Alliance for Financial Inclusion
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Financial Integrity Working Group (FINTWG)

Risk-based Approaches to AML/CFT
Balancing financial integrity and inclusion

This guideline note was developed by AFI's Financial Integrity Working Group (FINTWG) to provide insights from a FINTWG survey on risk-based approaches to enabling financial inclusion products in relation to implementation of the Financial Action Task Force's *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*.

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The AFI Financial Integrity Working Group (FINTWG) provides a platform for AFI members to discuss ways in which financial inclusion will strengthen financial integrity, through proportionate regulation and a risk-based approach to AML/CFT requirements. Since it was launched in 2010, FINTWG has not only provided numerous opportunities to its members to share knowledge on balancing financial inclusion, stability and integrity; it has brought the views of developing and emerging countries into the global policy dialogue on financial integrity and provided key inputs to the Financial Action Task Force (FATF) and other global Standard-Setting Bodies (SSBs). Moving forward, the working group will continue to expand discussion on enabling and monitoring financial inclusion products and services to keep the financial sector safe while drawing more people into the formal financial system.

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Context

In February 2012, the Financial Action Task Force (FATF) revised its *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*. One of the most notable additions is that it is now mandatory for countries, and for financial institutions and designated non-financial businesses and professions, to identify, assess and understand the money laundering and terrorist financing risks they face and to ensure that risk-based measures are in place to manage and mitigate these risks at the country and institutional level.[1]

In July 2012, AFI's Financial Integrity Working Group (FINTWG) conducted a survey of financial regulators from 12 country jurisdictions (members of the working group) that have taken risk-based approaches to enabling financial inclusion products in relation to the implementation of the former set of FATF recommendations.[2] This guideline note summarizes the key lessons and insights from this survey, focusing on two main issues:

- conducting a well-informed national risk assessment; and
- applying proportionate customer due diligence (CDD) measures.

A comprehensive report on lessons from the FINTWG survey can be downloaded from AFI's website. Both the full report and this snapshot report should be read in conjunction with the FATF Standards.

Critical issues

The FINTWG survey revealed three broad lessons about risk-based approaches to anti-money laundering (AML) and combating the financing of terrorism (CFT):

- **A flexible and evolving approach is essential:** Dynamic financial inclusion agendas, coupled with a growing understanding of FATF standards that are relevant to or have an impact on financial inclusion and exclusion, require a flexible regulatory framework that can accommodate change. Attempts to create a fixed, ideal model are unlikely to stand the test of time. In fact, most regulators that adopted a risk-based approach to financial inclusion products had to amend their models at least once to accommodate new products and services (especially mobile financial services), or because of negative feedback from providers and customers.

- **Risk assessments create both challenges and opportunities:** Most countries seem willing to conduct a national risk assessment to map out their national exposure to money laundering/financing of terrorism threats but do not have sufficient data to carry out a comprehensive initial risk assessment. The initial risk assessment should therefore be seen as the first in a series of steps toward improving the breadth, depth and quality of data. Alternatively, countries can also conduct sector, multi-sector or thematic risk assessments to start with.

- **Simplifying due diligence is not simple:** Simplified customer due diligence (CDD) is critical for enabling greater access to more cost-effective financial inclusion products and services, but reaching this point is challenging. At each stage of the process, from determining restrictions on products to identifying and verifying customers, a complex range of issues must be taken into account.

What about unknowns?

'Unknowns' can make simplified CDD even more challenging, such as when a country does not have the data to properly assess and categorize the relative risks of products, or when the regulator does not have sufficient information on the capacity and preferences of the unbanked. Solutions can be found, but they must be considered carefully and may need to be amended as weaknesses are revealed. This underlines the importance of a flexible regulatory framework.

[1] Recommendation 1, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation.
[2] The countries represented in the survey include: Fiji, Malawi, Mexico, Morocco, Mozambique, Namibia, Nigeria, Pakistan, Peru, the Philippines, South Africa and Uganda.

Guidance and recommendations

1. Conducting a well-informed national risk assessment

FATF recently published a Guidance paper, *National Money Laundering and Terrorism Financing Risk Assessment*,[3] which will assist countries in the conduct of risk assessments at the country or national level. It does not introduce a standard FATF methodology for assessing risks at the national level, but countries that have gone through this process have found the following actions to be beneficial.

Involve relevant public and private sector organizations

To ensure a coordinated national approach, it is important to involve public and private institutions in the assessment process through workshops and other forms of stakeholder engagement. This process can also help to secure political buy-in, highlight practical obstacles and solutions and identify new risks.

