G:ENESIS

Implementing FATF standards in developing countries and financial inclusion:
Findings and guidelines

Executive summary
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EXECUTIVE SUMMARY

This report, emanating from a project commissioned by the FIRST Initiative, considers the impact of the implementation of Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT) controls on financial inclusion in five countries (**Indonesia**, **Kenya**, **Mexico**, **Pakistan** and **South Africa**). Based on these findings, it develops a set of guidelines to assist the authorities in developing countries to design effective AML/CFT regimes that are compliant with Financial Action Task Force (FATF) standards and supports financial inclusion.

The report and guidelines will be of benefit to countries striving towards the dual goals of protecting their institutions against money laundering and the financing of terrorism as well as extending financial inclusion, irrespective of whether protective measures are being considered in the process of implementing or amending AML/CFT controls to meet the Forty Nine Recommendations of the FATF or in order to meet other, related international requirements, such as those set out in the 2000 United Nations Convention on Transnational Organised Crime or the 2003 United Nations Convention Against Corruption.

The project was supervised and guided by a steering committee consisting of representatives from the FIRST Management Unit, World Bank, International Monetary Fund (IMF), the UK's Department for International Development (DFID), the Consultative Group to Assist the Poor (CGAP), the South African National Treasury, the FinMark Trust and Professor Nikos Passas, an acknowledged world expert on AML/CFT standards and implementation.

Key findings

1. **The pursuit of financial inclusion and the pursuit of an effective AML/CFT regime are complementary and not conflicting financial sector policy objectives.** The objective with financial inclusion is that individual clients, particularly low-income clients currently excluded from using formal financial services, must be able to access and on a sustainable basis use financial services that are appropriate to their needs and provided by registered financial service providers. Without a sufficient measure of financial inclusion, a country's AML/CFT system will thus safeguard the integrity of only a part of its financial system – the formally registered part – leaving the informal and unregistered components vulnerable to abuse. Measures that ensure that more clients use formal financial services therefore increase the reach and effectiveness of the AML/CFT controls.

2. **The imposition of AML/CFT controls can and did have an impact on access to and usage of financial services in the countries concerned.** The most vulnerable clients are those who lack the prescribed identification documents, undocumented migrants and clients of institutions (such as money services businesses) whose links with formal financial institutions are severed for AML/CFT reasons. AML/CFT controls also tend to increase transaction costs which can cause financial institutions to withdraw from low-value transactions and client markets using these. Impact differed from country to country depending on the design of the national AML/CFT framework.

3. **Countries are finding ways to limit AML/CFT risk while promoting financial inclusion**. .Two complementary strategies are being following by regulators. Firstly, they apply reduced controls, especially money laundering controls, to lower risk transactions.

The most common is limiting the verification of client identity for low value transactions or products. Secondly, where countries do not have either the public or private capacity to apply full AML/CFT controls at once, they sequence implementation across financial institutions and transactions based on perceived risk.

A development path

The five countries included in the study are at very different stages of AML/CFT implementation. Mexico and South Africa are FATF members. Indonesia passed its AML legislation in 2002. Kenya has published an AML bill for public comment while Pakistan has issued a presidential decree enacting AML/CFT controls. Both Kenya and Pakistan have previously issued prudential regulations dealing with money laundering control.

The study found that, despite different starting points, the implementation of AML/CFT controls in the five countries appears to follow a similar development path. A country would set out to comply with the FATF standards by promulgating a law and regulations which are typically based on international templates rather than domestic circumstances (**phase 1**). As the financial supervisor and financial institutions seek to implement these controls, they would come up against capacity constraints and obstacles which either exclude or discourage clients from using formal financial services, or which tend to make it difficult for financial institutions to serve certain categories of clients (**phase 2**). In **phase 3** regulators respond to these pressures by applying two types of adjustments: (1) existing controls are re-calibrated on a risk-sensitive basis, and/or (2) sequencing the implementation of controls across sectors, transactions or entities based on the available resource envelope This development path may repeat itself as different aspects of the AML/CFT regime are developed.

Risk appreciation

The authorities base the application of reduced controls and the sequencing of implementation on an explicit or implicit appreciation of the risk involved.

The countries reviewed tended to separate their assessment of money laundering (ML) and financing of terrorism (FT) risk. As far as ML is concerned one or a combination of three risk considerations were used:

- Lower value means lower risk (the predominant factor and applied in all five countries);
- Transactions with a cross-border element are regarded as entailing higher risk; and
- Transactions or institutions which link to the formal payment system are seen to hold higher risk for the financial system than transactions or institutions which are not linked (for example third tier banks in Indonesia who do not have direct access to the payment system).

In countries where mobile banking and mobile payments are already introduced (the Philippines and South Africa) the regulators decided to limit the perceived risk through transaction caps rather than stifle the development of these business models. However, in none of the countries was there evidence that the risk-based adjustments to AML controls were made on the basis of an assessment of actual risk based on intelligence or law enforcement experience.

