G:ENESIS

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

Final report
May 2008

FIRST initiative

Strengthening Financial Sectors

23/05/2008 **VERSION 5.3**

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EXECUTIVE SUMMARY

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

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

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

Key findings

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

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

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

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

A development path

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

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

Risk appreciation

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

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

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

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

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

Sequenced implementation

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

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

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

Observed impact on financial inclusion

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

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

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

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

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

Drivers of impact

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

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

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

Towards guidelines

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1. INTRODUCTION AND BACKGROUND

Fighting international crime and ensuring international security necessitate the combating of money laundering and the suppression of the financing of terrorism. Since the late 1980s, the international community has committed itself to ensuring that every jurisdiction adopts laws and procedures that thwart the laundering of the proceeds of crime. From the late 1990s, and with increasing urgency after 11th September 2001, similar commitments have been made in respect of financing of terrorism.

Global uniformity has been a key element of the strategy to prevent money laundering and to suppress financing of terrorism. Early in the process, the Financial Action Task Force (FATF) formulated Forty Recommendations for the control of money laundering to guide countries in the adoption and enforcement of appropriate laws. These recommendations have developed into the international standard for money laundering control. The Forty Recommendations were subsequently revised and, in 2001, following the September 11th terrorist attacks, supplemented with Special Recommendations on Terrorist Financing. Both these sets of recommendations, jointly known as the Forty Nine Recommendations, are now used by the international community as best practice standards for individual countries' laws and procedures against money laundering and financing of terrorism. The Recommendations have ensured a large measure of conformity between the relevant anti-money laundering ("AML") and combating of financing of terrorism ("CFT") systems of countries around the world.

The Recommendations were drafted with a measure of flexibility to allow developed and developing economies to implement them in a context-sensitive manner. Due to a variety of reasons, developing countries have not always utilised this flexibility and simply fashioned their AML/CFT frameworks on the models of developed countries. This lack of context-sensitive implementation has given rise to unintended negative consequences.

The possibility that the indiscriminate implementation of AML/CFT regulation (in developed and developing countries) may lead to financial exclusion and undermine the development of the financial sector, gave rise to this study. Financial exclusion risks undermining the social and political stability and economic development of these jurisdictions and leaves the excluded with little choice but to make use of informal financial services. By creating larger unmonitored sectors of the economy, this directly undermines the purpose of the international scheme, namely, to increase international safety and stability.

As a result, this project was commissioned by the FIRST Initiative[1] to (1) assess the impact of the implementation of international anti-money laundering and combating the financing of terrorism (AML/CFT) standards on financial inclusion in developing countries and, (2) to develop a set of tools or guidelines to assist the authorities in developing countries to design AML/CFT regimes that are compliant with FATF standards, but that will not impact unduly on financial inclusion. The project is supervised and guided by a steering committee consisting of representatives from the FIRST Management Unit[2], World Bank[3], International Monetary Fund

[1] The Financial Sector Reform and Strengthening (FIRST) Initiative is a significant $53m multi-donor program, supporting capacity building and policy development projects in the financial sector. FIRST is a joint initiative being undertaken by the World Bank, the IMF and a number of bilateral development agencies. These include DFID (UK Department for International Development), CIDA (Canadian International Development Agency), SECO (the State Secretariat for Economic Affairs of Switzerland), MFA (the Ministry of Foreign Affairs of the Netherlands), and Sida (the Swedish International Development Cooperation Agency).

[2] Represented at various meetings by Subhrendu Chatterjee, Mark St Giles, Jayyad Malik and Rudi van der Bijl.

[3] Latifah Merican Cheong and Raul Hernandez-Coss.

(IMF)[4], the UK's Department for International Development (DFID)[5], the Consultative Group to Assist the Poor (CGAP)[6], the South African National Treasury[7], the FinMark Trust[8] and Professor Nikos Passas, an acknowledged world expert on AML/CFT standards and implementation.

The project entailed a cross-country study of five countries – Indonesia, Kenya, Mexico, Pakistan and South Africa – and three smaller case studies of mobile banking in the Philippines, the regulation of money service businesses in the US and the adjustment of CDD requirements in the UK to avoid exclusion.

This document presents the findings of the study and is set out as follows:

- Section 2 sets out the scope of the project and provides an overview of the analytical framework applied;
- Section 3 highlights the key findings of the country studies and case studies (details are summarised in Appendix A);
- Section 4 notes the observed evolution of AML/CFT regimes in the sample countries;
- Section 5 notes the drivers of AML/CFT impact on inclusion identified in the countries reviewed;
- Section 6 outlines the impact on inclusion and mitigating responses identified in the sample countries; and
- Section 7 concludes with the proposed guidelines based on these findings.

The detailed information and data on individual countries are contained in Appendixes B to F, with a summary table in Appendix A. Please note that the information contained in the report and appendixes is stated as at the dates of the respective country visits, except where key data, such as the contents of a bill, only became available subsequently. The key findings of the country studies in section 3 are not referenced to prevent repetition. Readers are referred to the references contained in the relevant appendixes.

[4] Represented at various meetings by Chee Lee and Maud Bökkerink
[5] Represented at various meetings Doug Pearce, Valsah Shah and Martin Alsop
[6] Represented by Jennifer Isern
[7] Represented at various meetings by Jonathan Dixon, Nkosana Mashiya and Raadhika Sookoo
[8] Represented by Jeremy Leach

2. ANALYTICAL FRAMEWORK

The analytical framework comprises key assumptions which underpinned the work, the scope definition and a working concept of financial inclusion and the driving forces which impact upon it.

2.1. ASSUMPTIONS

Two key assumptions were made to direct the study away from assessing the level of compliance with the FATF Recommendations (which fell beyond the scope of this study) and focus on the impact of different levels and stages of implementation on financial inclusion:

- *AML/CFT regulation need not impact unduly on financial inclusion.* The FATF Recommendations provide sufficient scope for individual countries to tailor AML/CFT regimes to suit their circumstances. If a country implements the FATF Recommendations in such a context-sensitive manner, it will not impact unduly on financial inclusion in that country.
- *Laws are implemented.* This project does not assess the extent to which countries comply with the FATF Recommendations. The assumption is that where a country has enacted an AML/CFT regulatory regime (comprising the entire spectrum of legal directives and guidelines), it will in due course be fully implemented. Where countries have implemented the FATF Recommendations, but are not yet effectively enforcing the regulatory regime, we do not evaluate the level of implementation, but do assess both the actual impact of partial implementation as well as the potential impact of full implementation. There are a number of reasons for this. Firstly, both partial and full implementation can have an impact on access to financial services, albeit through different dynamics. Secondly, financial service providers and transactions that operate cross-border will often require compliance with laws even when such laws are not actively enforced, to ensure that the institutions are legally compliant and are able to maintain correspondent relationships.

2.2. SCOPE

In order to ensure that the study achieves it objectives while remaining practical, the following focal points where chosen.

Focus on the vulnerable client categories. The analysis focused on three particularly vulnerable client categories: The poor, the informal and undocumented migrants (as well as the financial services providers serving these groups). As the most vulnerable client categories, these consumers can be seen as the “lowest common denominators”, implying that if they have access to financial services, higher-income households will also have access. The specific definition of poverty used is not important as the focus is on those households at the lower end of the income distribution who are excluded from access to a particular financial service.

Focus on access by individuals rather than legal persons. The study focused on access to financial services by individual persons, rather than legal persons. The recommendations are, however, also relevant for micro, small and medium enterprises (MSMEs) who often transact through the owner or are faced by similar challenges as individual clients.

Focus on deposit accounts and money transfer services. The study was limited to two financial services, deposit accounts and money transfer services, offered by bank or non-bank financial service providers. These services are extensively used by lower-income consumers and have been found to be particularly vulnerable to the introduction of AML/CFT regulation. In addition, a broader scan was also conducted to consider the way in which credit and insurance products may be affected but no evidence of any significant impact was found.

