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Emerald Article: Aligning anti-money laundering, combating of financing of terror and financial inclusion: Questions to consider when FATF standards are clarified

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Aligning anti-money laundering, combating of financing of terror and financial inclusion

Questions to consider when FATF standards are clarified

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Abstract

Purpose – The purpose of this paper is to identify key questions that should be addressed to enable the Financial Action Task Force (FATF) to provide guidance regarding the alignment of anti-money laundering, combating of financing of terror and financial inclusion objectives.

Design/methodology/approach – The paper draws on relevant research and documents of the FATF to identify questions that are relevant to consider when it formulates guidance regarding the alignment between financial integrity and financial inclusion objectives.

Findings – The FATF advises that its risk-based approach enables countries and institutions to further financial inclusion. It is, however, not clear what the FATF means when its uses the terms "risk" and "low risk". It is also unclear whether current proposals for financial inclusion regulatory models will necessarily limit money laundering (ML) as well as terror financing risks to levels that can be described as "low". The FATF will need to clarify its own thinking regarding low money laundering and low terror financing risk before it will be able to provide clear guidance to national regulators and financial institutions.

Originality/value – This paper was drafted to inform current FATF discussions regarding guidance on financial inclusion. The questions are relevant to all stakeholders in financial regulation.

Keywords Terrorism, Money laundering, Financial inclusion, Financing of terrorism, Customer due diligence

Paper type Conceptual paper

1. Introduction

The Financial Action Task Force (FATF) has agreed to provide greater clarity regarding the application of the 40 + 9 Recommendations, the international anti-money laundering (AML) and combating of terrorist financing (CFT) standards, in relation to financial inclusion initiatives (Uruttia Corral, 2010). Amendments to the

A draft of this paper was circulated in December 2010 to generate discussion regarding aspects of the guidance that the FATF is drafting in respect of financial inclusion. It was also submitted to the FATF secretariat as part of the FATF public consultation on its review program and for use by the drafters of the financial inclusion guidance paper. Oral and written comments were received from a number of parties, including Richard Chalmers, Emery Kobor, Lindsay Chan, Pieter Smit, Raadhika Sihin, Andrew Zerzan, Marina Solin and Roger Clarke. Their comments are acknowledged with appreciation but the author accepts full responsibility for the views expressed herein.

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Recommendations and their interpretative notes are being discussed as part of the current processes to review the Recommendations in preparation for the fourth round of mutual evaluations (FATF, 2010c). The FATF has also agreed to develop guidance on AML/CFT and financial inclusion in partnership with the Asia/Pacific Group on Money Laundering and the World Bank.

FATF attention to financial inclusion matters has been long awaited[1]. Countries and institutions have struggled to ensure that their AML/CFT controls do not unnecessarily bar socially vulnerable persons from accessing formal financial services (Bester *et al.*, 2008; World Savings Banks Institute, 2009). The FATF's attention is mainly focused on high-risk clients and transactions. Questions relating to financial inclusion initiatives are generally linked to low-risk matters and the challenges faced in relation to financial inclusion were regarded as peripheral to the FATF's work. However, growing international support for financial inclusion, especially the G20 support, brought the matter squarely onto the FATF agenda in 2010.

If the FATF succeeds in skillfully aligning financial inclusion and AML/CFT, the standards will provide better support for formalized financial services for millions of additional clients who are currently using informal cash-based services. To support financial inclusion, the FATF will need to clarify the conditions under which minimal AML/CFT controls can be imposed on low-risk products and also provide greater clarity in respect of those cases where countries may choose not to apply any AML/CFT controls at all. This will require the FATF to consider some of its basic objectives, whether they can be attained with simplified AML/CFT controls and whether low-value products should be excluded from these objectives. Failure to provide clear and principled guidance may produce an outcome that may actually weaken the current standards while still leaving questions that would continue to impede financial inclusion initiatives.

The FATF's task to align AML/CFT and financial inclusion is complicated by the absence of reliable money laundering (ML) and financing of terrorism (FT) risk data regarding the relevant financial products. The lack of reliable information may lead to an over- or under-estimation of the risks posed by the relevant products. Guidance based on assumptions rather than evidence and appropriate risk assessments may also undermine the more principled and fact-based AML/CFT risk assessment approach that the FATF is advocating.

This paper identifies a number of key matters that should be pondered when the FATF considers appropriate ways to align financial integrity and financial inclusion. It is not primarily intended to provide answers although the questions that are being put do reflect the author's views regarding potential answers and solutions[2]. The most appropriate answers for purposes of the FATF processes would, however, be formulated after open and intensive evidence-based debate at an international level. Neither is the note intended to summarize all the questions that should be posed in this process[3]. In the interests of space and time, this paper is deliberately limited to key questions that will support the formulation of principled guidance that could align financial inclusion and AML/CFT objectives.

2. Financial inclusion initiatives

Financial inclusion, simply defined as providing access to financial services for all (CGAP, 2009, p. 1), has gained prominence as an international policy initiative to combat poverty (Demirgüç-Kunt *et al.*, 2008). Financial inclusion initiatives are primarily aimed at low-income individuals and micro enterprises. Initially, the objective was to facilitate their access to micro credit. The drive expanded, however, to micro savings products and to micro insurance.

Different factors contribute to the current lack of access to financial services (Access Through Innovation Subgroup of the G20 Financial Inclusion Experts Group, 2010, p. 9). Potential barriers include geography (e.g. limited presence of financial institutions in thinly populated rural areas), product design (e.g. high minimum balance requirements or usage requirements), costs (e.g. standard fees that are too high for socially vulnerable clients), marketing practices (e.g. financial products that are marketed as aimed at wealthy clients), language barriers (where forms and marketing materials are not available in the language of the socially vulnerable groups) and identification requirements (e.g. processes that require potential clients to prove their identity with documents that are not readily available to socially vulnerable groups) (Isern and de Koker, 2009). The FATF will need to be mindful of barriers such as these because it should not unnecessarily exacerbate existing barriers or construct new ones. In addition, it will need to understand some of the realities and implications of financial inclusion business models:

- *Successful financial inclusion initiatives will add millions of new financial services clients.* The client base of financial services providers will expand dramatically. While there is space for development of the client base in many developed countries, the most spectacular growth will be seen in developing countries. Higher levels of financial inclusion will hold many social benefits but will also add to the current pressures on regulators and law enforcement agencies in those jurisdictions[4].
- *Underserved clients are diverse and client groups have different risk profiles.* The majority of underserved clients are low-income persons. However, in many countries factors such as culture and geography resulted in the exclusion of many higher income persons too. Underserved groups often include rural communities, women, undocumented migrants, prisoners and former prisoners as well as bankrupts. Risk profiles of groups and sub-groups of underserved clients may differ widely within a country and different country contexts may also lead to similar groups displaying different profiles in different jurisdictions. In some jurisdictions, for instance, underserved clients are actively involved in crimes such as opium production, illegal logging and terrorism. The term "underserved clients" therefore refers to a very diverse group of people with very different client risk profiles. As a consequence, regulators and institutions cannot simply classify all underserved clients as low-risk clients merely because they are financially excluded. On the other hand, appropriate risk assessment and customer due diligence (CDD) measures will be required if institutions have to differentiate between groups of underserved clients.
- *New providers and new provider relationships are emerging, challenging the traditional approaches of policymakers and regulators.* New business models, new partnerships and new providers are emerging to provide services to the underserved. Mobile money initiatives are particularly promising (Chatain *et al.*, 2011). Some of these initiatives are led by partnerships between banks and telecommunication

service providers but in some cases the telecommunications service providers are taking the lead role in the provision of these services (Chatain *et al.*, 2008, 2011). The mobile money business models rely on small, low-capacity retailers to perform cash-in and cash-out functions that would otherwise be performed by more expensive bricks and mortar agencies and bank branches. Key role players in these services are therefore very different from the traditional providers of financial services. They will require appropriate regulation and regulatory resources. Requirements and solutions may differ from country to country and model to model.

