network operators (MNOs) through agents can help advance financial inclusion by overcoming access barriers to traditional bank branches in developing countries. Agents in developing countries play a pivotal role in facilitating DFS, as they are responsible for the primary DFS functions of cash-in and cash-out. DFS, like other financial services, are exposed to risks such as fraud. It is necessary to understand where liability rests in the principal-agent relationship in the event of disputed transactions (which can arise due to agent negligence, theft or violation of customer privacy; or from customer misdemeanours). A sound legal and regulatory framework to govern agent and principal liability is important. Regulations are necessary to deter agent wrongdoing without dis-incentivizing prospective agents.

This briefing note identifies the primary areas to be considered when structuring agent liability and outlines key factors for consideration when crafting a legal and regulatory framework to govern the use of DFS agents.<sup>1</sup> Through a brief analysis of agent liability regimes in Fiji, Kenya and Malawi, this note highlights the importance of having in place a clear and functional regulatory structure and underscores the need to rebalance economic incentives through the principal-agent contract. In summary, this note advocates the adoption of rules that make principals vicariously liable for the actions of their agents, coupled with an explicit agreement as to agent penalties and rewards, and supported by a functional approach to regulation.

## Allocating agent liability

The liability allocation between a DFS agent and a principal can be broadly structured in one of two ways:



Three issues determine the best liability rules in any context.

### 1. Allocation of risk and economic incentives

The first issue is which liability rules best incentivize agents and principals to act in ways that promote long-term market sustainability. Agents decide whether to engage in DFS business by weighing risks and compliance costs against profitability. If agents are required to bear all liability for disputed transactions, then they are likely to want either higher commissions from the principal or higher fees from the customer. An agent may end up exiting the DFS business if compensation is unsatisfactory (agents are usually unable to dictate commissions earned or fees charged to the customers). Furthermore, principals are constrained by the low margins in DFS as to the commissions they can offer agents. Compensation for regulatory costs aside, agents may try to avoid the costs of regulatory compliance altogether if for some reason the effective and direct monitoring of agents is absent or weak. On the other hand, if principals are vicariously liable for disputed transactions, they are incentivized to monitor agents' behaviour.

### 2. Agent insolvency and liability

The second issue is insolvency risk, and which liability rules can better protect customers from such risk. In general, agents are far more likely to become insolvent than principals, which are typically well-resourced corporations. Under a regime of agent personal liability, an agent may be discouraged from investing in loss-avoidance strategies (e.g., indemnifying customers against loss) if they anticipate their insolvency will be the end result of a major customer loss.<sup>2</sup> Customers may therefore not be compensated under the agent personal liability model. In contrast, under the principal vicarious liability model, customers should be better protected, as principals are more capable than agents to absorb liabilities and remain solvent. Also, being vicariously liable should incentivize principals to monitor agents, ensure high quality service delivery, and mitigate litigation risks.

<sup>1</sup> This briefing note draws on the following article by the UNSW DFS team that can be found [here](#): Evan Gibson, Federico Lupo-Pasini and Ross P. Buckley, 'Regulating Digital Financial Services Agents in Developing Countries to Promote Financial Inclusion', *Singapore Journal of Legal Studies*, Sing. J.L.S.26 (July 2015).

<sup>2</sup> Alan O. Sykes, 'The Economics of Vicarious Liability', *Yale Law Journal*, vol. 93, No. 7 (June 1984), pp. 1231–1244.

### 3. Agent supervision

The third issue concerns the question of whether the financial supervisor or the principal is better suited to monitor and supervise agents. An agent personal liability model may well require the financial supervisor to supervise agents, as agents cannot be relied upon to supervise themselves. A principal vicarious liability model, on the other hand, should incentivize the principal to train and monitor agents in order to reduce its own risk exposure. We thus believe principals are better suited to monitor agents than supervisors. The activities being undertaken by agents are outsourced by the principal, whereas financial supervisors are essentially third parties to agents' activities. Financial supervisors are better placed to supervise the principal's activities directly and can require the principal to adopt specific risk-management procedures and policies relating to the appointment and supervision of agents.<sup>3</sup> The principal vicarious liability model therefore works well in the usual situation where the principal, not the financial supervisor, is expected to monitor and supervise agents directly.