Regulation and supervision. For the purposes of this study, formal financial services are defined as those provided by financial service providers which are registered with a regulatory body for the provision of such services. This definition of formality is, however, not always easy to apply and was not found to be a useful delineation for this analysis. For example, in the case where formal institutions are regulated but not supervised in practice (i.e. regulation exists but is not enforced) such institutions are often treated in a similar manner to informal entities by the regulated FSPs. In the implementation of AML/CFT regulation, this was found to be a critical issue affecting the relationship between large FSPs and small unsupervised (but regulated) FSPs.

Focus include formal and informal. The primary focus of this study is on the formal financial sector. It is, however acknowledged that the informal financial sector plays a critical role in financial sector development. Informal providers may provide a low-cost distribution mechanism for formal products (e.g. informal savings clubs that share the cost of one bank account, which may be unaffordable for any individual member of the group) or may offer completely informal products without any relationship with formal providers (e.g. informal insurance not linked to a formal financial institution or money transfers conducted by hawaladars). From an inclusion perspective, the objective is to facilitate the development of the formal sector while at the same time (and where appropriate) preserving the critical services provided by the informal sector. It is important to note that informal does not necessarily mean illegal. If no regulatory framework exists that criminalises a specific informal financial activity, it is unregulated rather than illegal.

Country selection. The criteria used to determine the sample of countries included in this study reflect a variety factors identified as potentially determining the degree of impact on financial inclusion of implementing the FATF Recommendations. These criteria can be grouped in four categories:

- Development and character of the banking sector;
- Nature and extent of remittances;
- Demographic characteristics relevant to AML/CFT and access; and
- AML/CFT risk.

By applying these criteria a short-list of 12 countries was identified that reflected sufficient variety to provide a basis for generalised conclusions. The final selection, determined by the project Steering Committee, aimed to ensure a sufficiently diverse (also geographically) base of evidence for the development of guidelines within the budget constraints of the project. It also took into account the practicalities of conducting research in the respective countries. The result of this was a list of five countries: Kenya, Indonesia, Mexico, Pakistan and South Africa. In addition, three smaller case studies on interesting developments in other countries were identified that could add value to the tools being developed by this project. These related to mobile banking in the Philippines, the regulation of Money Service Businesses in the USA and the adjustment of client due diligence requirements in the UK to avoid exclusion.

2.3. FINANCIAL INCLUSION: ACCESS, USAGE AND MARKET EFFICIENCIES

The purpose of this study is to determine the impact of AML/CFT regulation on financial inclusion. Financial inclusion is ultimately about whether individual consumers (particularly low-income consumers) can access and on a sustainable basis use financial services that are appropriate to their needs. Inclusion is affected by factors impacting on the individual directly (demand-side) as well as on the institutions providing the services (supply-side) (ultimately to impact on the inclusion/exclusion of the individual). These impacts may explicitly exclude individuals from using a particular service (referred to as access barriers) or it may discourage users from using (referred to as usage barriers) a particular service even if they are not explicitly excluded. Similarly, impacts may exclude or discourage FSPs from providing a particular financial service to the lower-income market (referred to as market efficiency barriers). Ultimately financial sector policy not only aims to ensure that users (and FSPs) are not excluded from the formal financial sector, but also that they are incentivised to use formal services and actively do so.

Accordingly, the analytical framework considers the potential impact on three dimensions of financial inclusion: access to financial services, usage (or take-up) of financial services and other aspects of market structure and efficiency. These concepts are explained below.

Access to financial services can be defined as the ability of individuals to obtain and, on a sustainable basis, use financial services that are affordable, usable and appropriate to their financial needs (Genesis Analytics, 2004b). The methodology used to assess access typically focuses on factors that may exclude individuals from being able to use a particular product. Five drivers of access have been identified (Porteous, 2004):

- *Proximity.* This considers how far a person must travel to access the service concerned and is usually defined in terms of the time required and/or the cost of travel.
- *Affordability*. This will differ across financial products, but the basic premise is that people are likely to be excluded from a particular financial service if the cost of using the service exceeds a critical threshold relative to their monthly income and/or the value of the transaction9. This also relates to the concept of value which we include under the usage factors.
- *Appropriate product features.* The features of the service should be appropriate to the user and be able to meet the user’s particular needs for the financial service. For example, some deposit accounts incentivise or explicitly set limited deposit or withdrawal activity10, which may not be suited to an informal trader who needs to deposit cash on a daily basis.
- *Appropriate terms or eligibility requirements.* These are defined as eligibility requirements imposed by financial service providers beyond what is dictated by regulation. Contractual terms imposed by financial service providers may inappropriately exclude specific categories of users from utilising the service. For example, some deposit accounts may require minimum balances, levels of income or formal employment, which may exclude the poor and/or unemployed.

[9] The benchmark typically used for deposit accounts is that bank charges should not exceed 2% of household income. See Genesis (2005) for a more detailed discussion on this benchmark. For remittance products this is more complicated as the cost also relates to the underlying value of the transfer. Money transferred often support subsistence at the receiving end and, therefore, transfers are not optional. Differences in cost of transfers is, therefore, likely to affect the choice between formal and informal channels but not the value or the occurrence of the transfer (see Freund & Spatafora (2005)). In terms of the country evidence, the cost of formal transfers in a number of cases exceeds 10% of the value transferred, which is clearly problematic from an affordability point of view.

[10] By, for example, only allowing a limited number of withdrawals/deposits and applying higher charges if this number is exceeded.

- *Regulation.* Regulation may inadvertently exclude specific groups of people (e.g. if regulation requires migrants to provide proof of legality of stay, thereby excluding undocumented migrants), or increase the cost of serving particular client groups (e.g. requiring banks to open physical files for clients even if account balances are low and transactions limited).

Usage of financial services. While the concept of access is focused on explicit barriers, the concept of usage focuses on factors that may discourage *taking up* or *using* formal financial services even if they do not present an explicit barrier. In some cases individuals may decide not to use a particular product even if they are not excluded from doing so. This does not simply refer to an arbitrary decision but to the fact that individuals are exercising their (often rational) judgement on the value of the product and its ability to meet their needs. This judgement is exercised within a complex set of considerations, constraints and priorities. It, however, remains the consumer's decision as they are not explicitly excluded by the actions of a third party. A number of usage drivers have been identified:

- *Value.* When considering the cost of a savings account the access analysis may conclude that the account is not unaffordable relative to the income level of the consumer. However, considering the interest an individual derives from the savings account it may be revealed that the costs (while not exclusionary) results in a negative return on a small savings balance. Even though the consumer is not excluded based on cost, they would be rational to decide not to use this product as it does not offer any value to them.
- *Relative cost.* In addition to considering the affordability and value of the product in terms of absolute cost, decisions on using specific products are also driven by the cost relative to alternatives. In the case of remittances, a reduction in the cost of the formal sector remittance may make this look affordable. However the cost of the informal sector product may still substantially less than that of the formal. It would be rational for the consumer to decide to use the informal product even though they are not explicitly excluded from using the formal one.
- *Hassle factor.* Convenience plays a major role in consumers' choice of service provider. In addition to the potential cost advantage of informal remittance product, it may also be more convenient to use as it does not require any paper work and can be done by a simple telephone conversation.
- *Perceptions and familiarity.* Reciprocal negative perceptions between formal FSPs and low-income clients may discourage use of formal products. FSPs often perceive the poor as unprofitable clients who require much time to serve and with whom their wealthier clients do not want to associate in their branches. Low-income clients in turn feel intimidated, ashamed or not respected when dealing with formal FSPs and, therefore, choose to use alternative (informal) providers who welcome their business.
- *Transaction culture.* If consumers are used to conduct transactions in a certain manner, it may be difficult to convince them to change (e.g. encouraging use of formal remittance providers when the use of informal hawaladars to send money is entrenched). However, it is likely that this is driven by perceived value (or lack thereof) rather than simply resistance to change.
- *Resistance to documentation.* In many cases, clients are sceptical of processes that require the presentation of official government documents because they prefer to remain below government's radar. This may be because of tax evasion, but also because of cultural or socio-political reservations.