- *Regulators should not weigh down financial inclusion business models with unnecessary compliance costs.* There are question marks hanging over the profitability of many of the new business models to enhance financial inclusion (with M-PESA in Kenya as one of the notable exceptions). Financial inclusion clients are extremely cost sensitive and business models are less able to allow costs to flow through to clients. Compliance costs are a significant cost factor for service providers and regulation that imposes unnecessarily high compliance costs may render key business models unviable. Regulators must therefore take great care when they design appropriate compliance obligations for these providers. Ideally, such obligations should be restricted to the essential. When determining what is essential, regulators should, however, be careful not to sacrifice the integrity of the services or the protection of the clients in order to ensure broader coverage.
- *Many financial inclusion business models will rely on technology and indirect and non-face-to-face client interaction.* The need for affordability and geographical reach will lead many providers to rely on technology and non-face-to-face transactions. Mobile phones, the internet and ATMs will feature prominently in these models. Retailers as agents, independent contractors and third parties, both for cash-in and cash-out functions, as well as client take-on and account opening procedures, will play a key role in major models.
- *Restricted, no frills financial products are developed for financially excluded clients, but there is a need for access to additional products too.* A number of countries balance AML/CFT and financial inclusion objectives by allowing simplified CDD measures in relation to products that are subject to stringent usage restrictions, for instance, transactional restrictions (e.g. capping the value of transactions that may be conducted daily or by excluding cross-border transactions or functionality) or balance restrictions (e.g. that the balance in an account may not exceed a stated amount). Restricted financial products serve basic needs but the needs of the underbanked are diverse. Occasionally, there may be a need to transact outside such restrictions, especially in cases of emergency, for example, when a family member dies or when an extraordinary payment is due, for instance, after a workplace injury. AML/CFT barriers that were removed in respect of basic products, may be encountered by such users when they need to access unrestricted products. Restrictions also impact on the attractiveness of the product from both a service provider and a client perspective[5].
- *Innovative developments will take place in low-capacity countries.* Many innovative developments will take place in low-capacity countries. These countries have a limited ability to enable cheap and secure means for residents to verify

their identities. Their regulators also have limited capacity and this capacity will be further stretched by the new developments.

- *Discussions regarding regulatory frameworks for financial inclusion business models are currently not informed by reliable data regarding the ML/FT risk profiles of different models.* Numerous financial inclusion models are being piloted around the globe. Most are functioning within regulatory frameworks that were shaped around their low-risk profiles. However, very little data about the financial integrity of these models have yet been gathered[6]. Key data about actual forms and levels of criminal abuse of these products that could have informed the FATF's financial inclusion deliberations are therefore not available. Evidence that is available, is of doubtful quality. It is mostly anecdotal or limited in time, range and context[7]. In a number of cases, regulators and businesses have provided information that is not complete or reflective of reality. Interesting ideas and models have therefore been proposed or implemented, but whether they succeed in balancing access and integrity successfully, has not yet been proved conclusively. Best practice approaches that have been tried and tested and have shown themselves to balance financial inclusion and AML/CFT successfully, have therefore not emerged yet.

3. Questions that should be considered when FATF standards are clarified

The brief summary of some of the implications and realities of financial inclusion business models above highlights a few of the aspects that will need to be considered by the FATF (2010a, pp. 66-71). However, it is important that the FATF also turns its attention to its own framework and principles. Solutions to financial inclusion challenges will need to be grounded upon the FATF's own principles otherwise they may undermine the broader AML/CFT framework. Some of these principles are not clearly expressed and members may hold different views on their interpretation and application. Consensus regarding more fundamental matters will, however, support a constructive and intellectually honest engagement of the financial inclusion challenges.

It is submitted that the following questions should be answered to ensure a constructive discussion:

- Is AML/CFT primarily geared to preserving the financial integrity of formal financial services?
- Is AML/CFT primarily exclusionary or inclusionary?
- What is meant by CDD in an era of modern mass provision of financial services in high- and low-capacity countries?
- Is it valid to view account-based financial products as more vulnerable to ML/FT abuse than occasional (non-account-based) transactions?
- What is the definition of "risk", "high(er) risk" and "low(er) risk" for purposes of a risk-based approach to AML/CFT?
- What are appropriate controls to impose on financial inclusion products?

The discussion that follows does not propose to answer these questions but attempts to explain why the question is relevant[8].

3.1 Is AML/CFT primarily geared to preserving the integrity of formal financial services?

The impact of AML/CFT on the ability of socially vulnerable people to access financial services has been under discussion for many years. Various countries (the UK, the USA, South Africa, etc.) experimented with simplified client identification and verification measures, but there was no clear indication whether their solutions met the FATF standards (Bester *et al.*, 2008). In a number of conference discussions, concerns were raised that these simplified measures eroded the quality of AML/CFT controls by providing criminals with backdoors into formal financial services[9].

In 2005, a study was launched to consider the impact of AML/CFT in five developing countries. The draft report was circulated in 2007 to the FATF, the Basel Committee on Banking Supervision, and various FATF-style regional bodies. The report was finally published in 2008 (Bester *et al.*, 2008). The authors of the report defused the erosion argument by arguing that financial inclusion and financial integrity are complementary policy objectives (Bester *et al.*, 2008, p. vi):

> 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.

This argument resonated with the 2009-2010 President of the FATF, Paul Vlaanderen. In an address to the ESAAMLG Ministers at a meeting in Lesotho in August 2009, he stated the following (Vlaanderen, 2009):

> I do believe that the pursuit of financial inclusion and the pursuit of an effective AML/CFT regime are complementary; they are by no means conflicting financial sector policy objectives. Without a sufficient degree of financial inclusion, a country's AML/CFT system will 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 enlarges the legitimate financial sector. A robust financial sector, including effective AML/CFT controls, are important ingredients for aspiring members of the global financial community[10].

The complementarity argument speaks to the absurdity of a narrow AML/CFT focus in countries with low levels of financial inclusion. For example, if Tanzania has an effective AML/CFT system in respect of the banking sector, the system can impact on the integrity of transactions of the 9 percent of the population with bank accounts[11]. It will fail, however, to safeguard the integrity the transactions of the vast majority of Tanzanians who can only transact informally[12].

This argument, however, assumes that the FATF concerns itself with financial integrity in the economy as a whole. FATF's initial 1989 brief was more limited. It was tasked with identifying measures to safeguard the banking sector and bureaux de change against abuse. This brief quickly broadened to financial institutions and later to designated non-financial businesses and professions. Although some of its

Recommendations and work range broader[13], FATF has not yet explicitly adopted a brief encompassing the economy as a whole.

If the FATF does acknowledge such a wider brief, it also needs to consider the implications of such a brief. It may require the drafting of additional Recommendations or at least amendments to its current Recommendations to ensure that the FATF addresses in greater detail all institutions in the formal economy that are vulnerable to ML/FT abuse. The FATF will also need to address integrity concerns relating to the informal and cash economy. It is submitted that such a brief will necessitate standards regarding government policy in relation to informal economic activity, the quality of a country's financial inclusion policy, its policy on regulation and regulatory scope as well as regulatory capacity building and its efforts to improve the ability of citizens to prove their identities. These matters will not be merely peripheral but part of the core standards and actions to mitigate ML/FT risk in the economy as a whole. These matters will also be investigated during mutual evaluations and elicit a compliance rating.

