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FocusNote

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AML/CFT REGULATION: IMPLICATIONS FOR FINANCIAL SERVICE PROVIDERS THAT SERVE LOW-INCOME PEOPLE

Executive Summary

Across the world, new measures are being introduced to combat money laundering and the financing of terrorism. All financial service providers, including those working with low-income communities, are—or will—be affected by these measures. This paper summarizes the implications of the international framework for anti-money laundering (AML) and combating the financing of terrorism (CFT) for financial service providers working with low-income people.

While each country may adapt the international AML/CFT standards developed by the Financial Action Task Force (FATF), in general financial service providers are required to:

- enhance their internal controls to cater specifically for AML/CFT risks;
- undertake customer due diligence procedures on all new and existing clients;
- introduce heightened surveillance of suspicious transactions and keep transaction records for future verification; and
- report suspicious transactions to national authorities.

These measures could bring additional costs of compliance to financial service providers; and customer due diligence rules may restrict formal financial services from reaching lower-income people. Although the framework applies to all financial institutions, the risk of money laundering or financing of terrorism varies with the country context, the institution's legal form, and the type of financial service. The introduction of new or tightened AML/CFT regulations may have the unintended and undesirable consequence of reducing the access of low-income people to formal financial services. As a means to avoid this outcome, this paper argues in favor of (1) gradual implementation of new measures; (2) the adoption of a risk-based approach to regulation; and (3) the use of exemptions for low-risk categories of transactions.

South Africa provides one example of how a country's AML/CFT regulations can be modified to take into account better the needs of low-income clients. Customer due diligence regulations which require an income tax number and proof of residential address for clients proved too stringent to allow many low-income people to open bank accounts. Often low-income clients have no tax number and are unable to produce third-party verification of address. The South African authorities have now adopted a more flexible approach to client identification and verification and introduced a compliance exemption that relaxes requirements for a category of clients known as "mass banking clients": those clients with small balances and small size transactions.

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This area of regulation is a young and rapidly developing field, and there is scope for further work to explore the particular challenges facing institutions serving low-income clients in complying with the new regulations.

Introduction

Since September 11, 2001, the introduction of measures to combat money laundering and the financing of terrorism has taken on new urgency for international agencies, governments, and financial service providers. Implementing these new regulations can present particular challenges for financial institutions serving low-income clients.

As recent fines and sanctions levied on banks in the United States have shown, the economic and financial impact on institutions that fail to comply with the requirements of the law can be devastating. Even the perception of having inadequate controls to prevent money laundering can damage an institution's reputation. Hence, it is important for financial institutions to develop internal controls to protect themselves from exposure to money laundering and the financing of terrorism and to comply with regulations. The Financial Action Task Force on money laundering (see box 1) has developed international standards on AML/CFT.[1] Within this comprehensive, general framework, individual countries are responsible for introducing local legislative and regulatory regimes.

AML/CFT regulations can have serious implications for financial institutions that serve low-income clients, especially in developing countries. The additional costs of compliance and tighter restrictions may have the unintended consequence of driving low-income clients from the formal financial sector. The challenge is to strike a balance that promotes prudential practices at a reasonable cost for financial service providers that want to offer services to less well-off clients. AML/CFT regulations should be implemented in a flexible way to ensure that they do not restrict access to formal financial services for low-income people.

All financial service providers dealing with financial transactions, including those working with low-income clients are required to comply with AML/CFT regulations. The universe of financial service providers that serve low-income clients includes specialized microfinance institutions, commercial banks, financial cooperatives and credit unions, low-capital rural and/or local banks, state development and agricultural banks, and postal savings banks and other postal financial service providers (see annex 1).[2] These institutions can be classified as more or less risky based on the financial services they offer.

AML/CFT—Why Is It Important?

Money laundering and the financing of terrorism can damage national financial systems. Illegitimate financial holdings, assets, and enterprises are unreliable sources of investment capital for sustainable economic development. Among other effects, money laundering destabilizes national economies by increasing the demand for cash, increasing the volatility of interest and exchange rates, and even contributing to higher inflation.[3]

Developing and transition economies strive to become reputable members of the global payments network to increase their ability to access capital flows, and consequently work to conform to international codes to combat abuse of this system. Countries with weak enforcement of AML/CFT controls could damage their reputations in international financial markets, and thus may not attract international flows such as foreign direct investment and/or donor funding.

Countries therefore have a public policy interest in making sure that their AML/CFT regime is comprehensive and appropriately includes financial service providers working with low-income clients. Likewise, these institutions have an interest in protecting themselves from the adverse effects of being involved, or even the perception of being involved, in money laundering and the financing of terrorism.

[1] Currently, there are 40 FATF recommendations on anti-money laundering and 9 special recommendations on combating the financing of terrorism.

[2] Today, financial service providers that serve poor clients go well beyond the traditional non-profit organization model that dominated the early days of modern microcredit or microfinance. In some countries, some of the original non-profit institutions have expanded their services to become regulated financial institutions, such as banks. Likewise, some conventional banks provide microfinance services to poor clients.

[3] See the web site of the United Nations Office on Drugs and Crime (UNODC), www.odccp.org.

Box 1 Financial Action Task Force and FATF-Style Regional Bodies

Financial Action Task Force (FATF) is an international grouping of nations that fights money laundering and terrorist financing. FATF currently has 33 country members, more than 15 international organization members, and some 20 observers, among them the International Monetary Fund and the World Bank. FATF has a secretariat headquartered in Paris, and numerous documents are available on their web site (www.fatf-gafi.org), including the *Forty Recommendations on Money Laundering and the Special Recommendations on Financing of Terrorism*. (See annex 3 for a detailed list of FATF and FSRB-member countries.)