Although it is difficult to quantify the impact of these drivers, the country reviews have found that they have a significant impact on take-up and use of financial products. In addition to impacting on access, government process and regulation, including AML/CFT controls, also impact on these usage drivers. Financial sector policy should ultimately consider both usage and access. It is of little benefit to facilitate access by the poor to financial services if steps are not taken to increase attractiveness and actual usage of the products. In the case of bank accounts, the benefits of increased financial security for the individual and intermediation for the broader economy are only achieved if individuals actually use the product.

Market efficiencies. In addition to access and usage factors, there are also supply-side factors which impact on financial inclusion. Market efficiency factors operate at the level of the financial institution and impact on the nature and extent of services being offered to lower-income clients and the competitive dynamics in the market. These factors include market and regulatory forces and may limit or discourage entry and operation of players in the low-income market. Examples of regulatory impacts on the supply-side include:

- Increased costs of low-value transactions that undermine their already marginal profitability, leading to a withdrawal from the low-income market;
- Regulation that prevents or delays the introduction of new models and technologies by imposing unnecessarily strict requirements;
- Regulatory bias against small institutions that undermines competition and innovation and ultimately increases costs for the consumer; and
- Regulation that (intentionally or unintentionally) undermines relationships between formal and informal FSPs. Given the important distribution role that informal FSPs can play, this will have a significant impact on inclusion.

Many factors impact on access. Even though the focus of this study is on AML/CFT regulation, the impact of AML/CFT on financial sector development should not be considered in isolation. The analysis shows clearly that there are numerous factors that impact on access and usage many of which do not relate to AML/CFT. Various other areas of regulation also impact on the market and, in general, FSPs are still currently viewing the profitability of serving the low-income market with some scepticism. As result, even where low-income products are made available, limited marketing and sales effort may, therefore, undermine take-up. This situation is, however, changing. Increased effort is invested into removing or reducing regulatory barriers and new models and technologies are improving the viability of serving low-income markets. Potential AML/CFT barriers that may currently be one contributing factor to exclusion may become pronounced as the other factors are being addressed. Accordingly, these non-AML/CFT barriers to inclusion do not remove the imperative to minimise barriers resulting from AML/CFT regulation.

With this as basis, we now proceed to consider the findings from the country studies. The next section provides an overview of the country context, before the subsequent sections highlight the cross-cutting findings and proposed guidelines.

3. COUNTRY CONTEXT

This section provides a brief overview of the experience of the five countries included in this study with the implementation of AML/CFT controls.

3.1. INDONESIA[11]

The Indonesian case shows the interplay between restructuring following the Asian crisis and the adoption and evolution of an AML/CFT regime. In particular, it illustrates the benefit of a flexible AML/CFT regime which focuses on high risk areas and is tailored to the capacity of the banking sector.

Bank Indonesia issued the first regulations regarding the application of KYC principles in June 2001, but this was insufficient to prevent Indonesia's listing by the FATF as one of the Non-Cooperative Countries and Territories (NCCT) in the same month. In response, the Indonesian government immediately undertook to adopt and implement a comprehensive AML/CFT system as a matter of urgency. In 2002, Law 15 of 2002 Concerning the Crime of Money Laundering was enacted, which criminalised money laundering and created reporting and record-keeping obligations for financial institutions. It also established the Indonesian financial intelligence unit (PPATK)[12]. A number of staff members of Bank Indonesia were seconded to the PPATK to establish the new agency and, by late 2003, the PPATK was operational. The money laundering control law was amended in 2003 to broaden the STR reporting duties and criminalised the financing of terrorism. Another amendment to the Act is currently being prepared to increase the powers of the PPATK and extend the reporting obligations to a number of non-financial businesses. In 2005 Indonesia was removed from the NCCT list with special monitoring continuing until February 2006.

During the same period, the Asian crisis of 1997/1998 halved the number of private banks through mergers and liquidations. Government recapitalisation of the banking system amounted to an estimated 50% of GDP (McLeod, 2003). Given the severity of the crisis, central bank policy shifted from the privatisation drive of the mid-1990s to stability, good governance and consolidation, which is currently still the focus. A positive spin-off of the post-crisis restructuring and mergers is that many banks have acquired advanced new IT systems. These systems are able to deal with the requirements of AML/CFT regulation with limited additional cost.

The Indonesian financial sector is large and diverse, spanning three tiers of banking service providers: 131 commercial banks, 2 000 BPRs or "peoples banks" and more than 11,000 MFIs (including 5,300 village cooperative banks or BKDs). Although included in financial regulation, the BKDs are effectively unregulated in practice. Furthermore, no AML/CFT regulation is currently enforced on the second and third tiers of institutions as these are considered to present low risk. The state-owned bank, BRI, dominates provision of banking services to lower-income households and is doing so profitably. Operating through 4,600 village units, the bank has 30m account holders, making it the largest bank (by number of accounts) in Indonesia. In addition, the BPRs have an estimated 6m account holders. The clients of BRI and the BPRs are estimated to make up as much as two thirds of all bank clients. However, banking

[11] The full country study with data references can be found in Appendix A
[12] Pusat Pelaporan dan Analisis Transaksi Keuangan.

penetration remains low with between 20% and 30% of adults estimated to have a savings account.

The AML regime as promulgated reflects an understanding of banking and bank capacity. For example, the regulations stipulate that banks are required to have a management information system in place but does not require these systems to be electronic or of a particularly advanced nature[13], which may be prohibitive for small players and unnecessary given the level of risk such players pose. The audit/traceability role of account monitoring is emphasized rather than real-time detection capability[14].

The country has a ubiquitous identification system. The integrity of the system is however often questioned and no uniform national identity number exists. CDD regulation requires upfront identification (verified generally in respect of Indonesian citizens with the widely available identity card, the KTP) as well as re-identification of current clients. In recognition of the limitations of the KTP, the regulation requires profiling information to be collected to allow monitoring of the account. The profile information is retained and the profiling information reflected on the KTP is verified with reference to the KTP. The government is in the process of improving the identity infrastructure. In support of re-identification efforts in respect of existing customers, Bank Indonesia initiated a marketing campaign to explain the reasons for re-identification and to inform the public that all banks will require the same information of clients.

Walk-in clients remitting or receiving an amount below Rp100m ($10,870) were exempted from KYC requirements. The average remittance amount is estimated to be about $250. However, in 2006 Bank Indonesia introduced a regulation requiring all new money remitters to be licensed and all existing money remitters to apply for licences before 31 December 2008. Licensed money remitters are required to identify and verify the identities of all remitting and receiving parties. In the new regime the Rp 100m exemption to the KYC requirements has fallen away.

It is estimated that between 3m and 5m mostly female domestic workers on 2-3 year contracts in the Middle East and South-East Asia remit between $3bn (lower estimate - formal only) and $15bn (upper estimate – including informal) per year. Based on these figures, at least 50% and as much as 80% of remittances may flow through informal channels or is carried in cash (by friends or by the worker at the end of her contract). Given the vulnerability of low-skilled migrant workers, the Indonesian government has launched initiatives to support workers abroad and encourage use of formal remittance channels. All migrant workers are required to use a government-approved placement agent that provides training, arranges the required documentation and can support the worker if she is treated unfairly by her overseas employer. Since June 2006, workers are also obliged to open a bank account before they leave for their working destination in an effort to introduce them to the formal sector. For this purpose, government (through the employment agencies) have formed alliances with commercial banks.

Despite these efforts, there are a number of reasons why informal flows remain high. Illegal Indonesian workers (as many as 2m) are not able to use the formal remittances system because of documentation requirements in the sending country. The shorter contract term for Indonesian migrants also means that the minimum amount is sent home while the worker is

[13] According to the 2003 guidance issued by Bank Indonesia, the system can either operate manually or automatically.