Government action that may actually grow the cash economy will also need to be considered. This would include bureaucratic red tape that may prevent registration and formalization of informal businesses, tax and tax enforcement policies that incentivizes informality and also the issuing of high-denomination banknotes. Such notes lend themselves to ML abuse. They enable criminals to transact informally and to convey large cash amounts with ease. The issuing of high-denomination notes is currently addressed by Recommendation 20 but the FATF has not been particularly vocal about this abuse. In this regard, the EUR 500 note is particularly problematic. According to a recent Citibank report 570 million EUR 500 notes to the value of EUR 285 billion are in circulation. They account in value for 35 percent of all Euro notes. The value of the EUR 500 notes in circulation grew by 32 percent per year since they were first issued in 2002[14]. In 1999, the FATF voiced concern about the then proposed EUR 500 note (FATF, 1999, para. 18) but these concerns were ignored. Evidence has since emerged that the EUR 500 note is a note of choice for bulk cash smugglers[15].

If the FATF fails to take action on matters such as these, it will not only be failing to act in accordance with the broader brief, but will also provide space for the abuse of the complementarity argument: the argument allows a country to implement simplified AML/CFT controls to facilitate access to the formal economy in order to counter the criminal abuse of the informal sector of its economy. If the country is not required to take active steps to formalize the informal sector, the simplified measures can become entrenched[16]. If the country actively or passively grows its informal economy, it may even argue for a further relaxation of AML/CFT controls given the increased threat posed by the larger informal economy. Failure to ensure that countries address the drivers of informal economic activity, may therefore gradually undermine the general AML/CFT scheme.

3.2 Is AML/CFT primarily exclusionary or inclusionary?

Is the primary objective of AML/CFT to keep criminal money out of regulated financial services or to have criminal money flows observed and reported? This question is closely linked to the one above.

Regulators, for instance, generally regard it as a primary duty to keep dirty money out of the sector that they regulate. Intelligence agencies, on the other hand, would rather want regulated institutions to take on criminal clients, identify them as such through appropriate CDD measures and report their suspicious activities to the authorities.

If AML is aimed at keeping criminals out, the purpose of CDD would be to identify undesirable clients to ensure that they are denied services. This is, for instance, the purpose of sanction schemes, for instance, those relating to terrorist financing.

If the aim is to include as many clients as possible to monitor their financial transactions, CDD should be aimed at identifying and profiling clients. Profiling information supports effective transaction monitoring.

When this question is settled, it is important to consider the impact of the answer. If AML/CFT is primarily inclusive, client profiling should feature more prominently in simplified CDD measures[17]. The alignment between the inclusivity of the standards and the exclusivity of the international terrorist financing sanctions regime should also be considered and addressed. The FATF should furthermore consider how this message is relayed to financial institutions and how they are incentivized to take on higher risk clients to support the FATF's broader crime intelligence gathering objectives.

If AML/CFT is primarily exclusive, financial institutions will tend to exclude criminal clients as well as honest clients who are not able to prove their credentials. This will especially happen where the risk mitigation measures in relation to such clients are not justified by the fees that can be raised when they are retained as clients. Such exclusion will undermine financial inclusion initiatives and of course also the ability of the AML/CFT system to generate crime-combating intelligence.

3.3 What is meant by CDD in an era of modern mass provision of financial services in high- and low-capacity countries?

The FATF's CDD standards (often referred to as "Know Your Client" or "KYC" measures) reflect a somewhat quaint, developed country, banking-centric view of client relationships that is at odds with the reality of modern mass financial services.

The CDD principles and the related "KYC" language reflect an era of banking where bankers and clients had personal relationships, where accounts were only opened after introductions and interviews and where transactions were primarily processed by persons who knew the client and could be struck by patterns of transactions that are at odds with their knowledge of the client. By 1990, when the FATF adopted its original Recommendations, banking practice had already moved into the mass marketing and mass processing era. Society had also developed and changed. Clients in developed countries are generally time poor and have little desire to meet and spend time with representatives of their banks. Clients value their personal time and prefer to interact and communicate with banks through non-face-to-face methods. ATMs, internet banking, mobile banking and other forms of branchless banking provide clients with more convenient and impersonal ways of interacting with the banks. Banks support these developments as non-face-to-face service delivery is cheaper and more profitable. While an element of client interaction and actual client knowledge is still retained in high-value private banking, it is certainly not part of the majority of modern financial relationships.

Although the term "KYC" is used in relation to AML/CFT-related CDD, this phrase often refers in practice to little more than a bureaucratic collection of standard information relating to the client, some level of verification of the information provided and either manual monitoring of some transactions through sampling or electronic scanning of all transactions against set parameters. These parameters are not necessarily particularly effective at identifying transactions involving proceeds of crime[18], but electronic scanning is the most appropriate method to be employed in relation to the millions of transactions that a large modern provider of financial services processes daily. The identification and verification of clients is a key element of CDD. Yet, as is argued in Section 3.6.2, it is generally realized that these processes are generally bureaucratic in nature and their efficacy can be questioned.

Given the general challenges and flaws of CDD in practice, what are the objectives these processes can and should attain? What is the function of CDD in a low-capacity country that tries to extend financial services to residents whose names are not captured on a comprehensive national identity base, whose births may or may not have been registered and where clients do not possess reliable documents to verify their identities easily and securely?

What purpose is served by simplified CDD in those circumstances, where the process may not be able to deliver much in terms of information or reliability? Should the standard CDD process in these circumstances merely be simplified or should it be re-designed or even substituted? Simplification may simply erode the already limited effectiveness of the processes[19] and alternative processes that are introduced, may hold unintended consequences. Where regulations were amended to allow those who do not have formal proof of their personal particulars to present letters of affirmation drafted by their employers, it increased the power and hold of employers over vulnerable employees. In some cases where village chiefs were allowed to draft such letters, the chiefs started to demand money for these "verification services". As a consequence, low-income persons in these communities face an additional financial barrier if they wish to access formal financial services. In these cases, the AML/CFT solution may open space for corrupt practices and the abuse of power while the verification "fees" introduce a new financial barrier that may undermine financial inclusion. In addition, the actual verification value of such letters of verification should be considered with care. The level of authentication that they afford depends heavily on the actual knowledge and integrity of the person who verifies the particular facts and it is very difficult for financial institutions to determine whether the verifier is reliable and is acting with integrity. In many cases such letters simply serve to produce a document that meets the regulator's requirement for a piece of paper but does little to advance authentication.

3.4 Is it valid to treat low-value account-based financial products as more vulnerable to ML/FT abuse than occasional (non-account-based) transactions?

The FATF differentiates between CDD measures in relation to account-based products and those in relation to occasional (non-account-based) transactions, such as occasional money transfers and many prepaid cards. Recommendation 5 states that no financial institutions should keep anonymous accounts or accounts in obviously fictitious names. Identification and verification measures must therefore be taken in respect of account-based products, irrespective of the value concerned. Occasional transactions, on the other hand, are treated differently. Customers only need to be identified and their particulars verified if the value of the transaction exceeds USD/EUR 15,000 or, in the case of wire transfers, USD/EUR 1,000. This exemption is set out in the Recommendations and countries do not need to argue and prove that they pose a lower risk to justify the exclusion of these transactions from the standard FATF CDD controls.

