CDC
Investment works

Driving value through customer-centric risk management

Principles for assessing risk to customers in financial services

Introduction

Background

This briefing note is designed to enable impact investors, fund managers and financial service providers understand the what, why and how of customer risk assessment and mitigation. This includes considerations of how financial services and products are designed and delivered; how agents, partners or digital platforms interact with and treat customers; how the company is structured and organised; and the processes in place to ensure protection and value creation to customers.

It is not intended to be a detailed technical guidance document nor a directive. The principles of financial customer protection presented are positioned as overarching and forward-leaning. We note that implementation of risk management requires careful consideration of specific company and geographic contexts. We encourage impact investors, fund managers and financial service providers to tailor their approach to customer risk assessment and management by asking "What does this mean to the segment of the population I am targeting?"; "What does this mean in the context of the country where I operate?"; "Are there aspects of the business model that might require extra attention?"

Introduction

CDC is the UK's development finance institution. We are a major investor in financial services, including in the more recent and innovative business models. Our current portfolio includes £1.3 billion invested in financial services companies. Our mission is to "support the building of businesses… to make a lasting difference to people's lives". This means that our investments have to not only protect customers but to impact their lives in a positive way. For our financial services portfolio, this means improving financial inclusion and allowing customers (individuals and businesses) to achieve better social and economic outcomes through improved access to finance.

We are increasingly aware of the need to adapt and develop an inclusive approach to assess and mitigate against customer risk. Customers present a wide array of needs, attitudes, and behaviours with respect to financial services. Their understanding and selection of financial services is heavily influenced by their socioeconomic and demographic status, geography, context, motivations, and challenges[1]. It is well known that while financial coverage has increased globally, active use of financial services has been slower.[2] As illustrated in Figure 1, active usage requires trust that financial services are designed and delivered based on customer needs, capabilities and conditions.

A key component of building trust is the ability of financial service providers to understand, assess and mitigate against risk. Conversely, if a customer trusts their financial service provider to safeguard them against risks, they are more likely to be active users and adopt additional products and services, and recommend their peers to do the same, thereby increasing value for the provider.

Furthermore, innovation, competition, low-interest economies, and low-income customers have led to significant pressure on margins for financial institutions. This has resulted in an urgent need to protect and create additional business value. Minimising risk to customers presents such an opportunity. For example, introducing effective customer-centric management processes reduces compliance costs and liabilities; effective resolution of customer grievances improves operational performance; improved customer experience reduces reputational risk and increases shareholder value. Financial service providers would do well to proactively understand, collate and leverage insights on the types of risks customers are exposed to, incorporate a customer-centric perspective into their business models and practices.

Figure 1: Insights on the value of customer-centricity[3]

Customer quotes	Insights
"If the company people are not keeping my data safe and sharing it, then I will avoid the company."	Some customers are increasingly aware and protective of their data. They are prepared to change providers if their data is not appropriately protected.
"Most of us get SMS in English from banks. It would be great to get them in Kannada so that we can read them. I understand numbers and the days of the week in English, but all the rest has to be in Kannada."	Inappropriate language or format of communication with customers can lead to uptake of products they do not need or cannot afford or limit effective use of the product.
"The same loan agent has been coming to the village every week for about 20 years. He doesn't cheat us and explains things to us. He asks if we need money. He calls to remind us of loan repayments. We have never had a problem."	Agent fair conduct with and support to customers is key for building trust. Relationship management with customers can enhance their lifetime value to the financial service provider.

Recommendations

Our conclusion is that investors in the sector require a framework that is customer-centric, comprehensive, actionable, and forward-looking, as follows:

- ***Customer-centric.*** Our principles of customer protection in financial services ("CDC Principles") focus on ensuring positive impact on users of financial services. This means making sure that these products and services are relevant and fit for purpose, designed and delivered in a way that meets customers' needs, behaviours and preferences, and are supportive of customers' financial literacy and wellbeing.

- ***Comprehensive.*** CDC Principles were defined based on a review of more than seven frameworks developed by other leading organisations. They build on existing principles and guidelines, and are applicable beyond traditional banks and microfinance institutions, to cover different types of risks that customers of financial services might be exposed to.