[14] As explained by the head of the PPATK (2006): “No country can prevent bombings by doing financial analysis. What we can do is backward analysis. Once the bomb explodes, and the police find a lead, we can trace their financial transactions. So, our function is more to facilitate the police investigation.”

abroad and the bulk is brought home in cash at the end of the contract. Furthermore, the use of informal channels is also inadvertently fostered by the agency system. The worker is in many cases introduced to an employment agency through a broker, who often also finances their initial costs of going abroad. The worker is then initially forced to send a proportion of earnings to the broker to settle their debt and, at an additional fee, the broker can also deliver money to their homes. After the debt is cleared, this practice is often continued. The convenience of dealing through informal channels and cash carrying, therefore, weighs against the use of formal channels. Commercial banks are now looking at using the agency basis to extend loans to workers going abroad. This will reduce the dependency on brokers and may facilitate an increase in formal remittances.

3.2. KENYA

Kenya has not yet enacted a dedicated and comprehensive AML/CFT law. In 1994, money laundering was criminalised in anti-drug legislation[15]. In 2000, the Central Bank of Kenya (CBK) issued prudential guidelines under the Banking Act, setting out basic AML rules for commercial banks. From this time on, banks began to implement practices and procedures to comply with their AML/CFT obligations. In January 2006, the CBK issued more comprehensive prudential guidelines relating to money laundering. The prudential guidelines apply to all institutions licensed under the Banking Act[16]. In 2003, the Kenyan government constituted a 14-member task force under the lead of the Ministry of Finance to prepare an AML bill. The Bill was gazetted during 2006 and re-gazetted in April 2007, but is unlikely to be enacted before the elections in 2008. The publicly available bill in conjunction with interviews with the task force was used to assess its potential impact on financial inclusion.

The Kenyan AML bill applies an ambitious “one size fits all” approach to a wide range of financial institutions. Whereas the current prudential guidelines apply only to banks, the Bill in its current form will also apply to Postbank, savings and credit cooperatives (SACCOs), all MFIs, money remitters (formal and informal), insurers and cell phone value transfers. Although the bill allows for the tailoring of regulations to the risk (and capacity) of different financial institutions, the task force has indicated that no exemptions are currently planned.

Commercial banks in Kenya have traditionally served a narrow market of middle and upper income clients and have applied exclusionary terms such as high minimum balances to their products. Only 19% of Kenyans had a bank account (including Postbank clients) through a formally regulated financial institution in 2006. A further 8% used a financial product from a SACCO or MFI (FinAccess, 2006). The impact of the AML bill on commercial banks is therefore likely to be limited as their clients will have little difficulty to comply with the requirements. The impact will be more pronounced for commercial banks such as Equity and K-Rep which are now targeting the poor. In April 2007, Equity Bank was serving 1.1m low-income clients and asserted that it had captured 31% of all account holders in Kenya (Muiruri, 2007).

The biggest impact on financial inclusion is likely to flow from the CDD requirements. New clients will be required to present proof of identity, residential address and source of income (even more onerous than the requirements in South Africa – see Section 3.5). Address verification is likely to be particularly problematic as it is estimated that only 5% of the

[15] Anti-Narcotics and Psychotropic Substances Act, 1994

[16] Postbank is exempted from the Banking Act and operates independently under the Kenya Post Office Savings Bank Act, 1978.

population will be able to produce a utility bill[17] as proof of address. As a result, low-income clients (of which Equity Bank alone has more than 1m) will need to use the alternative provided of having their address (or "living location" where there is no address) verified by a government official. This will increase the inconvenience cost and is likely to discourage rather than encourage clients from accessing formal financial services.

Postbank, which has the largest reported base of accounts (1m active accounts and a further 1m inactive accounts) in the country, is not subject to the current prudential guidelines relating to money laundering. As a result, its AML compliance is lower than that of commercial banks. Its KYC procedures require only sight of a national identity card but no documents proving or verifying address or source of income/occupation, it does not keep all records required of commercial banks and it does not monitor or report suspicious transactions. If the AML bill extends to the Postbank[18], it will require re-identifying 1m predominantly poor and rural clients, obtaining copies of records and complying with reporting duties, which will be expensive and difficult given the client profile. No exemption for Postbank is currently planned.

SACCOs, of which there are about 3,600 in Kenya with 2.2 million members, and MFIs (that can now start providing deposit-taking services under the Microfinance Act) have even more limited capacity to comply with the requirements as set out in the Bill[19]. SACCOs provide basic savings and loans services to members, as well as a linkage to the formal payment system through their keeping accounts with commercial banks. About 90% of SACCOs hold their accounts with the Co-operative Bank. If they cannot meet the compliance requirements, the SACCOs could run the risk that their accounts will be closed by commercial banks trying to avoid the risks of non-compliance and large sanctions being imposed (in the same manner in which the accounts of MSBs are being closed down in other countries). About 1.4m members of SACCOs and MFIs do not have their own bank accounts and would only have indirect access to a bank account through their SACCO or MFI (FinAccess, 2006). These individuals would, if SACCO and MFI bank accounts were closed, thus loose their link to the formal financial sector. Furthermore, the draft AML/CFT regulations that apply to institutions licensed under the Microfinance Act are just as restrictive as regulations that apply to banks with respect to the identification of clients. New clients will be required to present proof of identity, residential address and source of income.

The Central Bank of Kenya Act restricts cross-border money transfers to banks or specifically licensed operators. Currently only commercial banks, Postbank and the Kenyan post office, as well as Western Union and MoneyGram (acting as agents of Postbank and the commercial banks) are licensed to conduct cross-border transfers. As a result, competition in the formal remittances market is limited and this is reflected in charges which extend to 12-17% of the value of the transfer, significantly higher than the cost of informal operators who typically charge less than 5%. The high cost of formal remittances has fuelled a large informal remittance market estimated to be at least as large as formal flows. Although outflows may be significant, industry players estimate Kenya to be a net remittance receiving country. If applied in the intended way to remittance services, AML/CFT legislation will also have a direct negative

[17] Although a utility bill will be sent to an individual's postal address (which may differ from their residential address), the utility bill is likely to contain the residential address that is being billed for certain services.

[18] There is a difference of opinion on this point: Postbank has indicated that it will not be covered by the new Bill; the task force is clear that it will. On the explicit wording of the publicly available bill, Postbank is covered.

[19] Microfinance institutions are also required to comply with the Microfinance (Deposit-taking microfinance proceeds of crime and anti-money laundering) Regulations, 2007 which require verification of identity, residential addres and employment/source of income.

impact on access to new remittance services such as M-PESA that is currently being being rolled out in Kenya by Vodafone and Safaricom.

The AML/CFT bill in its current form also extends to informal remitters. To date, no attempt has been made to formalise the informal remittance sector or encourage informal remitters to register.

3.3. MEXICO

Mexico provides rich experience in the interplay between AML/CFT controls and financial inclusion. It has a liberalised market for remittance services and a tiered banking system. The level and coverage of AML controls applied to these various financial institutions have changed significantly over the past decade. The deposit-taking sector is divided into the commercial banking sector and the so-called “popular finance” sector. The existence of the latter is partly the result of the loss of confidence in commercial banks, but also reflects an explicit attempt by government to create the regulatory space for multiple entities to operate in the market. The regulatory facilitation of the popular finance sector was also done to widen the options available to consumers of financial services.

Mexico, a FATF member, was the first of the five countries reviewed in this study to adopt AML controls. Money laundering was criminalised in 1996 and a Financial Intelligence Unit under the Ministry of Finance (SHCP) was established in 1997. International terrorism and the financing of terrorism were officially criminalised in September 2006 through amendments to the Federal Penal Code. In 1997, one set of general AML regulations applicable to banks, casas de cambio (money exchange houses), insurance companies, stock brokerages, bond institutions and limited objective financial institutions (SOFOLES) was introduced. Money remitters and centros cambiarios (money exchange centres of which the activities are limited to foreign exchange transactions below $10 000 and that cannot wire money cross-border) were brought into the AML regulatory net only in 2004, although their activities remain unregulated for other purposes.