It is submitted that such a distinction undermines a principled risk-based approach in relation to financial inclusion products. USD/EUR 15,000 is a vast sum from the perspective of low-income persons. The majority of low-value financial inclusion accounts that are targeted at the unbanked will not have an amount of USD/EUR 15,000 flowing through them during the duration of the account. However, in terms of the current scheme of the Recommendations, such accounts must be subjected to appropriate controls and cannot be opened anonymously, unless such an exemption can be justified on the basis of risk. Occasional transactions under the USD/EUR 15,000 limit often present a far higher risk but are automatically exempted by the FATF scheme. This is inconsistent from a risk-based perspective.

The distinction between account-based and non-account-based products is probably both historical and practical in nature. One of the key aims of the original Recommendations was to remove bank secrecy and to ban anonymous accounts. This may explain the stricter approach to account-based products. Pragmatically, extensive due diligence is less feasible in relation to occasional transactions. Clients may not readily have verification documentation on their person when they wish to conclude a once-off transaction. Monitoring is also of less value because most institutions will only transact once with a particular client. The lack of a pattern of transactions will undermine the effectiveness of any monitoring that might have been required.

While these reasons are understandable, it is submitted that this distinction must be reconsidered in view of the FATF's risk-based approach. In terms of a principled risk-based approach products that share the same risk profiles should be treated similarly, where feasible. Low-value account-based products and low-value occasional transactions should therefore benefit from similar exemptions where their risk profile is similar.

3.5 What is the definition of "risk", "high(er) risk" and "low(er) risk" for purposes of a risk-based approach to AML/CFT?

Many AML/CFT solutions to the financial inclusion challenges lie in a risk-based approach. The implications of this approach are emerging gradually as the FATF's own thinking about the risk-based approach develops and matures.

In 2003, the FATF introduced risk as an element that may shape specific elements of national regulation and the design of institutional controls. The FATF was cautious when it introduced the approach. There were fears that countries may abuse risk arguments to evade compliance with the Recommendations. As a result, the approach was limited to specific aspects of the Recommendations. In addition, the FATF determined that some aspects must be treated as creating a higher risk.

After an initial period of uncertainty about the risk-based approach, various guidance papers and reports on the implementation of the risk-based approach were issued (FATF, 2007). The guidance is helpful but their value is limited by a lack of conceptual clarity regarding the meaning of "risk". In 2010, the FATF acknowledged in its global risk assessment document that the meaning of these terms has not yet been settled in respect of AML/CFT (FATF, 2010a, p. 13):

> The terms risk, threat and vulnerability are often used by the FATF when describing how jurisdictions should implement AML/CFT standards. For example, the FATF has published a number of documents which address the concept of ML/TF risk. However, there is currently no standard or universal definition for these terms.

The FATF documents therefore set out processes to be followed as well as lists of indicators of high and low risk, without defining what is meant by “low risk” and “high risk”.

In the past, the FATF appeared to believe that its framework is sufficiently clear to enable regulators of developing countries to adopt simplified CDD measures in relation to low risk, low-value transactions. Mr Paul Vlaanderen, the FATF President for 2009-2010, for example, remarked as follows (Vlaanderen, 2009):

> The 40 plus 9 FATF Recommendations were designed with some degree of flexibility to allow developed and developing economies to implement them in a context-sensitive manner. However, the last few years show that developing countries have not always used this flexibility and simply fashioned their AML/CFT frameworks on the models of developed countries.

It is debatable whether the framework is sufficiently clear. Without definitions and conceptual clarity, it is very difficult to determine whether a particular model or proposal will meet the FATF requirements for low-risk classification. The FATF also underestimated the level of caution that its blacklisting and grey listing processes produced, especially for regulators and policymakers in low-capacity countries. The fear factor often results in a very and conservative interpretation of the FATF standards. In addition, some of the FATF statements have added to the uncertainty. For example, the FATF guidance on the risk posed by low-value transactions did not guide regulators to classify low-value transactions as low-risk transactions (FATF, 2007; De Koker, 2009b):

> It should be noted that transactions associated with the financing of terrorists may be conducted in very small amounts, which in applying a risk-based approach could be the very transactions that are frequently considered to be of minimal risk with regard to money laundering.

Although the statement is quite correct, it creates a regulatory quandary. Regulators must be mindful of both ML and FT risk when they design regulatory frameworks. If the FATF informs them that low-value transaction may (“could”) pose a minimal ML risk, but not necessarily a minimal FT risk, a cautious regulator will not treat these transactions as posing a low (combined) ML/FT risk.

FATF representatives have also referred to countries that provide examples of simplified CDD that may be considered by other countries. South African regulations feature prominently in FATF presentations as an example of steps that can be taken. Yet, the FATF’s *2008 Mutual Evaluation Report of South Africa* discussed its simplified CDD regime, without endorsing it explicitly. Elements of its simplified CDD regime were actually criticized as eroding record-keeping in relation to client identification and verification. In general, South Africa’s broad CDD and record-keeping requirements were rated as partially compliant with the FATF Recommendations (CGAP, 2010, p. 10). This is not a particularly strong official endorsement of the South African model. The tension between the official FATF rating of its financial inclusion model and the oral endorsement of this model by FATF representatives feeds regulatory uncertainty.

It seems as if the FATF has grown increasingly sensitive to the need for direction and its impact on regulators in low-capacity countries. Mr Luis Urrutia Corral, the FATF President for 2010-2011, for example, remarked as follows at the XVII Caribbean Financial Action Task Force Council of Ministers Meeting in 2010 (Uruttia Corral, 2010):

> Over the years, signals have reached the FATF that the FATF Standard is in some ways an impediment to financial inclusion, and perhaps the aforementioned unique enforcement structure has encouraged regulators and legislators to follow the FATF standard strictly without taking into account the type of customers envisaged by the term "financial inclusion". It is important for FATF to ensure that AML/CFT measures are not an impediment to the supply of financial services to the low-income sector.

It is submitted that the FATF can achieve this objective by adopting appropriate definitions and being more principled, clear and consistent in its guidance. This in turn will assist national regulators to act with greater confidence.

3.6 What are appropriate controls to impose on financial inclusion products?

AML/CFT and financial inclusion experts agree that AML/CFT controls for financial inclusion products must be sensible. The financial services industry appears to be lobbying for tiered or progressive identification and verification processes that would allow for the following (Solin and Zerzan, 2009; World Savings Banks Institute, 2009; Alexandre *et al.*, 2010; Chatain *et al.*, 2011):

- Basic account-based and occasional transaction products that may be offered anonymously (alternatively with client identification but no verification or with simplified identification and verification) as long as transaction and balance restrictions are imposed to mitigate risks.
- Higher levels of verification for products with more relaxed transaction and balance limits.
- Due diligence processes in relation to any agents that may be used (referred to as "Know Your Agent" or "KYA" processes).
- Monitoring of transactions to identify suspicious transactions.

The proposed approach, though sensible, is clearly too general to be effective in relation to all financial inclusion models irrespective of where they are employed. For a national regulator, therefore, key questions are:

- Will the proposed approach be effective to support AML/CFT and financial inclusion objectives?
- What is the value that each of the controls would add?