FATF-Style Regional Bodies (FSRBs) have also been established. These FATF-Style Regional Bodies are crucial to the promotion and implementation of AML/CFT standards within their respective regions. As part of this process, the countries undertake peer reviews of their AML/CFT regimes, known as "mutual evaluations," and develop technical assistance programs to facilitate implementation in coordination with international donors. The following organizations have been formed to date:

- GAFISUD: Financial Action Task Force on Money Laundering in South America
- APG: Asia/Pacific Group on Money Laundering
- ESAAMLG: Eastern and Southern Africa Anti-Money Laundering Group
- CFATF: Caribbean Financial Action Task Force
- MENAFATF: Middle East and North Africa Financial Action Task Force
- EAG: Eurasian Group
- GIABA*: Intergovernmental Group of Action against Money Laundering in West Africa
- MONEYVAL: Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures

* GIABA is in the process of becoming an FSRB.
Source: FATF, www.fatf-gafi.org

What Is the Difference between Money Laundering and Financing of Terrorism?

Money laundering is the process of disguising the illegal origin of criminal proceeds without disclosing their source.[4] Illicit proceeds are derived from diverse criminal activities, including illegal arms sales, smuggling, organized crime, corruption, embezzlement, drug trafficking, and human trafficking. Financing of terrorism is fundraising for, or financial support of, organizations or persons involved in terrorism.[5]

As figure 1 shows, money laundering legitimizes illicit proceeds through various methods, while financing of terrorism uses legitimate or illegitimate funds to facilitate an act of terror. Both activities employ similar techniques:

- ***Placement:*** the initial posting of funds or assets into the financial system
- ***Layering:*** the relocation or alteration of funds or assets in order to disguise the illicit source or intent
- ***Integration:*** the conversion of illicit funds, or legitimate funds intended for illicit activity, to seemingly legitimate assets[6]

What Institutions Are Covered by AML/CFT Regulations?

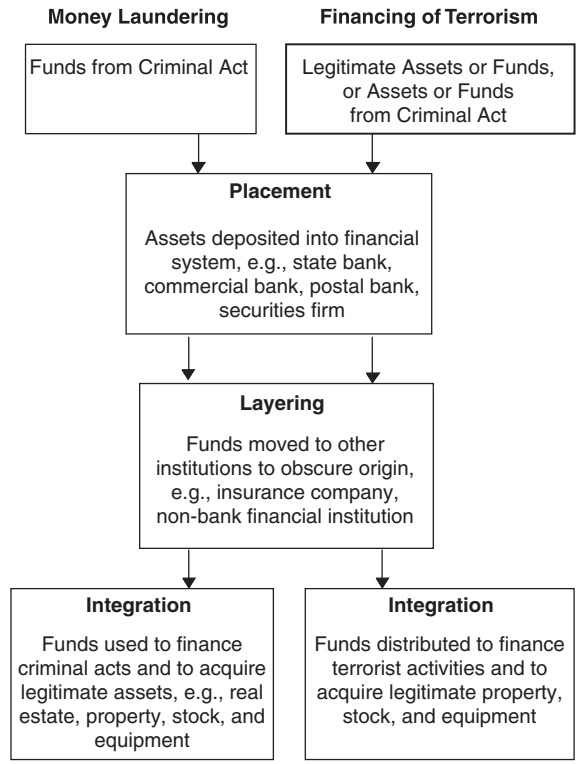
FATF covers any institution involved in financial transactions, including financial service providers working with low-income clients. In many countries, financial institutions that serve low-income clients

[4] Financial Action Task Force (FATF), www.fatf-gafi.org/document/29/0,2340,en_32250379_32235720_33659613_1_1_1_1,00.html, also known as GAFI, Groupe d'action financière sur le blanchement de capitaux.

[5] The UN International Convention for the Suppression of the Financing of Terrorism (December 1999), Article 2 in its provisions, describes acts of terrorism as "any act intended to cause death or serious injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing an act." Signatories to the UN convention continue to disagree on what actions constitute terrorism, since acts of terrorism in one nation can be perceived as acts of civil liberation in another.

[6] It is important to note that placement, layering, and integration are not always sequential steps to launder money. Funds from criminal activity can be used immediately for other criminal activity or invested, depending on financial system, without placement or layering.

Figure 1 Money Laundering and the Financing of Terrorism



Source: World Bank, 2004

are established as non-profit organizations.[7] FATF Special Recommendation VIII on Terrorist Financing explicitly addresses the exposure of non-profit organizations to terrorist financing, and requires countries to develop regulation to prevent these organizations from becoming conduits for money laundering or the financing of terrorism.[8]

FATF Recommendations on AML/CFT for Financial Service Providers Serving Low-Income Clients

FATF recommendations provide guidance on what actions institutions should implement internally to reduce the risk of money laundering and financing of terrorism, such as customer due diligence, record keeping, and reporting. In order to maintain a reasonable standard of AML/CFT compliance, countries are advised to adopt measures in proportion to the potential risk of money laundering and the financing of terrorism.

AML/CFT Measures Required at the National Level

Countries have an obligation to protect the financial integrity of their financial system. However, countries have flexibility in how they achieve this objective and can adopt a risk-based approach. For example, if the authorities decide that an institution's operations represent a low risk for money laundering and the financing of terrorism, they can exempt some financial service providers from compliance with AML/CFT regulations. If, on the basis of risk analysis, national authorities decide that there is a need to implement AML/CFT regulations, they still have considerable latitude in how to implement the measures. Establishing a risk-based approach to regulation requires a good understanding of the extent of risk for money laundering and the financing of terrorism within the country/jurisdiction.