Mexico follows a scheme of institutional regulation of the financial sector, i.e. different laws exist for various types of financial institutions, even though they may perform similar types of transactions. A general obligation to impose AML controls was therefore inserted into the relevant financial sector laws, with each law referring to a set of general AML regulations to be promulgated. One set of general regulations applicable to all institutions subject to AML controls was issued in 1997. This general set of regulations was refined in 2000. Since then the regulators have promulgated several sets of AML controls, each applying to a different category of financial institution. In each case the regulations have been tailored on a risk-sensitive basis to the differing realities that the respective financial institutions face, e.g. varying levels of capacity and systems, and different types and values of transactions. This gradual evolution continues and is especially prominent in regulations for banks and cajas (popular finance institutions) that were enacted in November 2007. Before the latter set of regulations was enacted, the same AML/CFT regulatory burden applied to commercial banks and popular loan and savings entities. With the new regulations, a more appropriate and less burdensome system has been created for the popular savings sector. Requirements regarding client identification and automatic alert systems were customized according to different entities’ activities. The regulations for cajas distinguish between two groups of cajas – a first group of Type 1 entities and a second group consisting of Type 2, 3 and 4 entities. These entities differ in terms of their asset and deposit base with Type 1 entities being much smaller. They will therefore be subject to lesser controls than Type 2, 3 and 4 entities.

Large, commercial banks have not been actively targeting the low-income market. Foreign ownership of Mexican banks exceeds 75% of banking sector assets (prominent foreign-owned banks include HSBC, BBVA Bancomer, Banamex and Santander) (CNBV, 2006). This is a direct result of the Mexican government's attempt to facilitate recapitalisation after the financial sector and banking crisis during the mid-1990s. Many of the foreign banks concede that the low-income market is not their direct target market and, since their internal AML policies are set at their international headquarters, they have to apply controls which are usually stricter than domestic controls. A recent CGAP report, focused on assessing the availability of savings services, concluded that "the prospect of traditional commercial banks reaching down on a large scale to serve low-income clients is not likely in the near future". (Klaehn, Helms & Deshpande, 2006: 8). This was confirmed by conversations with various commercial banks that see the payroll market (formally employed individuals) as their primary interest. This non-face-to-face client acquisition strategy is executed without KYC by the bank – the KYC process is effectively outsourced to the employer.

The onus of broadening financial inclusion has largely fallen on the popular finance sector. A number of financial institutions, in various legal forms (credit unions, SOFOLES[20], caja de populares and caja de sociedades[21]) and regulated under at least two different acts are providing valuable savings and credit services to the low-income market. The Mexican government has identified the popular finance sector and its formalisation process as one vehicle through which diversity (to facilitate growth in the low-income market) in the financial sector can be achieved.

The differentiated AML controls issued to cover these institutions, apply reduced controls to lower-risk transactions. For example, for certain entities full KYC (providing proof of identity and residential address) for occasional or walk-in clients for cross-border wire transfers need only be applied for amounts exceeding US$3,000[22]. Above this threshold, the financial institution will be required to open a physical file, with copies of the verified identity document and proof of residential address, for the sender. Some institutions need not open physical files for accounts with balances or transactions below $3,000 (centros cambiarios) and $5,000 (Banco Azteca). However, the requirement to check the names of low-income clients against lists of PEPs is considered too onerous, given the particularly broad legal definition of PEPs in Mexico.

Differentiation of AML controls by institutions has not only had benefits for financial inclusion, but has also created some problems. Institutions serving the same clients and performing the same transactions are subject to different controls and different levels of supervision. This is especially pronounced in remittance market in the uneasy relationship between casas de cambios and centros cambiarios. While casas de cambios are strictly regulated and supervised, with large minimum capital requirements applying, centros are essentially unregulated and unsupervised (although they are required to register with the national tax authority, SAT[23]). Given their largely unregulated nature and a perception of high risk, banks

[20] According to the IMF (2006a: 4), SOFOLES can be defined as "nondeposit-taking specialised credit institutions.

[21] Popular savings and credit institutions

[22] It is important to note that this threshold has been decreased from US$5,000 to US$3,000 for banks in the new regulations that apply to institutions regulated under the Credit Institutions Act.

[23] By December 2007, SAT had registered 2,212 centros cambiarios (SAT, 2007).

have started to close the bank accounts of centros cambiarios, thereby excluding them from the formal payment system. This will affect the ability of the centros cambiarios to form the last link in the remittance chain.

Mexico is the largest remittance-receiving country in Central and Latin-America and one of the top three remittance-receiving countries in the world[24]. During 2005, remittances to Mexico totalled US$20 billion (2.6% of GDP) – the result of 58m remittance transactions with an average value of US$341 each (Banco de México, 2006). The Mexican government, through the Institute for Mexicans Abroad, has been an active facilitator of formal remittance flows. Efforts to capture remittance flows through formal channels have included active lobbying for wide acceptance of the Matricula Consular card by American banks as proof of identity (in the opening of bank accounts and sending of remittances) for Mexican migrants without formal US documents proving legal residency (Institute for Mexicans Abroad, 2006). As a result of this and other initiatives it is estimated that only about 10% of remittances between the US and Mexico flow through informal channels.

3.4. PAKISTAN

Pakistan is under significant pressure to pass an AML bill. In 2002, a working group was formed to draft the AML law. The purpose of this law is to clarify the offence of money laundering[25], create an FIU and bring Pakistan's AML regime in line with international best practice. The bill is currently before Parliament, but its contents are not publicly known. Until the AML bill is passed, the current AML legal framework consists largely of prudential regulations. The State Bank of Pakistan (SBP) has issued prudential guidelines (under the Banking Ordinance and covering banks and money exchange companies) to be consistent with the FATF recommendations. These guidelines cover the areas of KYC policies, record-keeping, due diligence of correspondent banks and reporting of suspicious transactions. Separate guidelines have been issued for Micro-finance (MF) Banks.

The guidelines applicable to MF banks are fewer and more flexible than those applicable to commercial banks. Commercial banks have to KYC clients by obtaining a copy of their Computerised National Identification Cards (CNIC), their service cards (if they are employed) and must also have a formal introduction from a third person who can be trusted. Illiterate persons must produce a photograph and fingerprints. MF banks, in contrast, are only required to determine the true identity of clients and, although it is suggested that MF banks try to obtain the CNIC of clients, this requirement is not rigid. No AML requirements have been set for institutions like Post Bank and the Central Directorate for National Savings (CDNS) outlets that sell CDNS product/accounts. There are, however, general instructions developed by the CDNS under guidance from the Ministry of Finance, which seeks to establish a framework to 'encourage' institutions to know their clients better before they deal with them. These instructions are not related to the AML regime. When selling a CDNS product or opening an account, what is required is an introduction and verification of identity by the CNIC.

Extending financial inclusion is a key objective of the SBP. In November 2005, the SBP introduced a basic bank account (BBA) that all banks are compelled to offer to clients. The BBA allows a limited number of free transactions and a limited number of free deposits.

[24] During 2004, only India and China received greater absolute remittance flows. However, from a relative perspective (i.e. remittance flows expressed as percentage of GDP), Mexico is not one of the largest remittance receiving countries.

[25] The provisions of the AML bill are in addition to the Control of Narcotics Substances Act, the Anti-terrorism Act and the National Accountability Ordinance.

However, take-up has not been significant. This may be as a result of a very limited push by banks to market the product and other factors (such as a lack of disposable income) which keep the poor out of bank branches. Moreover, for most of the major banks the focus now is not on extending access, but rather on installing modern systems and practices following large-scale privatisation of banks during the past few years.

In the absence of a comprehensive AML/CFT law, the impact of AML/CFT implementation on usage has been muted due to a number of reasons. Firstly, commercial banks find themselves hampered in their attempts to re-identify existing clients since the prudential regulations do not provide for account closures by the banks where clients fail to comply with the controls. Furthermore, the ability of banks to report suspicious transactions remains limited by the dictates of client confidentiality. Secondly, usage of bank accounts in Pakistan is limited and individuals that currently use bank accounts derive from higher-income groups and, as such, have less difficulty to comply with KYC requirements. Thirdly, the bulk of the adult population has already been issued with the new CNIC. This new national identification system, managed by the National Database and Registration Authority (NADRA) is efficient and maintains high levels of integrity. As at June 2006, 52m adults (65% of the adult population) have been issued with CNICs since the system became operational in October 2001.