It is submitted that FATF should considered the following matters when it drafts guidance for national regulators:

- Is there room for anonymous products in the FATF framework?
- What is the difference between anonymity and identification in the FATF scheme?
- What are the advantages and disadvantages of a tiered CDD scheme?
- What do effective KYA measures entail in relation to small, informal retailers?
- What is the value of transaction monitoring in relation to basic financial products that are offered anonymously or in terms of a simplified CDD scheme?
- How do you prove or demonstrate that unproven new products are low-risk products?

- What are appropriate controls for financial inclusion products that cannot be rated as low risk, but moves users from high-risk informal transactions to formal and more controlled financial services?
- Should AML/CFT measures in relation to financial inclusion products be concerned with politically exposed persons (PEPs)?
- Should the FATF refer to specific minimum amounts in its standards?

3.6.1 Is there room for anonymous products in the FATF framework? The answer to this question is simple: yes. For example, the current FATF framework allows services to be provided anonymously in relation to occasional transactions below USD/EUR 15,000 or wire transfers below USD/EUR 1,000[20].

The space for anonymity has also been broadened by members of the FATF. The EU Third Money Laundering Directive, for instance, explicitly allows anonymous electronic money devices (prepaid cards) where, if the device cannot be recharged, no more than EUR 150 can be stored in the device. Where the device can be recharged, a general limit of EUR 2,500 is imposed on the total amount transacted in a calendar year, subject to some exceptions[21].

The question is therefore not whether the FATF allows some low-value financial inclusion products to be offered anonymously but how best to do so in the national environment and whether and how the resultant risks could be appropriately mitigated:

(1) What is the value and implications of transaction monitoring in relation to anonymous products (Section 3.6.5)?
(2) Are transaction caps the main risk control measure in relation to anonymous products and, if so, does that imply that the risk of small CFT transactions and low-level corrupt payments can be tolerated[22] (Sections 3.5 and 3.6.8)?
    - If such measures are only allowed in countries with low crime and CFT risk levels, how should such levels be determined and what levels will be classified as "low" for purposes of an FATF evaluation?
    - Where caps are the main risk control mechanism, what can feasibly be done to prevent clients from accessing more than one service from more than one service provider? Absence of appropriate controls means that caps can be circumvented by criminals simply by opening more than one account.

3.6.2 What is the difference between anonymity and identification in the FATF scheme? As part of its CDD standards, FATF's Recommendation 5 requires institutions to:

> Identify(ing) the customer and verify(ing) that customer's identity using reliable, independent source documents, data or information.

At face value, the requirement seems clear: business must combat ML and TF abuse by ensuring that they know the identity of their clients. In practice, however, this objective is elusive. Professional criminals are professional at identity fraud too and the identification and verification[23] systems of most institutions are just not sufficient and effective to identity sophisticated identity fraud, especially when it is not committed to cause financial loss to the institution. The quality of the identification and verification measures that an institution can implement is restricted by a number of factors, for example:

(1) *Costs*. It may be effective to research a client's background, but if the transaction is small such costs would not be commercially justifiable.
(2) *Client resistance*. Clients, especially potential clients, are mobile and will move to other institutions that are less intrusive or less bureaucratic in their account opening procedures.
(3) *Laws*. Privacy laws may restrict access to relevant information.
(4) *Internationalisation of the client base*. It is often more difficult to verify identities of foreign nationals because they may not be able to present verification documentation that is similar or equivalent to those that can be offered by citizens and it is more difficult to establish the integrity of such documents.
(5) *Consistency of identification particulars[24]*. Identifying particulars that an institution can gather may not be sufficiently consistent or reliable to support structured information management systems (names of clients may be subject to change, their addresses may be informal and/or may change often, etc.).
(6) Documents that can be used for verification, may not be highly reliable.

The last two factors are particularly problematic. The standard particulars that clients must furnish to institutions may not actually be of much value to ensure identification. In many countries, persons may use different names or may change the spelling of their names informally. Not all countries have national identification numbers and the integrity of the data of some who has, is tainted by corruption and maladministration. Many addresses may be informal and both formal and informal addresses may change frequently. In essence, the quality of identification and verification processes relies heavily on an effective public-private partnership. The state must determine how citizens will be identified and should ensure that each resident is able to do so effectively, securely and cheaply. Institutions on the other hand, must leverage off the system provided by the state and implement reasonable measures to ensure that they know who their clients are.

The FATF approach seems to lose sight of the relevance of this public-private partnership. This is possibly because the Recommendations were initially formulated by countries where public identification frameworks are in place and functioning well. As a consequence, the FATF focuses on the processes implemented by the institutions without actually considering the quality of the outcomes. A client will be therefore be "identified and verified" for AML/CFT purposes if the bank collected the client's personal particulars and verified the particulars against a government-issued national identity document, where that is available. Unfortunately, the quality of government documents in some countries may be problematic and the process may therefore fail to deliver a sufficient level of assurance. The FATF evaluation teams have, however, not consistently probed the reliability of a country's national identity documents. Some of these countries have received positive ratings for ensuring that institutions follow the prescribed processes even though the outcomes of those processes are of doubtful quality.

The use of the phrase "identification and verification" to refer to the due diligence processes rather than the outcome of the process has blurred the distinction between anonymity and identification[25]. A client would not be regarded as identified and verified unless he was subjected to the standard processes. As a result, a small financial services provider in a rural community who went to school with a client and knows his family well, will generally not be regarded as compliant if he does not subject the client to the formal processes. He will, on the other hand, be compliant if he subjects a new client to those processes even though the processes may not authenticate the client's actual identity. It is submitted that this approach should be revisited, especially in the context of financial inclusion products.

In the AML/CFT context, identification and anonymity as outcomes of the CDD process can be viewed as points on a continuum. In between, there are various other possibilities and grades of identification and levels of verification[26]. One such possibility is that the client is not identified upfront, but is identifiable. In such a case, various other bits of information may be triangulated in order to identify a client, when required[27]. For example, a mobile phone user may use the phone anonymously, but the phone usage data and patterns may enable law enforcement to identify the user. The phone may also act a tracking device enabling law enforcement to pinpoint the whereabouts of the user and apprehend the user. Although this may be time consuming, it will only be done when required. The current system requires all clients to be subjected to verification processes when the vast majority of the clients will never be of interest to law enforcement.

The emphasis on AML/CFT identification processes obscures some of the very real questions about the objectives of the processes. The objectives are relevant to the financial inclusion discussions because simplified CDD controls should at least be aimed at delivering the minimum. What is therefore the minimum that should be required by the international standards?

- What is the value of simplified identification and verification processes if standard processes are not able to reliably identify honest as well as criminal clients?
- Is it sufficient if a client is not identified upfront, but is identifiable or can be tracked and located?
- What does "identify" mean in a high technology, low-capacity context and when would a client cross the line between "identified" and "anonymous"?
- What is meant by "reliable, independent source documents, data or information" in a low-capacity country that lacks a reliable and comprehensive national identity scheme or commercial information covering the majority of the population?
- How should simplified CDD or anonymous products be reconciled with international obligations to deny financial services to listed terrorists or should the FATF press for an exclusion of low-risk products and transactions from the international sanctions scheme?

3.6.3 What are the advantages and disadvantages of a tiered CDD scheme? A tiered or progressive CDD scheme subjects clients accessing basic, low-risk products to no or very little CDD but requires higher levels of due diligence in respect of more comprehensive, higher risk products. Clients who wish to access only basic products are therefore not confronted by access barriers that may be posed by higher levels of CDD. Implicit in the discussion of tiered CDD is a suggestion that customers who access basic products are able to improve their formal standing and will be in a stronger position to meet higher due diligence requirements when they need to migrate to more complex products.