- ***Actionable and business-oriented.*** CDC Principles can be linked to different aspects of company culture, organisation, strategy and operations with potential impact on customers. They are framed as actions that companies can undertake to limit risks to customers.

- ***Forward-looking.*** CDC principles take a forward-looking perspective on how financial service providers can contribute to strengthen the broader environment of customer protection. This includes shaping the local regulatory environment through adoption of international best practice and the dissemination of information to regulators and other providers.

Why investors should address this topic

The landscape of financial service provision is changing. Innovation and the advancement of technology is increasingly enabling financial service providers to target new customer segments including previously-unbanked populations, often those with low levels of financial literacy and awareness. In addition, traditional banks and microfinance institutions are no longer the sole providers of financial services to customers. New actors include mobile money providers, mobile lenders, online payment processors, in addition to non-specialised actors that offer financial services as an add-on to their business (for example, off-grid solar companies offering pay-as-you-go solutions).

The changing landscape is bringing new types of risks to customers. The emergence of non-bank service providers, technology and interconnectivity with multiple systems and third parties has led to unprecedented innovation and competition in the financial services sector. As a result, previously underbanked and unbaked customers in frontier markets, are increasingly able to access a wider range of financial product and services offerings, such as cost-effective and small loans. While these innovations have accelerated financial inclusion and improved the customer experience, they do bring a number of different or new types of risks to customers. These include the risk of over-indebtedness due to easier access to small loans, or the breach and misuse of customer data due to the technology risk of interconnectivity with multiple systems and third parties.

Regulatory regimes are often ambiguous or unable to keep up with the myriad customer-centric risks. Unfair pricing, complicated terms and conditions, use of customer data without consent, aggressive sales tactics and misleading marketing practices are just some of the practices that can be deployed in the financial services sector. While customer protection is certainly a core objective of regulation in financial services, regulation is often insufficient to ensure optimal protection of customers - due largely to the lack of stipulated implementation norms. For example, mandated organisational and incentive structures to ensure that decisions around forbearance are suitable to individual borrowers personal and financial situation. In addition, updating regulation tends to be cumbersome. As a result, appropriate mitigation of customer risk often lags behind the continuous innovations to improve customer experience and convenience, and facilitate financial inclusion.

While well established, current frameworks fall short of providing guidance on how risks should be mitigated and are limited in their ability to capture customer risks emerging from new models and innovations. There is a variety of customer risk assessment frameworks, guidelines and principles developed by expert organizations in financial inclusion and customer protection over the past years[4]. While existing framework are largely aligned on the types of risks[5] to customers, they fall short of providing guidance on the how and fail to capture customer risks emerging from new models and innovations in financial service provision. Existing frameworks also tend to focus on micro-level risks induced by a financial service provider on its direct customers and overlook macro-level risks (such as over-lending) to the broader ecosystem of lenders and borrowers. As a result, these frameworks largely overlook the opportunity for financial service providers to be active contributors to both protection and value creation for customers. For example, by communicating credit information to regulated credit bureaus, financial service providers can reduce the risk of over-lending in a given country.

How investors should address this topic

CDC proposes four overarching principles to assess and mitigate against risks to customers to generate additional business value and achieve sustainable and positive impact. They each correspond to a different aspect of an organisation and its operations.

The first principle - Safeguarding of customers - is intended to be externally-facing and assesses the quality of a company's interactions and communications with its customers. This includes equipping customers with all relevant information, guidance, support and mechanisms empowering them to make informed decisions about financial products, make optimal use of these products, provide consent to the use and storage of their data, and seek redressal in case of conflict. In particular, financial service providers should maintain a high level of transparency and disclosure on product terms and conditions. They should put in place clear and effective complaint mechanisms that customers are aware of. They should also inform and seek consent from customers on data collection, use and storage. Finally, they should provide support to low-literacy customers on how to use their products in a safe manner.

The second principle - Fair treatment - is internally-facing and assesses whether the company's business practices are fair to customers. Financial service providers need to adopt internal measures to ensure fair treatment of customers across the product lifecycle and make responsible use of their assets (financial, physical, and data). Pricing should be reasonable and balance business sustainability with customer affordability; terms and conditions of product use should not induce disproportionate risk to customers; business practices should not discriminate against specific customers; and company interactions with customers should guarantee their respect and safety.