Re-identification of existing clients has posed a major problem. The deadline for re-identification was 30 June 2006, but was likely to be extended as banks were struggling with the re-identification process. One of the largest banks, with significant rural reach, has only been able to re-identify 30% of their clients and expects difficulties in re-identifying the remaining clients (particularly rural clients). The regulator has offered relief by allowing banks to re-identify clients without physical contact and by verifying identity against the NADRA database. The cost to banks of performing this process is however very high. NADRA is a self-financing parastatal and earns its keep from user fees and other services sold.

Pakistan is a major remittance receiving country. The inflow of remittances is a major source of foreign exchange for the country. The SBP has thus made considerable (non-AML related) efforts to increase the flow of remittances through formal channels. These include (State Bank of Pakistan, Exchange Policy Department, 2006):

- *Reducing transfer costs.* A subsidy equivalent to SAR25[26] ($6.70) for every remittance transaction sent through bank channels where the transaction is converted to rupees and where there is no charge to the sender or recipient is paid to banks.
- *Increasing competition.* The creation of a regulatory framework to facilitate formalisation of money changers by registering such institutions as either category A foreign exchange companies (who can remit money cross-border and trade in foreign exchange) or category B operators who cannot remit cross-border, but can buy foreign exchange and sell rupees.
- *More attractive exchange rate.* Reducing the differential between the official exchange rate and the kerb rate.
- *Support for Pakistanis abroad.* The establishment of a loyalty programme (through the Overseas Pakistanis Foundation (OPF)) for Pakistanis working abroad to support, amongst other things, the sending of money through formal channels.
- *Improving efficiency of the formal channels.* A code of conduct for formal channels was drafted, requiring, amongst others, a maximum delivery time through formal channels of 48 hours (rather than the reality of 2 to 3 weeks).

[26] Saudi Arabia Riyal

Despite the government's efforts to increase formal flows, informal flows remain high. About 1m households are estimated to receive remittances through formal channels, whilst 4.6m households receive remittances through informal channels (Genesis estimates based on various assumptions). Thus, use of informal channels is almost five times more than use of formal channels, although by value it is estimated that about equal amounts go through the formal and informal channels. As there do not seem to be barriers to using formal remittance channels, it would seem that the use of informal remittance channels is largely driven by issues like *familiarity, habit, culture, convenience, relative cost and resistance to documentation*. Furthermore, informal hawala systems are deeply embedded in trade and cultural relationships. Despite the strict money exchange registration regime, we could not trace any law enforcement steps taken against unregistered operators.

For AML purposes, money exchange companies only have to verify the identity of the senders of remittances in excess of $10,000 (per transaction). This is quite a generous exemption and assists in facilitating outward flows. However, within the Pakistan context this threshold is of less importance since it is mainly a receiving country and thus dependent on the AML regimes of sending countries.

3.5. SOUTH AFRICA

Compared to the other developing countries that were studied, the interplay between financial inclusion and AML controls received most attention from policy-makers in South Africa. Drug-related money laundering was criminalised in 1992 and laundering from any type of offence in 1996. The money laundering control law (the Financial Intelligence Centre Act or FICA) was passed in 2001 and the money laundering control regulations came into force on 30 June 2003. From that date, registered financial institutions were required, amongst others, to identify and verify the identity of all new clients. South Africa has a tradition of strong financial sector regulation and compliance for formal financial institutions, especially banks. The introduction of AML controls, however, added significant new compliance burdens for financial institutions. These burdens increased in 2005 when the terror financing laws took effect.

During the same period that the government was putting in place the AML regime, the cause of promoting financial inclusion gained strong momentum. The exclusionary effect of apartheid locked many poor South Africans out of the formal financial system and mainstream financial institutions have traditionally not been geared to servicing the poor. Post-1994, following the advent of democracy and as part of a broader movement to empower black South Africans, the new government has sought to make the financial sector more accessible. Negotiations within the financial sector resulted in the creation of the Financial Sector Charter (the Charter) in 2003 in which the banking industry committed itself, amongst others, to the provision of access to basic banking services to 80% of lower-income consumers by 2008. Since these targets impact directly on the ability of banks to secure government and other contracts, they are actively pursued by formal financial institutions. The government also committed itself to amend any regulations that inhibit compliance with the Charter.

From this commitment to access was born the Mzansi bank account, a savings account with basic transaction capability aimed at the low-income market, launched in collaboration by the big four banks and Postbank in October 2005. The AML regime presented a major obstacle to launching the Mzansi account. The FICA regulations prescribe that the identity of natural persons must be verified by means of an identity document and by comparing the person's residential address details with documentation that is reasonably practical to obtain and can reasonably be expected to achieve such verification. Although South Africa has a national identification system and most adults hold ID documents, there are problems with the integrity of the system. A recent investigative television program estimated that up to 25% of issued ID documents could be fraudulent (Special Assignment, 2006). The additional verification requirement relating to residential address was imposed to compensate for this weakness and to limit the opportunity for identity fraud.

The need for documentary verification of physical address proved insurmountable for many South Africans. Only approximately 44% of the population has a residential address (i.e. does not live in an informal settlement or in rural areas on communal or farm land where it is difficult to attach “an address” to the dwelling) (Genesis Analytics, 2004a). This amounts to just more than 4m addresses out of 9.1m households. The drafters of the AML regulations did in fact identify address verification as a potential obstacle for the poor to access financial services. As a result, the regulations were drafted to include a specific exemption (Exemption 17) which relieved institutions of the obligation to obtain details of and verify residential addresses if the financial product in question met certain stringent criteria. These criteria were drafted in consultation with the banks. Banks gave their input into this process based on the needs of their existing clients. As a result the conditions proved impractical for the majority of the financially excluded. Banks therefore found it difficult to verify key details of their low-income clients, both new and existing clients, whom they were required to re-identify. Moreover, the banks’ compliance officers tended to interpret the AML regulations narrowly rather than widely, even further restricting the leeway which the regulations allowed them.

The banks therefore approached the regulator for relief and guidance. The regulator responded by amending Exemption 17 to make it more appropriate for low-value accounts and transactions. This amendment was based on actual market research and an analysis of the needs and reality of the financially excluded. The amended Exemption 17 dispenses with the need to obtain and verify a client’s residential address in respect of accounts for which the balance does not exceed R25,000 ($3,300) and in which individual transactions do not exceed R5,000 ($660). The exemption also applies to single transactions below the threshold and money transfers within the Rand Common Monetary Area (CMA). The amendment of Exemption 17 facilitated the eventual launch of the Mzansi account which has brought more than 3m people into the formal financial sector over the past two years (Banking Assocation, 2006)[27]. The regulator also issued guidance notes for banks to address the uncertainty around acceptable documentation and other areas of uncertainty.

Whilst identifying new clients caused major challenges, it was the re-identification of existing clients that proved most difficult. Parliament decided that the re-identification process should be concluded within a year after the Act took effect. As the deadline for the completion of the re-identification process approached, the banking industry approached the Minister of Finance for an extension of the deadline, in the absence of which banks estimated they would have to freeze 80% of their accounts, a step posing great systemic risk to the banking system. In the event, the Minister of Finance issued a temporary and conditional exemption reflecting a risk-based approach. This exemption required banks to categorise their clients in terms of risk, and then re-identify high-risk clients within a few months, medium-risk over a longer period and low-risk clients over an even longer period. The banks were given discretion to categorise their

[27] It is important to note that the 3m figure is a slightly controversial statistic as there are some issues around d ouble counting and already banked individuals opening Mzansi accounts to benefit from lower costs.

clients as they saw fit. The re-identification deadline expired in September 2006 and indications are that banks succeeded in re-identifying the majority of account holders at costs estimated to be between R750m ($105m) and R1.5 billion ($210m).