The success of a tiered CDD scheme depends of course on the design of the scheme as well as the products, for example:

- If the basic product is too basic, it may not meet the market demands.
- The CDD requirements must be informed by the ability of clients for those products to meet the requirements. Clients for basic products may not be able to meet even simplified CDD requirements.
- The tiers and requirements must be set appropriately. If requirements are too simple (or none are imposed) or simplified measures are applied to an overly broad range of products, AML/CFT will be undermined.

A potential disadvantage of a tiered CDD system is that it locks clients into basic products, if they are not able to meet higher levels of CDD requirements. Experience has shown that the financially excluded has a range of financial needs. Simplified CDD may assist financially excluded persons to gain a foothold within formal financial services but they will still face CDD barriers when they need to expand their range of products or need to transact outside the parameters imposed on the basic products. Product restrictions also impact on the attractiveness of the product from both a service provider and a client perspective [28].

3.6.4 What do effective KYA measures entail in relation to small, informal retailers? Branchless banking models rely on non-bank businesses, such as small retailers, to provide cash-in and cash-out services in remote and rural areas. These retailers are customer contact points and in some models even perform account-opening functions. Such retailers pose AML/CFT risks that must be mitigated. One basic measure is to require service providers to perform due diligence measures on such retailers. This is referred to as Agent Due Diligence or KYA measures even though the retailers may not be strictly acting as agents of the service provider.

Standard KYA measures would often involve ensuring that the business is properly registered, verifying the business address, identifying the beneficial owner of the business, performing appropriate background checks on the beneficial owner and in general ensuring that the business is able to comply with its legal and contractual obligations (FATF, 2009, pp. 38-40).

In many developing countries, the retailers are primarily small, informal shops with very limited accounting records, if any. The proprietors of these shops will often face the same identity verification challenges that are faced by the financially excluded members of their society. The actual KYA processes that can be performed in respect of such businesses in low-capacity countries are often quite limited. The business premises would be visited by representative but background checks, if any, will be rudimentary and fairly informal. Such processes would, for instance, not necessarily deliver assurance that the retailer is not linked to organised crime. Thought should therefore be given to the circumstances under which KYA would be required and what such processes should entail. KYA processes in cases where little value can be derived, will add costs to the system without addressing integrity concerns.

3.6.5 What is the value of transaction monitoring in relation to basic financial products that are offered anonymously or in terms of a simplified CDD scheme? It is often argued that the risk introduced by simplified CDD can be mitigated by closely monitoring transactions linked to the relevant products and accounts.

Monitoring refers to manual or electronic scanning of transactions to identify outliers. Scanning uses parameters such as the country of origin or destination of the transaction, the value of the transaction and its nature. Client and beneficiary names are also used and these are scanned against national and international sanctions lists. The scanning process may flag a number of transactions for internal investigation. A client's name may be identical to a name on a sanctions list, but a brief internal investigation may show that the client is not the person who is listed. Transactions with values that exceed the normal value for that type of transaction, are often also flagged for internal investigation.

Monitoring and internal investigation requires capacity and, depending on the method of monitoring, may be time consuming and expensive. If an outlier transaction is identified, it must be investigated internally. The mere fact that a transaction does not fit the profile of the client does not render it suspicious and reportable. Additional facts must be gathered and considered. The investigator will typically require more information about the client and the transaction before a reasonable conclusion can be drawn that the transaction is innocent or that there are reasonable grounds to suspect that the transaction involves ML/FT. The investigation is complicated by the fact that tipping-off provisions bar investigators from contacting clients to obtain more information.

Depending on the level of CDD, effective monitoring in respect of basic account-based financial inclusion products may challenging: If the product is anonymous or very little CDD is undertaken, the monitoring process may not be able to deliver significant benefits. Monitoring systems will identify a range of outlier transactions that may or may not be suspicious. How should such transactions be investigated effectively to determine whether there are reasonable grounds to file a report with the Financial Intelligence Unit? The transaction values are generally low because the amount that may be transacted through that product is capped at a low value. If an outlier transaction is identified, it still involves a modest sum of money. It is therefore pragmatic to consider how much should be spent on initial internal investigation of low-value transactions that were flagged, especially if the internal investigators are not able to rely on comprehensive and reliable CDD information? Relevant information may be found, but investigations will require resources and the majority of flagged transactions will often not be reportable once the facts were established.

These questions are also relevant to public authorities. Once a report on a low-value transaction is filed with the Financial Intelligence Unit, how much time, effort and money will the authorities spend on investigating that report? This is particularly relevant in relation to mobile money where the client and the retailer may be in a remote, rural area far from the unit and often also far from a police office with capacity to investigate ML/FT. When answering this question it is also relevant to consider what the practical steps are that investigators can take to investigate such a report.

3.6.6 How do you prove or demonstrate that unproven new products are low-risk products? The definition of "financial institution" in the glossary to the 40 Recommendations states that:

> In strictly limited and justified circumstances, and based on a proven low risk of money laundering, a country may decide not to apply some or all of the Forty Recommendations to some of the financial activities stated above.

In the FATF's *The Review of the Standards – Preparation for the 4th Round of Mutual Evaluations 2010*, the principle is stated somewhat broader (p. 4):

> Where there is proven low ML/TF risk, and in strictly limited and justified circumstances, a country may exempt financial institutions or DNFBPs from applying certain FATF Recommendations.

This broader statement is in accordance with the general message that the FATF has given in relation to low-risk products. If countries can prove or demonstrate that there is low risk of ML/FT, some exemptions from standard obligations may be justified. These exemptions are therefore crucial to a financial inclusion framework. However, the requirement that low risk must be proved or demonstrated is problematic in respect of new products and services such as mobile money. The language creates a regulatory deadlock: proof and demonstration requires evidence and evidence can only be generated by launching and testing the product. Yet, the product cannot be launched without a facilitative regulatory framework that can only be shaped within the context of the low-risk exception and exemptions.

When the text of the FATF Recommendations and interpretative notes are amended, it would be helpful if the word "proven" is not used in this context. Language supports a thorough and objective risk assessment and a reasonable and justifiable conclusion about the risk profile of a product will be more appropriate to financial inclusion products than language requiring proof and demonstration.

3.6.7 What are appropriate controls for financial inclusion products that cannot be rated as low risk, but moves users from high-risk informal transactions to formal and more controlled financial services? Financial inclusion products can move clients from high-risk informal cash-based transactions to formal, regulated financial services. Such a shift will improve the overall ML/FT risk profile of the country and its economy. However, in some countries, effective financial inclusion products may not necessarily pose a low ML/FT risk. The risk profile of the products may actually be fairly high given the nature of the economy and the level of crime. However, they may still pose a lower risk than informal, cash-based transactions.

It would seem sensible to enable such a country to support a simplified regulatory regime for financial inclusion products (De Koker, 2009b). In these cases, simplified CDD will not be justifiable given the profile of the product but will be justified given its impact on informal financial services. If the FATF supports such employment of such products, it will need to adopt clear language expressing such support. It will need to signal that simplified CDD may be justifiable in these cases, even though the risk level of the products would normal dictate more stringent controls. The FATF would also need to consider appropriate principles to ensure that this exception is not abused by countries.