AML/CFT Measures Required at the Institutional Level

At the institutional level, AML/CFT compliance involves four main activities: internal controls, customer due diligence, surveillance and record keeping, and reporting of suspicious activities. Establishing new internal controls may require financial institutions to change client in-take forms, operating procedures, and information systems. Training staff in new procedures is vital to the successful implementation of internal controls and overall AML/CFT compliance. Background checks on board members, shareholders, and employees help protect the institution. Donations and contributions should also be verified to ensure they are from legitimate sources.

FATF requires financial institutions to be able to verify the identity of their clients. Implementing customer due diligence measures can help institutions to comply with the regulations. Although FATF's AML/CFT recommendations do not specifically mention the address of customers

[7] Even though the FATF recommendations do not explicitly mention financial institutions serving poor clients, any institution undertaking such activities falls under the broad AML/CFT framework.

[8] FATF Special Recommendation VIII on Terrorist Financing, "Non-profit Organizations," specifies that "countries should review the adequacy of laws and regulations that relate to entities that can be abused for the financing of terrorism. Non-profit organizations are particularly vulnerable, and countries should ensure that they cannot be misused (i) by terrorist organizations to pose as legitimate entities; (ii) to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset freezing measures; and (iii) to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organizations." See FATF, www.fatf-gafi.org/dataoecd/39/19/34033761.pdf.

Box 2 FATF Definition of Financial Institutions and Their Activities

"Financial institutions" refers to any person or entity conducting as a business one or more of the following activities or operations for or on behalf of a customer:

1. Acceptance of deposits and other repayable funds from the public, including private banking
2. Lending—includes, inter alia, consumer credit; mortgage credit; factoring, with or without recourse; and finance of commercial transactions (including forfeiting)
3. Financial leasing—does not extend to financial leasing arrangements in relation to consumer products
4. The transfer of money or value—applies to financial activity in both the formal or informal sector, e.g., alternative remittance activity. See the Interpretative Note to Special Recommendation VI. It does not apply to any natural or legal person that provides financial institutions solely with message or other support systems for transmitting funds. See the Interpretative Note to Special Recommendation VII.
5. Issuing and managing means of payment (e.g., credit and debit cards, checks, traveler's checks, money orders and bankers' drafts, electronic money)
6. Financial guarantees and commitments
7. Trading in:
    a. money market instruments (checks, bills, certificates of deposit, derivatives, etc.)
    b. foreign exchange
    c. exchange, interest rate, and index instruments
    d. transferable securities
    e. commodity futures trading
8. Participation in securities issues and the provision of financial services related to such issues
9. Individual and collective portfolio management
10. Safekeeping and administration of cash or liquid securities on behalf of other persons
11. Otherwise investing, administering, or managing funds or money on behalf of other persons
12. Underwriting and placement of life insurance and other investment related insurance—applies both to insurance undertakings and to insurance intermediaries, i.e., agents and brokers
13. Money and currency changing

When a financial activity is carried out by a person or entity on an occasional or very limited basis (having regard to quantitative and absolute criteria), such that there is little risk of money laundering activity occurring, a country may decide that the application of anti-money laundering measures is not necessary, either fully or partially.

Source: FATF, *The Forty Recommendations*, "Glossary," which includes both information and interpretative notes on the recommendations; www.fatfgafi.org/glossary/0,2586,en_32250379_32236930_34276935_1_1_1_1,00.html#34276864

in reference to customer due diligence, some countries have included verification of client addresses in their national AML/CFT frameworks. FATF says that "there are circumstances in which it would be reasonable" for a country to allow its financial institutions to apply customer due diligence measures "on a risk-sensitive basis." A few countries have shown flexibility in implementing customer due diligence requirements that accommodate the situation of low-income people. Uganda, Tanzania, and Kenya all accept letters from the local authority in rural villages as identification for their clients who do not have an official identity card. More work is needed to ensure a high level of security in customer due diligence that does not threaten poor people's access to services. Financial service providers, working closely with their industry associations and national authorities, are well placed to develop effective methods of verifying the identity of their clients.

In addition, institutions are encouraged to monitor transactions and keep detailed transaction records. For financial services providers working with low-income clients, surveillance and record keeping could involve new information systems.

Box 3 Financial Intelligence Units

FATF recommendations require the creation of a specialized government unit, usually called a financial intelligence unit (FIU), as a central point for monitoring transactions and collecting information. In addition, local regulators—and in some cases, industry associations as well—issue guidance notes or circulars on how to interpret sections of the laws or regulations.

FIUs at a minimum receive, analyze, and disclose information on suspicious or unusual financial transactions provided by financial institutions to competent authorities. Although every FIU operates under different guidelines, under certain provisions they can exchange information with foreign counterpart FIUs. In addition, many FIUs can provide other government administration data and public record information to their counterparts, which can also be helpful to those investigating money laundering and financing of terrorism. There are currently 94 countries with recognized operational FIUs, with others in various stages of development. The ongoing development of FIUs exemplify how countries around the world continue to intensify their efforts to focus on research, analysis, and information exchange in order to combat money laundering and financing of terrorism, and other financial crimes.

Source: Adapted from the "The Egmont Group Financial Intelligence Units (FIUs)," *www.egmontgroup.org/about_egmont.pdf; www.egmontgroup.org/list_of_fius_062304.pdf.*

Specific software can reduce the operational cost and time required to comply with the need to monitor complex, unusual, and large transactions and patterns of transactions. Finally, FATF recommendations make it clear that financial institutions have an obligation to report all suspicious transactions to their national authorities.

Annex 2 provides more background on FATF recommendations and possible institutional compliance measures.