The introduction of cell-phone banking once again tested the AML controls. By its very nature, cell-phone banking relies on paperless and convenient non-face-to-face client origination. How then to originate new clients while complying with KYC requirements? The regulator approved cell-phone banking only for products that fall within the ambit of Exemption 17[28]. The regulator also approved non-face-to-face client registration, provided the bank offering the cell-phone product obtains a national identity number from the client and then cross-reference this against an acceptable third-party database. However, since the regulator is of the view that this model introduces higher AML risk, clients who utilise the non-face-to-face registration process cannot transact against their accounts for more than R1,000 ($130) a day. Given the unknown nature of the risk, the regulator chose to limit the functionality of the account rather than to prohibit the business model. Clients are free to exceed this transaction limit once they have submitted to a face-to-face KYC procedure, but still within the limits of Exemption 17.

The formal sector money remittance market is limited in South Africa. The main reason for this is limited competition due to strict foreign exchange rules which restricts the dealing in foreign exchange (necessary for a cross-border transfer) to institutions holding a banking licence. Western Union entered South Africa in 1995, but exited after a few years. MoneyGram offers a cross-border service (in partnership with a bank) but its products remain beyond the affordability of the mass market (a R500 transfer costs up to R185 (i.e. $70 costs $25)). Moreover, only legal residents can purchase foreign exchange. South Africa is host to high numbers of undocumented migrants. A 1996 study estimated that between 2.5 and 4.1m persons reside in the country illegally[29], the majority of whom arrive from Mozambique, Zimbabwe, Lesotho and Asia[30]. Other sources put the estimates for illegal migrants at even higher levels. No cheap formal options are available to undocumented migrants and low-income clients wishing to send money cross-border. They continue to place their trust in informal money transfer mechanisms, either transferring money in person or using the extensive taxi and bus network which is much cheaper than formal systems (sending R500 to a neighbouring state with a taxi driver will cost about R50 ($70 costs $7). Even if exchange control is abolished, undocumented migrants would still not be able to access formal money transfer services due to the provisions of the country’s immigration legislation. It is estimated that 48% of all domestic remittances flow through informal channels, while 42% of all inter-Southern African Development Community (SADC) remittances are sent informally (Genesis Analytics, 2005b).

[28] See South African Reserve Bank, Banks Circular 6/2006 in respect of cell phone banking issued on 13 July 2006.

[29] The study by the HSRC was commission by the Department of Home Affairs in 1996 and although initially posted on the Department of Home Affairs website, it was later withdrawn due to methodological issues and flaws.

[30] According to a study released at the end of 2006, the number of undocumented migrants in South Africa could be as high as 10m. However, as the fundamental assumptions on which this estimate is based are questionable, we do not use it here.

4. EVOLUTION OF AML/CFT REGIMES

Although differing in the levels of AML/CFT controls that have been implemented, the implementation paths followed by the five countries included in this study show certain common factors as they relate to financial inclusion.

4.1. AN EMERGING DEVELOPMENT PATH

Of the three countries that have already implemented AML/CFT legal frameworks (Indonesia, Mexico and South Africa), Mexico and South Africa have followed very similar development paths. Indonesia followed a different path to reach Phase 3 but still supports the argument for a tailored approach. Kenya and Pakistan are still in the process of implementing their AML/CFT framework but show signs of following a similar path. Despite these differences, their combined experience suggests that there are three potential development phases as illustrated in Figure 1.

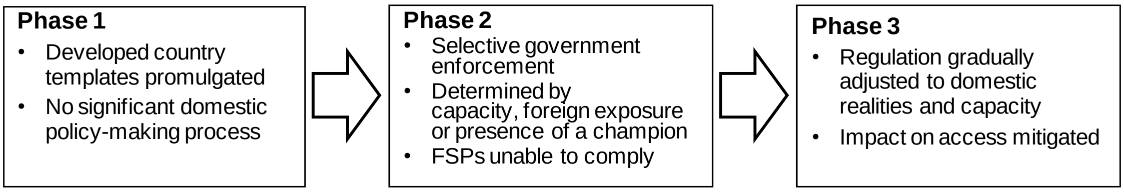

Figure 1. Emerging implementation evolution

Source: Genesis Analytics

During **phase 1** financial sector policy makers typically set out to satisfy domestic or international pressures to comply with the international standards set by the FATF. In the countries reviewed, no significant domestic policy-making process which considered the impact of AML/CFT controls on financial inclusion was followed and, as result, laws and regulations drafted often did not reflect domestic priorities, risks and capacities. The controls implemented were typically based on templates for AML/CFT controls applied in developed countries and tailored to conditions in developed countries. In the case of South Africa the insistence on physical address verification even surpassed the level of controls normally applied in developed countries. The CDD requirements contained in the Kenya AML bill also seems more appropriate to a developed rather than a developing country, which would seem to indicate that Kenya will also follow this development path.

However, once the regime has to be enforced (**phase 2**), reality sets in. FSPs that are already well supervised for prudential and other purposes (normally banks) are usually also the first to be supervised for AML/CFT purposes. Well-supervised institutions therefore have little choice but to implement AML/CFT controls. However, extending AML/CFT controls and their supervision beyond this regulated sphere has generally met the same difficulties as attempts to extend general financial sector supervision to the unregulated sub-sectors. Passing an AML law and regulations present no quick solution to the challenges of formalising informal financial services in a developing country. If anything, experience in the five countries show that overly ambitious AML/CFT controls will retard rather than enhance formalisation. Even though *centros cambiarios* in Mexico are required to register with the Mexican revenue authority for AML purposes and impose AML controls, in practice only 124 out of the estimated 5000 to 7000 centros had forwarded their contact details by September 2006. This environment of selective enforcement tends to be unnerving for the well-supervised institutions, particularly if they have business relationships with less supervised institutions.

During **Phase 3** regulators start to correct their initial over-reach, gradually adjusting AML/CFT controls to domestic risks and capacities. These adjustments typically (although not always intentionally) amend some of the negative impacts on financial inclusion experienced in phase 1 and 2. They are generally two-fold. Firstly, reduced controls are introduced for what regulators consider as lower-risk transactions, clients and institutions. Secondly, even if the risks are material, limited resources force countries to consciously or unconsciously adopt some form of sequencing in the implementation of the controls by sub-sector or categories of financial institutions.

4.2. RISK APPRECIATION

ML risk. The countries reviewed tended to separate their assessment of ML and FT risk. To the extent that regulators in the five countries applied reduced controls to what are considered as lower-risk (ML) clients, business relationships or transactions (in order to facilitate financial inclusion) these reduced controls were based on one or a combination of four risk considerations:

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

In countries where mobile banking and mobile payments are already introduced (the Philippines and South Africa) the regulators decided to limit the perceived risk primarily through transaction caps rather than stifle the development of these business models.

However, in none of these cases was there evidence that the risk-based adjustments to AML controls were made on the basis of an assessment of actual risk based on intelligence or law enforcement experience. Neither could we identify any feedback process from law enforcement or intelligence agencies to financial regulators providing information on effectiveness of the controls and whether they are set at the right levels. The thresholds for transactions to which reduced controls are applied therefore vary greatly across countries, from $140 (daily transaction limit for non-face-to-face originated cell phone accounts in South Africa) to $10,870 (KYC remittances threshold applied in Indonesia). Where categories of financial institutions were designated as lower risk, such as popular finance institutions in Mexico or rural banks in Indonesia, this assessment was based on the fact that these institutions typically handled lower-value transactions.

FT risk. Where countries did criminalise terror financing and imposed CFT controls, the only risk consideration used was the identity of clients and institutions known for their links to terrorist organisations. The CFT controls entailed checking the names of clients against lists of known terrorists and terrorist organisations provided by the state or international organisations. Regulators and financial institutions in the five countries also had a vague sense that informal money transfer operators presented FT risk. However, not a single person or institution could articulate the risk or any manner of dealing with it other than to refer to lists of persons and institutions provided by intelligence agencies.