3.6.8 Should AML/CFT measures in relation to financial inclusion products be concerned with PEPs? FATF's Recommendation 6 requires all financial institutions to take specific measures to determine whether a potential client is a PEP and, if so, to mitigate the risks of handling proceeds of corruption. PEP provisions extend to close business associates and family members. While the vast majority of PEPs may be wealthy and banked, not all persons falling within the definition are. In many developing countries, persons who may be subject to PEP controls may also be potential clients for financial inclusion products. Should the FATF expressly exclude small providers of financial inclusion services and products in general from the PEP measures? These measures are expensive and create a significant compliance burden for small financial inclusion service providers and products. An exclusion, on the other hand, may undermine PEP measures and combating of corruption in general in those developing countries where low value corruption is systemic.

3.6.9 Should the FATF refer to specific minimum amounts in its standards? The FATF lists various amounts in the interpretative notes to the standards, for instance, designated thresholds and maximum amounts for some examples of low-risk transactions and products. On the one hand, it may be attractive to state amounts in international currency to ensure a standard level of global compliance. On the other hand, such an approach does not necessarily ensure equivalent results in countries around the globe (De Koker, 2009b). The amounts that are listed are often too low for developed countries or too high for developing countries. If amounts are too low, the compliance burden will be onerous and financial inclusion will be undermined. Amounts that are too high, may undermine AML/CFT.

4. Towards solutions

If the FATF addresses the questions set out above, it will be in a stronger position to provide guidance regarding the alignment of financial inclusion and AML/CFT. It may be difficult to get consensus about some of the answers, but it is important to pursue consensus because that will determine the level of clarity and consistency of its financial inclusion and integrity guidance.

Guidance that fails to provide certainty relating to AML/CFT and financial inclusion products, will continue to disrupt the design of appropriate regulatory frameworks. Challenging though the task may be, the FATF should do its utmost to clarify its views. Governments and regulators in developing countries feel very exposed to FATF mutual evaluations of compliance. If they do not feel comfortable that proposed regulatory frameworks for financial inclusion programs will meet FATF standards, they will be hesitant to endorse them. This hesitation will continue to retard financial inclusion developments. It is therefore important that the FATF considers its position from the viewpoint of these policymakers and regulators. The text of the FATF Recommendations read with the interpretative notes, guidance notes as well as the mutual evaluation methodology, must provide them with the required level of confidence.

It is submitted that the FATF should clarify its conceptual thinking and illustrate it with examples. The current approach in the 2003 FATF texts and risk-based guidance papers is to list some examples and indicators of risk but to leave it to the reader to construct the underlying concepts of risk. This approach raises more questions than it answers. Ideally, the FATF should, at the very least:

- define "risk" for purposes of the risk-based approach;
- define what it means by "high/er risk" and "low/er risk" and how these concepts should be applied in relation to ML and FT;
- indicate whether it has a tolerance level for risk, and if so, what that level is. Should AML/CFT systems try to identify all dirty transactions irrespective of size – as was often implied when the CFT measures were first introduced – or has it been accepted that the main focus is on larger flows of money? and

- ensure alignment between its simplified CDD guidance and the international CFT sanctions regime.

Once the principles are defined, they can be illustrated by examples. However, unless the principles are clearly defined, lists of potential examples of low or lower risk, for instance, examples of products that "may" or "could" be classified as low risk "depending on the context" are not particularly helpful. Without conceptual clarity, a regulator will still not be able to determine whether the particular version of the example in its jurisdiction will be one that meets the requirements of a "low-risk" qualification.

Country examples are helpful but they need to be contextualized. If a particular country's regulation is cited, it is important to outline why that country's approach is regarded as successful and compliant with the FATF standards. How does that country succeed in balancing financial inclusion and AML/CFT? What is the level of risk that the approach allows? How did they country determine that level of risk and how does it monitor and manage that risk?

It is also important to be realistic about achievable outcomes.

The FATF sets international standards and cannot be expected to be overly explicit on details (De Koker, 2009b). Neither can it be radical or have short-term outlook. Countries need to amend their laws and institutions their practices to comply with any amendments. These changes are expensive and can take years to implement. The FATF must therefore be forward-looking and in this regard there are a number of matters that would exercise their minds, for example:

- Will they need to change tack in foreseeable future? One of the complications is that products and services that currently pose a low risk, may have a different risk profile in future. Low-risk products that are subjected to simplified controls, attract criminal attention. They may be more difficult or cumbersome to abuse, but the lower level of controls render them more attractive to abuse. Perversely the "low-risk" designation alerts criminals to the potential for abuse and invites them to design schemes that can exploit the absence of comprehensive controls. There is evidence that organized crime is laundering money in increasingly smaller amounts[29]. Will FATF need to revisit financial inclusion products in the near future because levels of abuse will be of concern? Users of financial inclusion products will constitute a significant group in all countries and in many countries may in a relatively short time comprise the majority of the users of formal financial services. Clients in these countries that are subject to simplified CDD measures will therefore outnumber clients who are subject to standard CDD measures. That result is justifiable within a risk-based approach, but may require FATF members to undergo a mind shift.
- How is the new approach aligned with CFT? CFT focused the attention of FATF on low-value transactions. The revision may require the FATF to take a more pragmatic view of what is practical and achievable in respect of mass market low-value transactions and may require the FATF to also engage the United Nations on the general CFT strategy (Counter-Terrorism Working Group, 2009). If the global CFT focus on low-value transactions is retained, CFT will continue to undermine financial inclusion, especially in a number of developing countries with terror financing risk. This focus will therefore deny such countries the social

benefits – and longer term economic benefits and potential for increased political stability – that are associated with financial inclusion. A CFT focus on low-value transactions therefore has the tendency to undermine the potential of financial inclusion to address poverty and social concerns, which may be key drivers of support for terrorism. The concept of "low" CFT risk also needs to be clarified. How should that level of risk be measured and what are the levels that can be tolerated and described as "low" or even "standard"?[30]

Financial inclusion experts also need to be realistic regarding the impact of any amendments that the FATF may make:

- Amendments to the FATF standards will not immediately translate into relaxed practices by financial institutions. The FATF amendments will take some time before they are reflected by national laws and regulations. Even when that happens, some institutions may decide to "overcomply" with CDD obligations by electing not to implement simplified measures to the extent allowed by national laws. Overcompliant behaviour is driven by various factors[31]. For example, the FATF requirements are not the only set of international CDD requirements. The Basel Committee on Banking Supervision issued guidance on CDD in 2001 (Basel Committee on Banking Supervision, 2001). This guidance reflects conservative banking practices and influence compliance mindsets of banking regulators and banks. Fraud is also a significant driver of stringent client identification and verification. Although institutions may be allowed to employ less stringent CDD, they will generally elect not to, where it exposes them to fraud risk and loss[32]. The requirements of national and international sanctions laws and schemes, including those relating to CFT, will continue to inform a more conservative approach[33].
- If amendments are made to the FATF framework, but these fail to clarify how simplified CDD may be employed in relation to financial inclusion products, it may take years before some regulators in low-capacity countries will be willing to adopt such measures. They will wait for a measure of clarity to emerge from reports produced during the fourth round of mutual evaluations before they will be confident to endorse a simplified CDD regime.

The debate regarding appropriate alignment of AML/CFT and financial inclusion goals also requires input from civil society. All AML/CFT stakeholders should be sensitive to the potential consequences of aligned processes. AML/CFT controls place personal information of clients in the hands of financial institutions where they can be accessed by governments, depending on national legal conditions that may apply. Clients in countries that are subject to the rule of law can rely on constitutional and other legal protection. The FATF footprint – and compliance pressure – extends, however, to countries that do not have appropriate protection for civil liberties and especially for client privacy. Those targeted by financial inclusion initiatives are often vulnerable members of society. The complementarity argument enables countries to harness market forces to bring vulnerable communities into a formal and more transparent financial framework. It is submitted that society should be concerned about appropriate protection of new users of financial services and this concern should extend further than the general concept of consumer protection.