## Regulating the use of digital financial service agents and legal liability

Regulating the use of DFS agents by banks and MNOs requires an appropriate legal framework. Factors influencing the framework's design include the following:

- *Business relationship;*
- *Principal-agent contract;*
- *Supervisory and regulatory structure; and*
- *Legal foundation of the economy (common or civil).*

The nature of the business relationship determines the extent of the principal's vicarious liability and the agent's personal liability. In broad terms, the business relationship between a principal and an agent is known as 'outsourcing.' Rather than being treated as employees of the principal, agents are generally viewed as independent contractors, and therefore, the principal is not necessarily vicariously liable for their conduct.

*A principal-agent contract can serve to clarify the legal relationship and allocate liability between principal and agent.*

Nonetheless, liability allocation should not depend solely on contractual arrangements as the bargaining power between principals and agents is typically asymmetric. Principals are almost invariably better placed than agents in terms of financial resources, regulatory compliance skills, DFS experience and financial literacy. Agents are thus at a disadvantage when negotiating with a principal to allocate liability. A statutory legal framework that predetermines the allocation of risk and liability is consequently distinctly preferable. Furthermore, the efficient allocation of risk depends on the judicial system to interpret the relevant contract and/or statutory regulations that allocate liability. Therefore, the role played by a jurisdiction's supervisory and regulatory structure and its legal principles are also significant.

The dynamic interplay of the foregoing factors can be better understood through the three brief country analyses below. These analyses underscore the importance of a clear supervisory and regulatory structure, and illustrate how such a structure can help clarify the scope of vicarious liability and facilitate the governing of agents.

In Fiji, the Agent Banking Guideline states that a commercial bank shall '[b]e liable for the actions and omissions of its Agent relating to Agent Banking services or matters connected therewith, as agreed to in their contracts with Agents.'<sup>4</sup> Though it is obvious that banks under the Guideline should be primarily liable for their agents' conduct, it is not clear as to whether such a liability can be significantly or entirely waived or excluded by the principal-agent contract. In contrast, Kenya's Guideline on Agent Banking requires that a bank principal be 'wholly responsible and liable for all actions or omissions of its agent and this responsibility shall extend to actions of the agent even if not authorised in the contract so long as they relate to agent banking services or matters connected therewith.'<sup>5</sup> This provision excludes the possibility of a principal's liability being waived through contractual arrangements.

Both Fiji and Kenya's Guidelines, however, apply only to banks and are silent about liability allocation between agents and non-bank principals. This left room for MNOs to contract around their liability. For instance, Safaricom in Kenya states in its M-PESA contract with customers that '[y]ou acknowledge that M-PESA Cash Merchants are independent contractors and Safaricom shall not be liable for the acts or omissions of M-PESA Cash Merchants.'<sup>6</sup> The M-PESA

3 Bank for International Settlements, 'Range of Practice in the Regulation and Supervision of Institutions relevant to Financial Inclusion' (Basel, January 2015). Available from <http://www.bis.org/bcbs/publ/d310.pdf>

4 Reserve Bank of Fiji, Banking Supervisory Policy Statement No. 18 - Agent Banking Guideline (2013), Part II, art. 4.1. Available from <http://www.rbf.gov.fj/docs2/Banking%20Supervision%20Policy%20Statement%20No%2018-Agent%20Banking%20Guidelines%201.pdf>

5 Central Bank of Kenya, Guideline on Agent Banking - CBK/PG/15 (2010), Part V, art. 5.1.1. Available from <http://www.bu.edu/bucftp/files/2012/01/Guideline-on-Agent-Banking-CBKPG15.pdf>

6 Safaricom, 'M-PESA Customer Terms & Conditions' (n.p., March 2012), clause 18.11. Available from [http://www.safaricom.co.ke/images/Downloads/Terms\\_and\\_Conditions/CUSTOMER\\_TERMS\\_March\\_2012.pdf](http://www.safaricom.co.ke/images/Downloads/Terms_and_Conditions/CUSTOMER_TERMS_March_2012.pdf)

contract essentially limits customer recourse solely to agents. Although, in practice, we suspect that Safaricom usually accepts liability in situations of agent misconduct in order to preserve its reputation.

In Malawi, unlike in Fiji and Kenya, there are no agent banking guidelines and the existing E-Money Regulations do not explicitly allocate agent liability. Liability allocation, then, needs to arise from contractual arrangements or the law.