Where countries did criminalise terrorist financing and imposed CFT controls, the only risk consideration used was the identity of clients and institutions known for their links to terrorist organisations.

Sequenced implementation

None of the countries included in the study has the capacity to implement all of the FATF recommendations at the same time across all sectors or even only those areas identified as high risk. Accordingly, and by force of circumstance, differentiated levels of AML/CFT controls have emerged within each country. These levels do not signify a static state, but stages in the progression towards a comprehensive regime. Broadly speaking, five levels of implementation were observed:

1. *No AML/CFT controls in place:* This is normally the case where the sub-sector is not subject to any financial sector supervision.
2. *Coverage:* entails basic registration of financial services providers, ensuring that they become visible to the supervisor and their information accessible to state agencies. Example: Money Transfer Operators in Mexico.
3. *Traceability of customers and transactions:* requires basic customer identification procedures (even though verification may be limited) and standardised record-keeping. Example: savings and credit cooperatives and microfinance institutions in Kenya.
4. *Profiling, verification and monitoring:* require more extensive verification of customer identity, extended profiling of customers and the pro-active monitoring of transactions for suspicious activity. Example: commercial banks in Indonesia.
5. *Advanced verification and interdiction:* is possible where the national identification system and capacity of financial institutions enable verification with high levels of integrity to be performed and suspicious individuals and transactions can be prevented from using the formal financial system. Example: Although none of the five countries have yet reached this level, the national identification system in Pakistan has this capacity.

Progress along this sequence can be facilitated by market-facilitating reforms. For example, it was found that countries with strict controls relating to entities who may transfer money (South Africa, Kenya and Indonesia) had less AML/CFT coverage of total transfers than countries with liberalised regimes (Mexico and Pakistan).

Observed impact on financial inclusion

Financial inclusion is affected not only by AML/CFT controls, but also by other factors.

Non-AML/CFT factors: Affordability was found to be the most significant barrier to inclusion for transaction bank accounts in all the countries reviewed. Significant proportions (Indonesia 75%, Kenya 95%, Mexico 64%, Pakistan 85%, and South Africa 33%) of the adult populations in the respective countries are excluded from access to transaction bank accounts due to the cost thereof relative to their income. Affordability was also found to be a significant barrier for remittances transactions processed by regulated service providers. Furthermore, regulations across all five sample countries effectively prohibit financial institutions from opening accounts or conducting transactions for undocumented migrants. This affects an estimated 2.5-4.1m undocumented migrants in South Africa and at least 800,000 in Kenya. These non-AML/CFT barriers to inclusion do not remove the imperative to minimise barriers resulting from AML/CFT regulation as AML/CFT barriers may become pronounced as the other factors are being addressed.

AML/CFT factors: From the client side, the most prominent barrier to inclusion was customer due diligence (KYC) regulations requiring identity and address verification. Large groups of adults in these countries are unable to provide such details. In South Africa 1.75m individuals do not have any identity document and in Kenya it is estimated that as much as 95% of adults will not be able to prove their residential address as required in the published AML bill. Increased process and documentation requirements also discouraged clients from using formal financial services. From the supplier side, there is now sufficient evidence that many well supervised financial institutions are severing their business relationships with informal and unsupervised institutions through the combined effect of potentially huge financial implications of contraventions of AML/CFT laws (criminal penalties, reputational damage and potential civil liability) and limited profit opportunities. Banks are closing the accounts of money services business in the USA. Similarly, banks are declining to serve *centros cambiarios* in Mexico. The increased transaction costs imposed by AML/CFT compliance on small, low-value transactions have also lead a number of financial institutions to withdraw from certain low-income markets.

Mitigating responses: The three countries which have enacted comprehensive AML/CFT regimes – Indonesia, Mexico and South Africa – have mitigated the impact of AML/CFT controls on financial inclusion through a number of measures. These include:

- Requiring limited verification for low-value transactions or for products which limit transaction values to specified thresholds (where attempted transactions exceed these thresholds, full verification is required before further transactions can be processed);
- Allowing in specific cases verification of client information against third party databases accessed independently by the financial institution (this can also facilitate non-face-to-face client acquisition in mobile banking business models);
- Compensating for simplified verification procedures (where national identification infrastructure is deficient) with more extensive client profiling to support monitoring of activity to identify deviations from the profile supplied;
- Reduced or streamlined record-keeping requirements to reduce costs, e.g. permitting records to be kept electronically;
- Allowing longer timelines for overall compliance, for example client re-identification if financial institutions are able to identify and prioritise high-risk client categories.