Challenges for Financial Service Providers Working with Low-Income Clients

The main challenges for financial service providers in complying with AML/CFT measures arise from the requirement to undertake customer due diligence and to absorb the potential costs involved in implementing new regulation. Additional challenges include internal control and surveillance and record keeping.

Special Features and Risk Profiles of Financial Service Providers that Serve Low-Income Clients

Microfinance clients are typically low-income, do not own assets that are conventionally accepted as collateral, may be self-employed, or may have uneven streams of income. In general, the majority of clients served by these institutions are "natural persons," not legal persons or entities such as companies or trusts. This client profile reduces the risk of such institutions being used for money laundering.

Microfinance transactions are also generally very small—whether they are savings, credit, or transfer. Given the predominant small loan sizes, sudden flows of large amounts would stand out easily. In the financing of terrorism, however, authorities are increasingly concerned about even small transactions.[9]

The type of financial service offered also affects the institution's risk. Some institutions are legally authorized to mobilize savings. Some may have restrictions on providing money transfers, leasing, and/or insurance. Non-depository institutions with no access to the national payment system may present relatively lower risk from an AML/CFT perspective. Among financial services for low-income people, money transfers may pose higher risks of money laundering and financing of terrorism. For criminals to succeed, they usually need access to institutions that facilitate domestic and international funds transfers, exchange currencies, and convert these proceeds into different financial instruments and other resources. Terrorist financiers and money launderers may pose as legitimate entities to transfer funds that later may be diverted to criminal purposes or to disguise funds from illicit activities. Countries therefore need to regulate providers of transfer

[9] See FATF, 2004, "Guidance for Financial Institutions," www1.oecd.org/fatf/pdf/GuidFITF01_en.pdf. Several law enforcement experts have noted that the funding needed to mount a terrorist attack does not always call for large sums of money and that the associated transactions are usually not complex, but rather are small sums, below the usual thresholds for cash transaction reporting, and in most cases consisted solely of wire transfers.

facilities appropriately to reduce or prevent abuse for money laundering and the financing of terrorism. Further analysis is needed to distinguish the risk that each type of financial service provider presents depending on their financial services.

Some institutions serving low-income clients, such as financial cooperatives and NGOs, have ownership structures that may require additional information and verification by authorities. Financial cooperatives are member-owned institutions with a board and other oversight committees, while NGOs typically have no share-based ownership and appointed boards and management.[10]

Compliance Costs

Like any other financial regulation, the costs of complying with AML/CFT measures may increase the cost of services. For example, the cost of monitoring suspicious transactions may be high if suitable automated systems are not in place. Financial institutions serving low-income people may have to purchase and install new technology or increase their human resource capacity to comply with the requirements in their jurisdiction. In addition, rules for reporting and record keeping may obligate institutions to save all physical documentation of transactions for defined periods, usually at least five years. Microfinance institutions in particular will need to develop systems, aided by available software, to reduce the operational cost and time required to comply with this requirement. Industry associations can play a valuable role by helping members keep costs to a minimum as they comply with regulations. For example, they could consult with the banking association in a country to see if AML/CFT software is available. They could work with national authorities to provide such software and take the lead in offering training on AML/CFT awareness and compliance.

Although there are always costs associated with regulations, these costs tend to be greater in countries where there is generally a culture of poor compliance. Developing or encouraging wider acceptance of compliance, not only for AML/CFT systems, is more cost effective because it reduces risk of fraud, helps protect savers and investors, and increases the integrity of the institution.

Box 5 gives examples of two types of financial services providers that serve low-income clients in Mexico, a FATF member country. Both BANSEFI and Compartamos have implemented policies and systems in line with international standards and national law. In addition, the Mexican National Association of Non-bank Financial Institutions (AMSFOL) has been proactive in forming new members institutions about AML/CFT issues, offering courses in new AML/CFT regulations, and developing a procedures manual to help members ensure AML/CFT compliance.

Customer Due Diligence

It is a universal challenge for financial service providers to identify clients according to international standards. In developing and middle-income economies, for example, it is difficult for many clients to comply with certain "customer due diligence" identification requirements, such as

[10] See annex 1 for a description of the variety of financial service providers including financial cooperatives and NGOs.

Box 4 Basel Criteria for Customer Due Diligence

The Basel Committee document on customer due diligence (BIS 2001) provides some guidelines to financial institutions on how to implement CDD practices: "Banks should develop graduated customer acceptance policies and procedures that require more extensive due diligence for higher risk customers … It is important that customer acceptance policy is not so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged."**

These general principles were taken further in the Basel Committee's *General Guide to Account Opening and Customer Identification*, issued in February 2003.*** This statement of international best practice defines what a bank needs to know about a client to build a risk profile. The list includes obtaining and verifying name, permanent address, date and place of birth, nationality, occupation and/or name of employer, identity number, type of account and nature of the banking relationship, and signature.

** Bank for International Settlements, "Customer Due Diligence for Banks," www.bis.org/publ/bcbs85.pdf.

*** www.bis.org/publ/bcbs85annex.htm

Box 5 AML/CFT Implementation in Mexico by Two Different Financial Service Providers

Mexico has been a member of FATF since 2000, although money laundering and related offences were criminalized in 1996. Banks there have been required to report suspicious transactions over US $10,000 since 1997. In May 2004, Mexican authorities issued more detailed AML/CFT regulations and extended compliance to non-bank financial institutions. These two different financial service providers, BANSEFI and Compartamos, which both serve low-income clients in Mexico, implemented policies and systems in line with international standards and national law.