Despite the differences among the three countries, since they all are common law jurisdictions, the rule of liability allocation is also subject to common law principles. The law generally holds that a valid contract between the customer and agent, within the scope of the agent's actual authority, renders a disclosed principal vicariously liable for the agent's acts or omissions.<sup>7</sup> So, in the case of Kenya's M-PESA, despite the inclusion of Safaricom's disclaimer in the contract, Safaricom as a principal may still be deemed liable if the issue comes before the courts.<sup>8</sup> Furthermore, the agent in this instance may well be personally liable to the principal for damages.<sup>9</sup>

The proposition that the principal should be vicariously liable has been made even more explicit with the introduction of Kenya's National Payment System Regulations (NPSR) in 2014. NPSR provide that a payment system provider (bank or non-bank provider) is liable to its customers for the conduct of its agents within the scope of the agency agreement, and such a liability cannot be excluded by the agency agreement.<sup>10</sup> An agent is defined as 'a person who, for a fee, provides limited payment services on behalf of a payment service provider', so as to capture all outsourced persons.<sup>11</sup> This functional approach to regulation creates an incentive for principals like Safaricom to carefully monitor the conduct of agents or other agent-like entities.

*A functional approach to regulating principals' use of DFS agents is preferable as it captures all principals regardless of whether they are banks, MNOs or other entities.*

## Rebalancing economic incentives with the allocation of liability

The weakness of allocating liability onto the principal can be that agents are insufficiently incentivized to comply with regulations. To overcome this problem, incentives need to be rebalanced between principal and agent. This rebalancing can be achieved by a mandatory vicarious liability rule that imposes liability upon the principal, supported by a mandatory explicit agreement between the agent and principal. This agreement must include a mechanism of penalties and rewards to link the agent's remuneration to his/her regulatory and contractual compliance, in order to align the incentives of the agent and the principal. The mechanism should pay the agent when he/she is compliant and impose penalties when he/she is not.

## Conclusion

Successful DFS delivery is contingent on an appropriate legal framework that allocates agent liability effectively and properly. The choice is between agent personal liability and principal vicarious liability. Neither liability regime is perfect. Each can impede DFS delivery and financial inclusion. Furthermore, existing agent guidelines typically apply to bank principals and not MNOs, and are typically less than clear when it comes to whether or not the principal's vicarious liability can be excluded by the principal-agent agreement. A more efficient approach, therefore, is to adopt clear principal vicarious liability rules coupled with an explicit contractual agreement regarding agent penalties and rewards, and supported by a functional regulatory approach that applies to all DFS agent activities irrespective of the type of entity offering the DFS.

<sup>7</sup> Peter Watts and F M B Reynolds, *Bowstead & Reynolds on Agency*, 20th ed. (London, Sweet & Maxwell, 2014), para. 8-001.

<sup>8</sup> Michael Tarazi and Paul Breloff, 'Regulating Banking Agents,' CGAP Focus Note, No. 68 (Washington DC, CGAP, March 2011), p. 10, Box 3.

<sup>9</sup> Watts and Reynolds, *Bowstead & Reynolds on Agency*, para. 9-002.

<sup>10</sup> Central Bank of Kenya, The National Payment System Regulations (2014), Reg. 14(4) and 14(5). Available from <http://www.centralbank.go.ke/images/docs/legislation/NPSRegulations2014.pdf>

<sup>11</sup> *Ibid.*, Reg 2.

For more information, contact Tillman Bruett at [tillman.bruett@uncdf.org](mailto:tillman.bruett@uncdf.org) or Ross Buckley at [ross.buckley@unsw.edu.au](mailto:ross.buckley@unsw.edu.au). This briefing note is brought to you by MM4P in partnership with UNSW Australia.



Law



\*Background on the Digital Financial Service (DFS) team can be found [here](#). The research for and preparation of this briefing note was supported by the Centre for International Finance and Regulation (CIFR) (project no. E226), United Nations Capital Development Fund (UNCDF), Standard Chartered Bank and UNSW Australia. CIFR is a Centre of Excellence for research and education in the financial sector which is funded by the Commonwealth and NSW Governments and supported by other consortium members (see [www.cifr.edu.au](http://www.cifr.edu.au)).

November 2015. Copyright © UN Capital Development Fund. All rights reserved.

The views expressed in this publication are those of the author(s) and do not necessarily represent those of the United Nations, including UNCDF, or their Member States.