Drivers of impact

The level of impact of similar AML/CFT controls was found to differ across countries and is determined by a number of country specific factors and characteristics:

1. *Limitations in the national identification infrastructure* which either excluded individuals through lack of documentation or made it more costly for financial institutions to achieve verification;
2. *Limited government capacity* in financial sector supervision and law enforcement which limits their ability to formalise the economy, undermines the implementation of AML/CFT controls and increases the compliance risk for regulated institutions dealing with the unregulated/unsupervised sectors;

3. *The structure, capacity and incentives of formal financial institutions* which cause them to apply the controls more conservatively than intended by the regulator;
4. *Large-scale usage of informal financial services* which make it easier for clients to opt out of formal financial providers if AML controls become too costly or inconvenient;
5. *Linkages to international financial markets* which lead foreign-controlled domestic institutions to apply AML controls designed for developed rather than developing countries.

Towards guidelines

It is recommended that the following general principles should guide the design of a regulatory framework that seeks to support both effective AML/CFT controls and financial inclusion:

1. Where the FATF recommendations allow flexibility and tailoring, AML/CFT measures should be attuned to the domestic environment, especially domestic AML/CFT risks;
2. AML/CFT controls should be proportionate to the prevailing or likely risks;
3. AML/CFT obligations of public and private institutions should not exceed the capacity of those institutions. If their capacity falls short of what is required by an effective domestic policy or by the FATF standards, capacity increases must be closely managed and AML/CFT obligations gradually increased in accordance with the resultant improvements in capacity.
4. While all stakeholders must uphold the law, law enforcement is primarily the responsibility of the state. The state must not privatise law enforcement by unnecessarily shifting law enforcement responsibilities to private institutions.

The following nine guidelines have been formulated based on the observed experience in the sample countries:

Guideline 1: **Develop a policy**
Before an AML/CFT regime is enacted or even if already enacted, the domestic financial sector policy-maker or regulator should consider the interaction between imposing AML/CFT controls and financial inclusion. Policy makers should guard against adopting templates or regulations imposed in other jurisdictions without first considering the appropriateness and potential impact of those regulations in their own jurisdictions.

Guideline 2: **Follow a consultative and flexible approach**
Getting the balance between effective AML/CFT controls and financial inclusion right will require regulators to consult on an ongoing basis with the key interest groups. These include financial institutions, both registered and unregistered, law enforcement agencies, as well as other national agencies, notably those responsible for the national identification infrastructure.

Guideline 3: **Assess and define the risk**
The financial sector policy-maker, relevant regulators, and law enforcement and intelligence agencies, must assess the domestic ML and FT risks drawing upon information provided by the agencies concerned as well as formal and informal financial and other relevant institutions. The identified risks must be mapped to financial sub-sectors, institutions, transactions, client categories or other relevant characteristics (e.g. geographic area) to produce a risk framework and resultant priorities for regulation and control.

***Guideline 4*: Identify excluded and vulnerable groups**

Identify the levels of financial exclusion as well as the main causes for such exclusion in order to scope the potential impact of AML/CFT controls on financial inclusion. Excluded groups refer to all those persons who do not use financial services provided by financial institutions registered with the relevant supervisors of financial services and typically include the poor, the informal and undocumented migrants.

***Guideline 5:* Assess the domestic resource envelope**

The imposition of AML/CFT controls which cannot be implemented within the domestic resource envelope tends to increase financial exclusion without contributing to effective AML/CFT risk management. Key national resources to assess include (1) the capacity of financial services providers (eg their systems), (2) the capacity of the financial sector regulator/supervisor (including the FIU if one is already established), and (3) the coverage, integrity and accessibility of the national or other identification systems.

***Guideline 6:* Reduced control for lower-risk transactions**

Where the risk of money laundering (as opposed to the risk of the financing of terrorism for which no risk-scaling model has yet emerged) is lower, reduced controls can be applied to facilitate financial inclusion. These adjustments aim to mitigate or reduce the inability or difficulty for clients to provide documentary evidence to verify identity or residential address; compliance costs for financial institutions flowing from systems requirements; and CDD and record-keeping obligations (notably a requirement to keep physical records, especially for once-off transactions).

***Guideline 7:* Risk-based sequencing of AML controls**

Where countries do not have the capacity to implement full and effective AML/CFT controls on all relevant transactions and institutions all at once, a sequencing approach can be followed. The level of controls imposed must be scaled to the capacity of the regulator and the institutions involved. Sequencing and scaling must be coupled with a framework to manage an increase in the required capacity to ensure that the international standards are reached.

***Guideline 8*: Promote market-based reforms facilitating formalisation**

The twin objectives of effective AML/CFT controls and financial inclusion can be greatly enhanced by market incentives that contribute to (1) formalise informal or unregistered providers of financial services and/or (2) migrate users of informal financial services to formal or registered providers. Although such reforms are not strictly part of AML/CFT regulation, their short-term impact on both objectives may be more significant than the actual AML/CFT regulation and should be favourably considered by regulators seeking to implement AML/CFT controls.

***Guideline 9:* Develop the national identification infrastructure.**

If a country's national identification infrastructure and other private databases lack coverage, integrity or is not easily and cost-effectively accessible to financial institutions for verification purposes, the state should address the deficiencies.