BANSEFI is a national savings bank established by the federal government of Mexico in 2001 to support the development of popular savings and credit institutions. It has an active client base of more than 2 million clients, almost all individuals at the lower end of the income spectrum. BANSEFI has developed an AML/CFT policy and appointed a compliance officer as well as an AML/CFT committee. Internal controls, policies, and procedures were upgraded in 2004, and suspicious transactions are actively monitored, especially money transfers. Implementing some of the current laws has been challenging, particularly verifying physical addresses and re-identifying existing customers. BANSEFI puts "know-your-customer" procedures at the heart of detecting and preventing money laundering and terrorist financing.

It added these specific procedures to implement AML/CFT:

- BANSEFI developed a new IT system to support the implementation of AML/CFT measures.
- A new manual of enhanced internal controls, policies, and procedures was approved in June 2004.
- It performs customer due diligence on new and existing customers, which includes client interviews, and verification of photo ID, physical address, and tax numbers.
- It monitors all transactions, and reports suspicious transactions to the local financial intelligence unit, including transactions of US $10,000 and over.
- BANSEFI employees are trained in AML/CFT compliance and kept up-to-date. Potential employees are screened before being hired.
- It maintains all transaction records for at least ten years.
- It also receives outside technical assistance to better comply.

Financiera Compartamos, a specialized MFI, began operations in Mexico as a non-governmental organization in 1990 and transformed to a regulated financial institution in 2000. (Financiera Compartamos is legally registered as a *sociedad financieras de objeto limitado,* a non-bank regulated financial institution.) It currently serves over 300,000 clients—mainly individuals who operate microenterprises that usually employ one or two people of the same family, who often are the main income source for the family. Compartamos offers loans with an average outstanding balance of US $310.

When it implemented the new AML/CFT regime for non-banks in 2004, Compartamos benefited from already being a regulated institution. This meant that compliance systems, staff, and procedures were already in place. Furthermore, part of the Compartamos loan methodology included weekly visits to clients by loan officers, who already knew their clients well. Use of credit is monitored through the group lending system whereby clients disclose the use of their loans to other group members.

Since 2000, Compartamos has been obliged to report any client transaction larger than US $10,000 to the Mexican banking authority, although it has not yet processed any transaction of this size. Compartamos, too, instituted additional procedures for AML/CFT:

- Transaction records are maintained for ten years.
- Compartamos monitors all transactions using customized software that identifies any unusual, complex, or large transactions by clients.
- It appointed a formal AML/CFT compliance officer, the risk manager. In compliance with regulation, a special AML/CFT committee was appointed consisting of the general manager, the risk manager, the internal auditor, and legal officer.
- All employees have been trained in AML/CFT issues and compliance requirements, and refresher courses are offered annually. In addition, when hiring new staff, Compartamos screens their legal history before making an employment offer.
- The internal audit department and annual external audits verify compliance with AML/CFT regulations.

Sources: CGAP-World Bank Survey questionnaire with BANSEFI Chief of Staff David Estefan and Norma Figueroa, AML/CFT compliance officer, January, 2005; CGAP World Bank survey questionnaire with Compartamos General Manager Carlos LaBarthe Costas and Risk Manager Lizette Escamilla Miranda in January 2005.

national identity numbers or third-party verification of physical home address. These requirements are already part of customer due diligence regulations in South Africa, but financial institutions there are experiencing problems with them because at least one-third of South African households do not have formal addresses.[11] The issue at stake is how to devise customer due diligence requirements that are tailored to specific categories of clients, such as those the Basel Committee proposes for banks in member countries (see box 4). In particular, a certain level of stringency could be applied to the institution's "normal" or low-risk clients, and an enhanced due diligence applied to the riskier clients.

Since the FATF recommendations do not specify how to establish and verify the identity of clients, it is important that financial service providers that serve low-income clients work with regulators to develop appropriate rules in each national jurisdiction to ensure:

- that current or potential low-income clients are not excluded from access to services, and
- that the regulations do not limit the ability of banks to use microfinance providers as agents to accept or pay out remittances and other money transfers.

What Should Financial Service Providers that Serve Low-Income Clients Do?

It is important that microfinance institutions do not compromise their core objective of providing financial services to a broad range of poor people as a result of compliance with AML-CFT regulations. At the same time, to ensure their long-term sustainability and to meet their client needs, these institutions must protect themselves from abuse by terrorists and money launderers. In working towards compliance with AML/CFT measures, regulators and financial service providers serving low-income clients need to work together to strike a careful balance between regulation and sustainability and client needs:

- ***Gradually implement regulations.*** Financial service providers should coordinate with country regulators to develop and gradually implement new AML/CFT regulations in order to give institutions adequate time to adapt their internal procedures in accordance with the new regulations. Such an approach will help minimize disruptions in their services to clients.
- ***Take a risk-based approach.*** The AML/CFT risks of financial service providers vary by country, institutional type, and financial services provided. FATF Recommendation V states that "for higher-risk categories, financial institutions should perform enhanced due diligence. In certain circumstances, where there are low risks, countries may decide that financial institutions can apply reduced or simplified measures."[12] For example countries could exempt non-depository institutions that offer low-risk financial products and have no link to the payments system.
- ***Create appropriate exemptions.*** FATF recommendations recognize governments' discretion to exempt low-value transactions that fall below a certain threshold from AML/CFT requirements. For example, FATF Special Recommendation IX requires cash couriers to declare amounts exceeding a pre-set maximum threshold of US $15,000.[13] Associations of financial service providers that serve low-income clients would be well advised to use this approach to negotiate with their respective governments to reduce or eliminate the AML/CFT regulation requirements applicable to them for transactions below a specified threshold value.

