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Why Remittances Cost So Much — and How to Make Them a Lot Cheaper

By Penny Crosman
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EDITOR@ LARGE

European and African leaders gathered in Valletta, Malta, last November set a goal of lowering the cost of remittances to 3% of the transaction value by 2020. Innovative technology combined with policy changes could make this happen.

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The World Bank estimates there are 250 million migrants who have left their home countries mainly for economic reasons (only 6% are refugees from strife- and war-torn places like Syria; the rest are simply looking for work). Those migrants typically earn about $180 a month and send home $140 or $160. These payments will add up to more than $600 billion this year, the organization says. The number grows every year.

These small payments are expensive — on average, they cost 8% of the payment amount, according to the World Bank (in the U.S., it's 5%). This is due, industry observers say, to inefficient and paper-bound processes, oligopolies that can charge high prices, the networks of banks and money transfer operators involved in an international payment that each take a cut from the transaction, and excessive regulation. Technology is a big part of the answer.

"It's extremely easy to fix it," said Dilip Ratha, manager of the migration and remittances unit at the World Bank. "At a time when we're receiving real-time pictures from Mars and I can do a Skype or Facetime call to the other side of the planet, often for free, why is it so hard to transfer something like value? We always thought money was one of the most fluid things. Why is it so expensive to send money anywhere?"

This relates, he says, to a bigger question: Why are so many people in the world without a bank account? (Remittances are generally cheaper for bank account holders.)

'Monitor Every Transaction'

One source of cost is regulation, Ratha says. "The fear that we need to know the money flows to track criminals has a lot to do with keeping costs high," Ratha said. "It keeps smaller players from stepping into the remittance market, because if some of their transactions are flawed, regulators might put a heavy fine on them and overnight they'll go bankrupt."

Regulation of international payments ought to be risk-based rather than rules-based, Ratha said.

"Saying 'We'll monitor every transaction, and we want to know the sender, where the person got the money, who he or she sent money to,' all seems like a good thing on paper and doable because of the computing power we have," he said. "But shouldn't we go to a risk-based approach where we say, 'The remittance is under $1,000; that's a normal remittance to a family. Let's go slow on that'?"

Banks and money transfer operators could monitor every 20th transaction, to avoid even the appearance of ethnic profiling, he suggests. "Requiring every transaction to be monitored puts too much burden on small money transfer companies," he said. And the correspondent banks they use to transfer the money worry that they won't know all the individual transactions that are undertaken by their clients, so they're starting to pull out of remittance markets, he said.

"The main change that has to occur is to recognize that small remittances are not money laundering," Ratha said. "And they're not systemically important."

Alix Murphy, a senior mobile analyst at WorldRemit in London, agrees. "You have to take a risk-based approach," she said. "Unfortunately, so far some regulators still don't distinguish between the old, cash-based, agent-based models for remittance companies and the newer digital, online model."

WorldRemit provides an online remittance service for senders, drawing money from their bank accounts, debit cards or credit cards. The firm says it can manage risk more easily than brick-and-mortar providers and pass the cost savings to customers. (To use WorldRemit's service, customers have to open a bank account. Thus each bank does its own customer due diligence, but WorldRemit does its own. The company also works with Jumio's authentication technology, through which the customer takes a picture of her passport or driver's license, which Jumio checks for signs of fraud.)

A related issue is lack of competition for the large money transfer operator companies like Western Union and MoneyGram.

"Many post office systems have allowed their post offices to have exclusive partnerships for providing remittance services with one or the other money transfer company," Ratha said. The fees these post offices collect amount to a tax on poor people — the migrants sending and receiving money, he said.

"The governments could easily say, 'Post offices are to be shared by everybody, so there should be a choice of money transfer companies,' " he said.

The cash- and paper-intensive nature of remittances also adds cost, according to Murphy.

"Ninety percent of the industry is cash-based," she said. "If you're from Uganda and living in London, and you want to send money back home to your friends and family, you'll have to go personally to a High Street agent. You'll have to wait in line, fill out paper forms, hand over a wad of cash, wait three to five business days, and pay a fee to an agent." The person receiving the money has to travel to an agent location and show a form of identification to accept the money.

It's expensive for money transfer operators to manage a network of agents around the world, many of whom are not their own employees. Handling and moving large quantities of cash is also challenging, Murphy said.

All of that adds up.

"Older structures like Western Union are expensive and one can complain about it, but where you're talking about cash, there are real costs that make it much more expensive and much less compliant," said Mike Laven, CEO of Currency Cloud, a company that provides cloud-based payment technology to banks and money transfer operators. "A lot of cost is in the first and last mile, maybe the first and last 100 yards — getting money from the U.S. to Kenya is not the hard part. Getting it into somebody's bank account or mobile wallet is."

Nevertheless, Laven believes the objective of reducing remittance costs "is very real and incredibly achievable. And it's not just the transfer piece that's important. The other is, how do you get the benefits of low-cost account transfer in a realizable way to people who are unbanked?"

The older, paper-bound methods of traditional providers also come with high compliance costs, Murphy said, as well as high levels of potential and actual fraud and money laundering.

"You're not able to see the transaction for a potential fraud case until it's already happened," Murphy said. "Most of the fraud recognition is unfortunately retroactive, and it takes months to find out. That's why a lot of the large money transfer operators have huge fines and they have to build that into their business model. Those costs are passed on to the customer."

The nature of correspondent banking networks also contributes to the cost of remittances. "When you're transferring money from one place to the next, say from Canada to Rwanda, you have to go through many sister banks, each one of which is taking a fee along the way," Murphy said. Those fees, again, are paid by the sender of the payment.

Tech Answers

"The only way we can bring costs down to 3% is to allow new technologies to come in and to scale up," Ratha said, referring to mobile phone and Internet-based remittances.

Because billions of people own mobile phones, they're a natural fit for sending and receiving payments. TransferWise and Zenbanx are two examples of companies offering international mobile payment apps.

Laven agrees that electronic payments will eventually lower costs.

"Where there are firms like Remitly and TransferWise that work totally in the electronic market, it's an account-to-account transfer. It's possible to dramatically reduce costs down to 1% or less. In countries where people who are unbanked can receive funds electronically, through innovations like mobile wallets and M-Pesa" — the mobile money transfer service in Kenya — "that's a major way to bring costs down."

In WorldRemit's digital process, "you're not managing an agent network, you're not managing physical branch locations, you have the ability to monitor transactions in real time, you have the ability to do KYC checks on your customers before they even use the service," Murphy said. "All those elements help pretty drastically to bring down the costs."

Then there are the blockchain startups, ranging from Ripple, which offers to streamline banks' back-office payment processes, to firms such as BitPesa in Kenya and Rebit in the Philippines that use bitcoin as a cross-border payment rail.

"I personally feel extremely excited about that," Ratha said. "Blockchain technologies applied to remittances and financial services can greatly disrupt the current practices in financial services that belong to the 18th century. There is still this struggle to find one that's really good, in terms of value, one that is fraudproof."

Providing immigrants affordable, efficient financial services is a growing problem that calls for thoughtful, creative solutions. In an interesting case, the United Nations has distributed $120 million in aid to almost two million refugees in Jordan with the help of iris-scanning technology.

The refugees, mostly from Syria, are vetted by government officials and get their eyes scanned at a bank branch or supermarket equipped with iris scanners from IrisGuard. The technology has helped reduce overhead for the program, and it helps integrate immigrants into their new country's banking system. The scans follow migrants from one camp to another — a big difference from fingerprints, which tend to stay local.

Technology like this can help restore order and normality in the chaos of starting over in a strange country.

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