Civil society should, for example, question whether the FATF framework has appropriate controls to ensure that law enforcement objectives are balanced with an appropriate emphasis on human rights and especially privacy protection. The exposure of new, vulnerable financial services clients to breaches of international human rights standards by oppressive regimes acting ostensibly in furtherance of AML/CFT and financial inclusion, would be unconscionable.

In this debate, it should also be considered whether the interests of socially vulnerable persons are appropriately served by simplifying CDD requirements. Would their long-term interests and those of society not best be served by supporting the development of national identification and legal frameworks that would enable all residents to prove their identity with ease, while balancing their right to privacy with the need for reasonable and justifiable transparency?

Notes

1. This has been the subject of discussion at various rounds of the Cambridge International Symposium on Economic Crime since the 1990s. See also the calls for FATF sensitivity for developing country requirements in Bester *et al.* (2008) and De Koker (2006).
2. I expressed my personal views on some of the key matters in a series of articles and papers that I reference in this paper.
3. I refrained from repeating questions that have already been put to the FATF in public documents such as FATF (2010b, pp. 66-71).
4. Higher levels of financial inclusion in Kenya are, for example, accompanied by increased levels of fraud and misappropriation (*Business Daily*, 2010).
5. For interesting perspectives on some negative experiences of Mzansi clients in South Africa, see Bankable Frontier Associates (2009, pp. 115-18, 127).
6. For a limited study of experiences and perceptions relating to some products in a country context, see De Koker (2009c).
7. Some countries, for example, have data regarding the reporting of suspicious transactions but it is not clear how the data should be interpreted. A low reporting rate relating to financial inclusion products may indicate that these products pose a low risk. It may, however, also indicate an inability in the system to identify suspicious transactions.
8. For some of the author's personal answers to these questions, see De Koker (2006, 2009a, b, c).
9. This was raised in particular by law enforcement officials on 10 September 2004 at the Twenty-first Cambridge International Symposium on Organised Crime during a workshop entitled "'Know your customer' rules and the financially excluded" presented by L. de Koker and J. Kaetzler.
10. Princess Máxima advanced a similar argument in her address to the FATF plenary meeting in Amsterdam on 23 June 2010.
11. According to FinScope Statistics on Tanzania, available at: www.finscope.co.za/tanzania.html (accessed 20 November 2010).
12. See De Koker, 2006. See also FATF, 2010b, para. 39: "The first feature that money launderers and terrorist financiers abuse prevalently is cash and bearer negotiable instruments. The summary of the 2009 Strategic Surveillance exercise indicated that a noteworthy proportion of ML/TF activity continues to involve cash. The use of cash or currency (i.e. banknotes and coins used as a medium of exchange) is attractive to criminals mainly because of its anonymity and lack of audit trail. Criminals look for as much flexibility as possible and are

interested in avoiding detection. Cash provides that flexibility, as it is universally accepted and can be used and moved with little or no record keeping"). See also para. 57 on financial inclusion as a means to mitigate cash risks.

13. For instance, Recommendation 20 on more secure money management, SR IX on alternative remittance and SR IX on cash couriers.

14. The article states amongst others: "Gangsters, drug dealers and money launderers appear to be playing their part in helping shore up the financial stability of the euro zone. That's thanks to their demand, according to European authorities, for high-denomination euro bank notes, in particular the €200 and €500 bills. The European Central Bank issues these notes for a hefty profit that is welcome at a time when its response to the financial crisis has called its financial strength into question. The high-value bills are increasingly 'making the euro the currency of choice for underground and black economies, and for all those who value anonymity in their financial transactions and investments,' wrote Willem Buiter, chief economist at Citigroup, in a recent research report. The business of issuing euro notes, produced at almost zero cost, is 'wildly profitable' for the ECB, Mr Buiter wrote" (*Wall Street Journal*, 2010).

15. In May 2010, grave concerns about the criminal abuse of the EUR 500 led to a ban a UK ban on banks and bureaux de change from giving out EUR 500 notes to customers (*Miami Herald*, 2010).

16. Bester *et al.* (2008, p. 39) therefore advises countries to, amongst others, promote market-based reforms to facilitate formalisation and to develop identification infrastructure.

17. This is, for example, advocated in Bester *et al.* (2008) and Isern and de Koker (2009).

18. Software vendors may argue to the contrary and may point to the high number of flagged transactions and a low number of "false" positives (innocent transactions that were incorrectly flagged for investigation) as evidence of the effectiveness of their systems. However, we lack reliable data on the number of transactions that involve proceeds of crime that are not detected by the monitoring systems. Given the large amounts of proceeds of crime that are allegedly swirling about in the world economy, the number of undetected transactions appears high. For data challenges in this context, see Demetis (2009).

19. Simplification will not have this effect where the simplified processes merely dispense with requirements that were superfluous to the standard processes. The South African Exemption 17 simplified processes could dispense with address verification as this served little purpose in the standard requirements (De Koker, 2004).

20. CDD should be undertaken when there is cause for suspicion but this does not amount to much in practice: When CDD is not undertaken as a standard measure, institutions have far less cause for suspicion and therefore CDD measures are less likely to be triggered.

21. Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the Prevention of the Use of the Financial System for the Purpose of Money Laundering and Terrorist Financing, article 5(d), available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:309:0015:0036:EN:PDF (accessed 13 November 2010).

22. In respect of risk toleration, see De Koker (2009b).

23. Regarding verification and whether it is optional or not, see De Koker, 2009a.

24. For a valuable discussion of the bases for formal human identification, see Clarke (1994).

25. For broader perspectives on CDD processes and their functions, see Maurer (2005).

26. For a more comprehensive discussion, see De Koker (2009a).

27. A client who purchases items from a supermarket is normally not subjected to identification processes and would be rated as "anonymous". Yet, the customer may be paying by credit card, may swipe a pre-registered store loyalty card or may have his image captured on the store's security camera. This means that information is available that will enable the identification of that client by law enforcement, should that be required. The client may therefore not have been identified prior to the transaction, but is reasonably identifiable, should there be a need to identify the client.
28. See the brief discussion in para. 1 above.
29. See in relation to "micro-structuring", Isern and de Koker, 2009.
30. A possible solution lies in a careful repositioning of the arguments regarding the impact of the FATF's CDD measures on the FT, for instance, that these measures impact on larger flows of funds to terrorists and their organizations and, while reasonable steps are taken to safeguard smaller transactions against abuse, where feasible, CDD measures are not primarily focused on those (De Koker, 2009b, p. 345).
31. For an analysis of drivers of overcompliant behaviour, see De Koker and Symington (2011).
32. Good corporate governance principles require appropriate risk managements systems that also address fraud risk and the reputational damage that the institution may suffer if it facilitates ML or FT, even unwittingly.
33. Policymakers who wish to see financial institutions implementing simplified CDD should not only amend national AML/CFT laws and regulations but also any other law (statutory or common law) that may compel institutions to identify and verify the identities of their clients. They will also need to identify and counter the impact of any foreign laws that may have an extraterritorial impact in relation to simplified CDD practices. In addition, they will need to address business concerns regarding fraud risk and reputational risk that the institution may face if clients are not subjected to comprehensive CDD. They will also need to address consumer protection risks that may be linked to simplified CDD as these may undermine the relevant business models.

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