As financial institutions serving low-income people face rising pressure to comply with increasingly strict AML/CFT regimes in many countries, they should seek to identify, understand, and comply with the local laws and regulations applicable to them.[14] Even where there is no national AML/CFT regime or where national supervision capacity is weak, institutions should take the initiative to establish measures based on internationally-accepted practices to protect themselves

[11] See Genesis Analytics, "Access to Financial Services."

[12] FATF, 2003, *The Forty Recommendations*, www1.oecd.org/fatf/40Recs_en.htm

[13] FATF Special Recommendation IX and its interpretative notes, www1.oecd.org/fatf/SRecsTF_en.htm#IX.%20Cash%20courriers

[14] For a list of existing national legislation that has created compliance regimes with AML/CFT regulations, see the FATF web site, www1.oecd.org/fatf/Legislation_en.htm.

Box 6 South Africa's Customer Due Diligence Framework

South Africa was admitted as the fifth developing-country member of FATF in June 2003. The Financial Intelligence Centre Act (FICA) of 2001 established the Financial Intelligence Centre (FIC) as the unit within the South African National Treasury responsible for surveillance of suspicious transactions and coordinating policy efforts to counter money laundering in the country. (Legislation to criminalize terrorist funding is currently being developed by the parliament.)

FICA covers a broad range of institutions, from banks and insurance companies to money remitters. Non-depository microfinance institutions are not specifically covered unless they remit money, but regulated institutions which offer products at the low end of the market are "accountable" under the legislation.

To date, the FIC has promulgated regulations that govern customer due diligence and require "accountable" institutions to report suspicious and unusual transactions. These "know your customer" regulations, which applied to new clients as of June 2003 and were phased in for existing clients beginning in 2004, follow international precedent and require financial institutions to verify identity number, date of birth, income tax number (currently exempt due to system-related issues), and residential address "by comparing these particulars with information which can reasonably be expected to achieve such verification and is obtained by reasonably practical means." In practice, the latter has been interpreted by the banking sector to require utility bills, as is common in other countries.

Many low-income clients have no tax number and are unable to produce third-party verification of address—as an estimated one third of SA households have no formal address. These requirements therefore prevent low-income and/or some self-employed people from opening bank accounts.

A guidance note was issued by the FIC in April 2004 that advocates a risk-based approach for client identification and verification. A compliance exemption (Number 17) in the FICA law relaxes the "know your customer" requirements for a category of clients known as "mass banking clients." The exemption applies to accounts that have a maximum balance at any time of around US $4,000, that limit the size of deposits or withdrawals, and that do not have the ability to transfer funds internationally.

Because of difficulties in applying this exemption, the Money Laundering Advisory Council raised the issue with the minister of finance in June 2004. He requested proposals from the Council for an exemption to promote the national priority of greater access to financial services. This resulted in the issuance of a revised exemption regulation in November 2004 that gives greater clarity and addresses industry concerns about customer due diligence requirements for low-income clients. However, informed commentators have proposed that changes should go further to eliminate the need for a tax payer number and the verification of address except where there are grounds to suspect it is false.

Source: FIC: www.fic.gov.za; Genesis Analytics, "A Brief Case Study of the Effect of the Implementation of the FATF Recommendations"; L. de Koker, "Client Identification and Money Laundering Control: Perspectives on the FIC Act 38 of 2001."

from being used for money laundering and the financing of terrorism. Financial service providers that serve low-income clients should develop an AML/CFT policy that identifies areas of risk based on their country, client, and product profiles, and strengthens institutional capacity. Based on the implications of planned or existing laws and regulations, microfinance institutions should engage policy makers and law enforcement experts in dialogue about changes where such laws and regulations could potentially affect their operations.[15]

In the post 9/11 world, AML/CFT regulation cannot be ignored. This area of regulation is a young and rapidly developing field, and there is scope for further work to explore the particular challenges facing institutions serving low-income clients in complying with the new regulations. However, measures that drive low-income people back to informal means of saving and credit will be counter-productive and make it even harder to secure the integrity of the financial system. It is therefore in everyone's interests—regulators and institutions alike—to grapple with these issues and develop solutions that accommodate low-income clients.

[15] See FATF Methodology 31.2. Associations of financial service providers that serve poor clients would benefit from participation in reviews of their national systems for combating money laundering and financing of terrorism.

Annexes

Annex 1: Microfinance Institutions and Other Financial Service Providers that Serve Low-Income People

A microfinance institution (MFI) is an entity in the business of providing financial services to low-income people. The original focus of modern microfinance was on the provision of micro-credit—small loans usually for short periods to finance working capital for microenterprises usually run by low-income people. However, the field of microfinance has broadened greatly beyond credit only, to include micro-savings, micro-insurance, remittances, and other payments, all of which can have a great impact on the lives of the poor.

As the field has broadened, so has the recognition that a wide variety of entities provide these services, well beyond the non-profit organization model that dominated the early days of modern microcredit. Some of the original institutions have commercialized and expanded to become regulated financial institutions, such as banks. Some conventional banks have launched successful retail strategies to reach microfinance clients. Today, financial service providers who cater to low-income clients take a wide variety of legal forms.

Recent CGAP research has established that there exist many financial institutions which had traditionally been excluded from definitions of the microfinance market, but which provide services to as many as 750 million account holders who are mainly low-income people across the globe.§ These include credit unions and co-operatives as well as postal savings, and rural and agricultural banks, which remain important in developing countries. Figure A1 below, excerpted from the paper, gives an indication by region of the number

§ Excerpts from CGAP Occasional Paper 8, *Financial Institutions with a "Double Bottom Line": Implications for the Future of Microfinance*, www.cgap.org/docs/OccasionalPaper_8.pdf.