Use the process to identify and address gaps in data

Given that risks need to be assessed regularly, a robust system for collecting high-quality data quickly and effectively is essential. As mentioned earlier, the initial national-level risk assessment should be viewed as an opportunity to pinpoint data collection weaknesses and to plan how to address them, in addition to gleaning initial insights into the relative risks.

Capitalize on the expertise of intergovernmental bodies

Designing a risk assessment is not only a new experience for many countries — it can also be quite complex. To ease this process, some countries have worked with international institutions that have well-established AML/CFT risk assessment methodologies and expertise, such as the World Bank, International Monetary Fund (IMF) or regional bodies such as the Asia/Pacific Group on Money Laundering.

Engaging stakeholders in Peru

When Peru developed its national AML/CFT plan, nearly a dozen departments and agencies critical to the success of the plan participated in discussions, from the national police and the Ministry of Foreign Affairs to the Superintendency of the Stock Market.

2. Applying proportionate customer due diligence (CDD) requirements

The FATF Standards give regulators a significant amount of flexibility to tailor CDD requirements to their national context and to allow institutions to develop proportionate controls. The regulators identified the following opportunities and challenges.

Clustering products by risk

Increasingly, regulators are designing tiered regulatory parameters and CDD controls for products with different risk levels. In general, the lower the risk, the lower the CDD requirements. One of the advantages of this approach is that it enables regulators to determine whether existing requirements, such as customer verification, are proportionate to particular products. In the past, CDD requirements for standard products have sometimes been too stringent, restricting access unnecessarily.

Striking the right balance between access and functionality

The vulnerability of a low-value product or service to criminal abuse can be reduced by:

- restricting access to lower-risk customers only, for example to individuals and not to legal persons such as companies; and
- limiting its functionality, such as the type of transaction allowed.

Depending on the risk level, a combination of access and functionality restrictions and CDD measures may be necessary. However, regulators need to balance customer needs against the risk of abuse.

Mexico takes a tiered approach to CDD

In Mexico, the regulator has introduced a tiered approach to CDD for banking services:

- Level 1 services are low-risk and exempt from identification requirements.
- Level 2 and 3 services are slightly higher risk and require only simplified CDD measures.
- Level 4 services are standard risk accounts and require full CDD.

Accounts in all four tiers are subject to close monitoring and suspicious activity must be reported to the Financial Intelligence Unit.

[3] http://www.fatf-gafi.org/documents/news/nationalmoneylaunderingandterroristfinancingriskassessment.html.

Deciding when and how to conduct identification and verification of customers

Institutions, professions and businesses subjected to AML/CFT requirements are mandated to identify their customer when entering a business relationship. According to FATF standards, identification is only required when business relations are established between a provider and a customer, a wire transfer (usually only if above USD/EUR 1,000) is made or an occasional transaction exceeds USD/EUR 15,000. When identification is required, care should be taken in determining the appropriate amount of information: too much will raise costs and possibly undermine financial inclusion objectives, while too little can compromise security. Providers that have required only the names of customers have reported difficulties in monitoring transactions and reporting suspicious activity.

Verifying a customer's identity is mandatory under the FATF recommendations but financial institutions can defer verification until a certain monetary risk threshold is reached, using the tiered approach. However, financial institutions have found that customers do not tend to provide additional information once an account is open.

Verifying identities in countries without national identity systems remains challenging. It is helpful to have an agreed list of verification documents that the financially excluded can easily provide. In Fiji, for instance, these documents include birth, marriage and citizenship certificates.

Moving forward

Risk-based approaches to AML/CFT and financial inclusion products are still in early stages of development. As more countries apply these approaches, fresh insights into what works, and what does not, will emerge. Sharing and learning from these experiences will be essential. Comprehensive and rigorous data will also be critical to making more informed decisions about the relative risks of products and services. Above all, regulators and Standard-Setting Bodies will need to establish an effective policy dialogue on the implications and lessons learned from implementing risk-based approaches to AML/CFT, and balancing financial integrity and inclusion.

A regulatory balancing act

Excessive restrictions on transaction limits might make a product unattractive not just to money launderers but to customers as well. To strike the right balance, regulators need to consider the transaction patterns of both customers and criminals (among other issues). This requires both data and the cooperation of related agencies, and underscores the importance of cooperating with other stakeholders.

About AFI

The Alliance for Financial Inclusion (AFI) is a global network of financial inclusion policymaking bodies, including central banks, in developing countries. AFI provides its members with the tools and resources to share, develop and implement their knowledge of financial inclusion policies. We connect policymakers through online and face-to-face channels, supported by grants and links to strategic partners, so that policymakers can share their insights and implement the most appropriate financial inclusion policies for their countries' individual circumstances.

Learn more: www.afi-global.org

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