The third principle - Enabling organisation and culture - assesses whether the company's culture, policies, processes and governance structure enable it to meet the first two principles. These factors should enable it to effectively implement and ensure appropriate mitigation of risks to customers. This includes built-in checks and balances for complaint resolution; processes and systems to protect customer assets and data from fraud or misuse; and acceptance of liability for fraud or misuse of customer assets and data or other forms of harm to customers due to failure of internal processes and systems.

The fourth principle - Sustainable and innovative approach to customer risk management - is intended to be forward-looking. It assesses the ability of the company to contribute to strengthening the broader customer protection environment and maintain a high level of customer protection in the face of continued innovation in the sector. This includes innovating to create value to customers (for example, by using customer-centric approaches to better understand their needs and respond to them), proactively identifying and mitigating emerging risks (such as through credit bubbles), and contributing to strengthening the broader ecosystem of financial customer protection (including information sharing with regulators and other financial service providers). This principle encourages companies to go beyond regulatory compliance – especially when local regulation is not sufficient – to define their own internal policies and create or adopt industry best practice.

As fund managers and other investors start adopting these principles and translating them into their investment practices, we expect effective and optimal use of financial services by customers to increase. Customers will be better served by financial service providers, with products that meet their needs, capacities and preferences – and protect their assets and personal information, resulting in a greater level of customer trust. Adoption of these principles can also encourage a striking balance between supporting product innovation and ensuring adequate protection of customers in regulatory and market environments. As the financial service sector continues to evolve, market participants will increasingly align to understand, assess and mitigate against the associated risks to generate enhanced value to the sector and social impact.

Please see CDC's Customer Risk Assessment Toolkit for further detail including a framework for assessment, examples of best practice, questions for investees and high-level action plans to redress and mitigate against risks to customers.

The CDC Principles are intended to build on xisting principles, guidelines and frameworks developed by leading organisations. Our aim is to consolidate alignment in the sector, respond to the social impact need for customer protection, enable fund managers to take a '360-degree' view on how to assess and reduce risks to customers, and protect and create additional value for the financial services sector as a whole.

Endnotes

1 Omidyar Network, "Current of Trust", 2017
2 Sources: CGAP, "Customer-Centric Guide", 2017; expert interviews
3 Sources: CGAP, "Privacy on the Line,"2016; Omidyar Network, "Currency of Trust," 2017
4 For example, SMART's "Client Protection Principles", the G20/OECD's "Financial Customer Protection Principles", and the World Bank's "Good Practices for Financial Customer Protection". There are also sector-specific guidelines like Better Than Cash Alliance's "Guidelines for Responsible Digital Payment", and GOGLA's "Customer Protection Principles" for the off-grid solar industry
5 For example, risks to customer assets (physical and financial), data privacy risks, exclusion and discrimination, physical and moral harm, unfair treatment and exploitation of vulnerability

Further resources

CDC Toolkit of Customer Risk Assessment in financial services

- CDC Group, "Customer Risk Assessment Framework," 2018
- CDC Group, "What good looks like for customer protection in financial services," 2018
- CDC Group, "Case studies of customer protection in financial services," 2018

Guidelines of financial customer protection

- OECD, "Effective approaches to support the implementation of the remaining G20-OECD high-level principles on financial customer protection," 2014
- World Bank, "Good Practices for Financial Consumer Protection," 2017
- Responsible Finance, "Responsible Digital Financial Services Guidelines," 2018
- The SMART Campaign, "Client Protection Certification Standards," 2016
- Better Than Cash Alliance, "Responsible Digital Payment Guidelines," 2016
- GOGLA, "Consumer Protection Code of Conduct," 2018
- Social Performance Taskforce, "Universal Standards for Social Performance Management," 2016

Guidance on customer centricity in financial services

- CGAP, "Customer-Centric Guide," 2017
- CGAP, "Insights Engine Blueprint: Building an Insights-Driven Organization," 2016

Customer insights in financial services

- CGAP, Dalberg, Future of Finance, "Privacy on the line," 2017
- Omidyar Network, "Currency of Trust," 2017

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