Figure A1 Combined Loans and Savings Accounts in AFIs* (in thousands)

Region	MFIs**	Co-ops and credit unions	Rural banks	State/ agricultural/ development banks	Postal banks	Total	% of total
AFR	6,246	5,940	1,117	634	12,854	26,790	4%
EAP (incl. China)	81,430	12,145	6,054	78,772	141,005	319,406	48%
China only	154	200	–	46,570	110,000	156,924	24%
ECA	495	5,692	–	28	11,503	17,718	3%
MENA	1,422	11	–	30,712	16,980	48,670	7%
SA (incl. India)	25,825	2,434	11,623	61,980	136,383	238,245	36%
India only	5,589	392	–	57,821	124,010	187,812	28%
Total	120,573	34,843	18,955	172,207	318,450	685,028	100%
% total	18%	5%	3%	26%	48%	100%	

Key
AFR— Africa (sub-Saharan)
EAP— East Asia and the Pacific
ECA— Europe and Central Asia
LAC— Latin America and the Caribbean
MENA— Middle East and North Africa
ECA— Europe and Central Asia
SA— South Asia

* For institutions reporting numbers of loans and savings accounts, only the larger of the two numbers is included in this table.
** Includes NGOs, banks, and non-bank financial institutions that specialize in microfinance, as well as microfinance programs in full-service commercial banks.

Source: CGAP

of accounts held by low-income people in these financial institutions.

The CGAP paper distinguishes the following groupings with the broad AFI sector:

- ***Specialized MFIs.*** These MFIs are non-governmental organizations or officially licensed non-bank financial institutions. Some MFIs have become licensed (and are supervised by governmental financial authorities) to provide voluntary deposit services to their target clienteles and to fund themselves either with deposits captured from the public or from commercial funding.
- ***Commercial bank MFIs.*** As a group, commercial banks do not share the social objectives that characterize most of the AFIs, or alternative financial institutions. Nevertheless, a number of specialized MFIs are organized as commercial banks. In addition, a number of commercial banks have created specialized microfinance services or departments in addition to their more conventional operations.
- ***Financial cooperatives (including credit unions).*** This category embraces a wide range of member-owned savings and loan institutions. Membership is usually based on some "common bond" (e.g., employment at a company or residence in a village).
- ***Low-capital rural and/or local banks.*** Several countries offer a special license for small, locally owned, non-cooperative financial intermediaries (e.g., Philippine Rural Banks, Indonesian BPRs, Nigerian Community Banks, Ghanaian Rural Banks, and Chinese Rural Credit Cooperatives). Some of these institutions are owned by individuals, others by a combination of local and regional governments.
- ***State development and agricultural banks.*** In order to reach sectors that commercial banks do not serve, many governments have established state-owned banks to promote agriculture or other perceived development priorities. These banks are often large.
- ***Postal savings banks.*** Many countries take advantage of their postal infrastructure to provide financial services. Postal banks usually do not make loans: their services are limited to savings and payments/transfers. Account and transaction sizes tend to be quite small.
- ***Non-postal savings banks.*** This category includes both private and public institutions. The latter are often very large. As the name suggests, they are heavily savings-focused.

Annex 2: Recommended Actions for Financial Service Providers that Serve Low-Income Clients

AML/CFT measures seek to promote international standards for transparency in financial transactions and protect the integrity of the financial sector. FATF takes into consideration the diverse legal and financial systems of countries worldwide and recommends minimum standards that should be implemented depending on the specific characteristics of each country. FATF recommendations outline criminal justice and regulatory measures for country regulators, preventive measures to be taken by financial institutions and other financial service providers, and international cooperation efforts (including information sharing).†

Table A2 suggests some actions that financial service providers can take to move towards AML/CFT compliance regardless of the status of their country's compliance with international AML/CFT guidelines.

† See FATF web site, www.fatf-gafi.org/dataoecd/38/47/34030579.PDF

Table A2 AML/CFT Measures

AML/CFT Measures	Recommended Actions for Financial Service Providers that Serve Low-Income Clients
Internal controls *(See FATF Recommendation XV and interpretive note.)* Institutions should develop internal programs against money laundering and financing terrorism with regard to their risk for abuse and the size of business.	Financial service providers that serve low-income clients should consider forming an association on AML/CFT, discussing AML/CFT within an existing industry association, and/or liaising with the AML/CFT committee formed by the government to design internal policies and establish common practices. Establishing new internal programs may require changes to client-intake forms and procedures, information systems, transaction monitoring, human resource policies, and internal controls. Examples include: • Presenting AML/CFT policies in a manual that is easy to disseminate among employees • Establishing internal thresholds for transfer amounts in order to detect suspicious transactions • Providing annual training for employees on AML/CFT issues and compliance requirements • Conducting in-depth background checks on potential employees, shareholders, and board members • Ensuring that controlling interests, governance, or management positions in the institution are not held by criminals and their associates • Verifying that donations and contributions are from legitimate sources

Table A2 AML/CFT Measures (con't.)

Customer due diligence *(See FATF Recommendations V, VI,VIII, and interpretative notes, where applicable.)* Financial institutions are required to be able to identify and verify the identity of their clients and the nature of the businesses and ownership structures of the entities that they serve. Anonymous and/or non-face-to-face business transactions and new technologies that encourage anonymity are particularly risky and should receive special attention. According to FATF, "the general rule is that customers should be subject to the full range of customer due diligence measures. However, there are circumstances in which it would be reasonable for a country to allow its financial institutions to apply the extent of the customer due diligence measures on a risk-sensitive basis."‡ ‡ FATF, 2004, "FATF Methodology for Assessing Compliance with the 40+9 Recommendations"; FATF Recommendation V and interpretative note.	For financial service providers that serve low-income clients, implementing "know-your-client" and customer due diligence measures would require: • verifying the identities of new and existing customers; and • obtaining executive approval within the institution to establish any relationships with politically exposed persons (PEPs)◆ and then continually monitoring the relationship. ◆The FATF *Forty Recommendations* Glossary defines politically exposed persons, PEPs, as individuals who are or have been entrusted with prominent functions in a foreign country, for example, heads of state of government; senior politicians; senior government, judiciary or military officials; senior executives of state-owned corporations; and important political party officials. Business relationships with family members or close associates of PEPs involve reputation risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories.
Surveillance and record keeping *(See FATF Recommendations X, and XI, and interpretative notes, where applicable.)* Institutions are encouraged to monitor transactions and keep detailed, efficient transaction records to facilitate swift information sharing with competent authorities.	For financial service providers that serve low-income clients, surveillance and record keeping would require: • ensuring that their information systems are adequate to maintain transaction records. Financial service providers in some jurisdictions may be required to keep all physical documentation of transactions for defined periods. • paying special attention to all complex, unusual, or large transactions; and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose; and keeping record of the background and purpose of such transactions. Some financial service providers have further developed systems, aided by available software or changes to their existing transactions processing and client information systems, to reduce the operational cost and time required to comply with this requirement.
Reporting Suspicious Transactions *(See in particular Recommendations XIII, XIV, and XV, plus the interpretative notes.)* Institutions have an obligation to promptly document and report all suspicious transactions to their national financial intelligence unit, or FIU (see box 3 in the text), the administrative body charged with ensuring national compliance with AML/CFT measures.†† Competent authorities have the responsibility to establish guidelines, together with feedback mechanisms, to assist all relevant institutions, including pro-poor institutions, to implement AML/CFT measures. (Countries should consult FATF "Best Practice Guidelines," 1998.) †† All institutions and their employees should have legal protection from civil or criminal liability that results from reporting suspicious activity and, as required by law, should keep the facts of such cases confidential.	Financial service providers that serve low-income clients can handle suspicious transactions by liaising with their national FIUs and developing systems of monitoring and reporting suspicious transactions; and reporting suspicious transactions to law enforcement and competent authorities, in the case that the country does not have an FIU.

Annex 3: List of FATF and FATF-Style Regional Body Country Members

The list in Table A3 shows the countries, territories, and organizations that make up the membership of the FATF and the various regional bodies. The FATF-style regional bodies (FSRBs) have similar form and functions to those of the FATF, and some FATF members are also members of these bodies.

Table A3 FATF and FATF-Style Regional Body (FSRBs) Country Members

FATF	APG	CFATF	EAG	ESAAMLG
Argentina	Australia	Anguilla	Belarus	Botswana
Australia	Bangladesh	Antigua & Barbuda	Kazakhstan	Kenya
Austria	Brunei Darussalam	Aruba	Kyrgyzstan	Malawi
Belgium	Chinese Taipei	Bahamas	China	Mauritius
Brazil	Cook Islands	Barbados	Russia	Mozambique
Canada	Fiji	Belize	Tajikistan	Namibia
China (observer)	Hong Kong, China	Bermuda		Seychelles
Denmark	India	British Virgin Islands		South Africa
European Commission	Indonesia	Cayman Islands		Swaziland
Finland	Japan	Costa Rica		Tanzania
France	Macau, China	Dominica		Uganda
Germany	Malaysia	Dominican Republic		
Greece	Marshall Islands	Grenada		*Not signed MOU*
Gulf Co-operation Council	Nepal	Haiti		Lesotho
Hong Kong, China	New Zealand	Jamaica		Zambia
Iceland	Niue	Montserrat		Zimbabwe
Ireland	Pakistan	Netherland Antilles		
Italy	Republic of Korea	Nicaragua		
Japan	Palau	Panama		
Luxembourg	Philippines	St. Kitts & Nevis		
Mexico	Samoa	St. Lucia		
Kingdom of the Netherlands	Singapore	St. Vincent & the Grenadines		
New Zealand	Sri Lanka	Suriname		
Norway	Thailand	Trinidad & Tobago		
Portugal	United States	Turks & Caicos Islands		
Russian Federation	Vanuatu	Venezuela		
Singapore				
South Africa				
Spain				
Sweden				
Switzerland				
Turkey				
United Kingdom				
United States				

GAFISUD	GIABA*	MENAFATF	MONEYVAL
Argentina	Benin	Algeria	Albania
Bolivia	Burkina Faso	Bahrain	Andorra
Brazil	Cape Verde Islands	Egypt	Armenia
Chile	Gambia	Jordan	Azerbaijan
Colombia	Ghana	Kuwait	Bosnia and Herzegovina
Ecuador	Guinea	Lebanon	Bulgaria
Paraguay	Guinea-Bissau	Morocco	Croatia
Peru	Ivory Coast	Oman	Cyprus
Uruguay	Liberia	Qatar	Czech Republic
	Mauritania	Saudi Arabia	Estonia
	Mali	Syria	Georgia
	Niger	Tunisia	Hungary
	Nigeria	United Arab Emirates	Latvia
	Senegal	Yemen	Liechtenstein
	Togo		Lithuania
			Moldova
			Malta
			Monaco
			Poland
			Romania
			Russian Federation
			San Marino
			Serbia and Montenegro
			Slovakia
			Slovenia
			The Former Yugoslav Republic of Macedonia
			Ukraine

* Currently FATF observer, in the process of becoming an FSRB

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