4.3. SEQUENCED IMPLEMENTATION

None of the countries included in the study has the capacity to implement all of the FATF recommendations at the same time across all sectors or even only those areas identified as high risk. Accordingly, and by force of circumstance, differentiated levels of AML controls have emerged with each country in its own way developing a priority list that shaped the implementation of AML/CFT regulation. These levels do not signify a static state, but stages in the progression towards a comprehensive regime. Countries also tended to apply different levels to different sub-sectors depending on (1) risk perception, (2) the extent to which the sub-sector is currently subjected to supervision, (3) the capacity of the FSPs in that sector, (4) the general capacity of the state to impose controls and ensure their implementation. The levels shown below do not necessarily reflect the sequential progression found within countries. Sample countries tended, in fact, to aim for level 5 and were then forced to tailor it back to lower levels to fit within the enforcement capacity. Furthermore, this progression may apply to individual components of the financial sector as the implementation of an AML/CFT regime evolves. The observed levels of implementation are shown in Figure 2 on the next page.

Progress along this sequence can be facilitated by *market-related reforms*. For example, it was found that countries with conservative entry requirements limiting the types of entities that may transfer money (SA, Kenya and Indonesia) had less AML/CFT coverage of total transfers than countries with liberalised regimes (Mexico and Pakistan). Where non-bank remittance providers are categorised as illegal, it is more difficult to bring them onto the official radar screen for AML/CFT control purposes than if they are simply unregulated (as was experienced with centros cambiarios in Mexico).

Country evidence also shows that AML/CFT *effectiveness is related to available resources* and can be achieved at each of these levels. The most effective AML/CFT regimes are those that manage to correlate the level of control (and, therefore, resources) with the risk of respective sectors and within their resource capacity. Similarly, risk of financial exclusion exists at all of these levels and mitigating steps have to be taken. Extending regulation beyond regulatory and supervisory capacity was found to be counterproductive from both AML/CFT and inclusion points of view.

Along this progression of AML controls the regulator should attempt to maximise effectiveness by ensuring that maximum information is available, even if not supplied in the form of STRs or other reports, to the FIU and law enforcement agencies. For example, banks dealing with MSBs which are only registered or at the level of traceability (see Figure 2), can be required to report volumes of transactions to the FIU. Such information can, in turn, inform the sequencing process and highlight priorities for stronger controls.

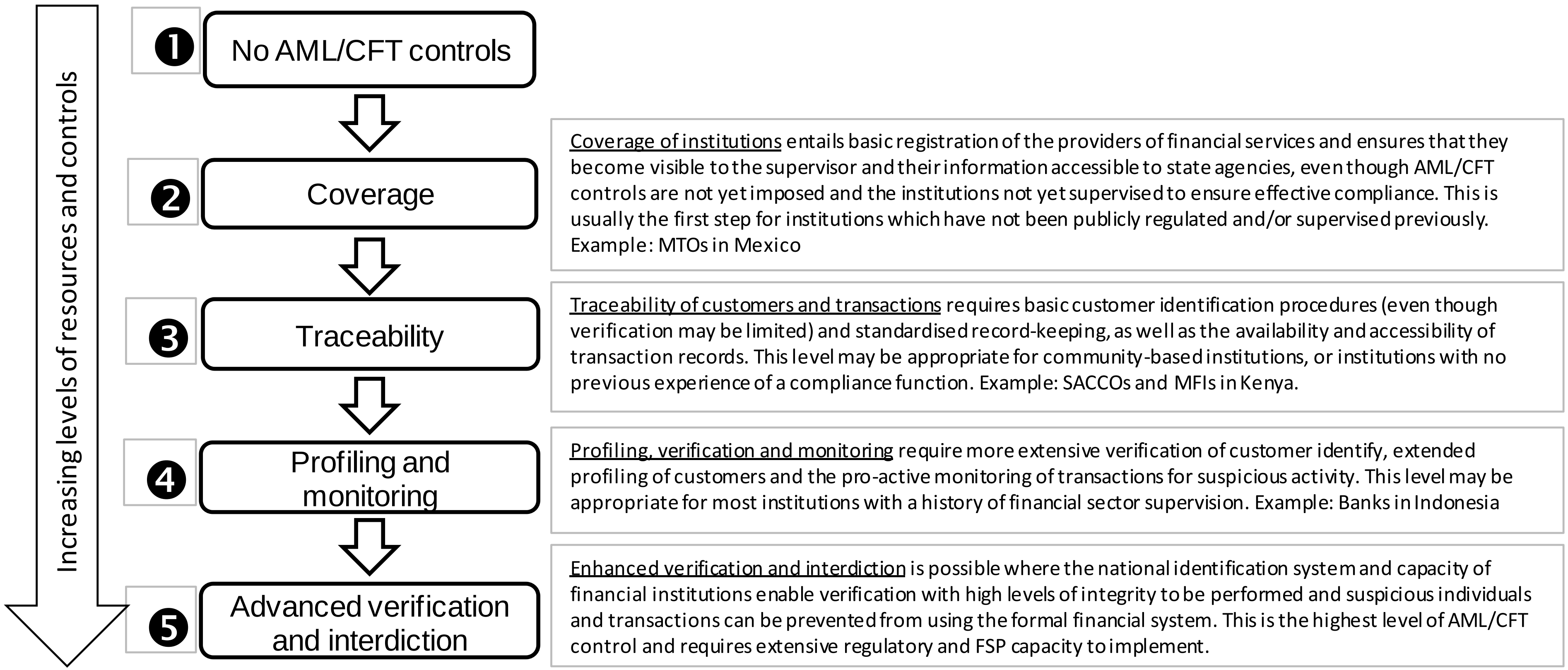

Figure 2. Emerging framework of implementation options

Source: Genesis Analytics

5. DRIVERS OF IMPACT

The level of impact of similar AML/CFT controls differs across countries and is determined by a number of country specific factors and characteristics. This section provides an overview of the main impact drivers identified and provides a brief description of the manner in which they affect the impact of AML/CFT regulation on financial inclusion.

5.1. LIMITATIONS IN THE NATIONAL IDENTIFICATION INFRASTRUCTURE

Financial institutions: Identifying clients and verifying their identity is a key element of all AML/CFT controls. The extent to which financial institutions can rely on public identification systems for verification will be a material cost element for them. If there is no national identification system, or the system lacks integrity, or the database is not accessible, it will force financial institutions to incur additional costs to achieve the requisite verification standard. This may result in the institutions withdrawing from low-value, lower-profit transactions and markets, a sentiment often expressed, for example, by commercial banks in Mexico. The dynamic is even more pronounced with client re-identification and new business models involving non-face-to-face client acquisition. These rely on the availability or provision of a minimum amount of client identification information which must then be verified against third party databases, such as a national identification database or credit bureau databases. If these are absent, lack integrity or is expensive to access (a major inhibition for the Wizzit mobile banking business model in South Africa) the risk levels may be too high for regulators to allow the business model or re-identification to proceed.

Clients: Similarly, if clients do not possess the required documentation, especially poor or rural clients far removed from public offices at which the documents are issued, it will be an absolute barrier or at least a cost barrier for them to accessing formal financial services.

5.2. LIMITED GOVERNMENT CAPACITY

Three forms of government capacity are relevant: (1) the capacity of the financial regulator/supervisor to supervise and enforce the implementation of AML/CFT controls on financial institutions, including alternative institutional capacity which can be brought to bear on this process; (2) the capacity of relevant law enforcement and intelligence agencies; and (3) the general capacity of the state to formalise the economy.

Supervision: With limited capacity, supervisors will tend to supervise what is within reach – usually the largest regulated entities. There will be little compliance pressure on informal and unsupervised institutions, who fall within the ambit of AML/CFT regulation and who render similar services to those of registered institutions. As a result the compliance cost for institutions within the reach of the supervisor will increase, with no similar increase for unsupervised institutions. This may result in the well supervised institutions withdrawing from low-income markets where they compete with unsupervised institutions. Uneven supervision may lead not only to the withdrawal of well supervised institutions from markets, but also the severance of business relationships between well supervised and unsupervised institutions. For example, the fact that regulators do not have the capacity to effectively supervise MSBs increases the risk for formal institutions to have them as clients. Combined with the increased liability under AML regulation on the supervised institutions the result is severance of relationships.

Law enforcement: Deficiencies on the law enforcement side usually mean that risk assessments are not based on actual information, but on hypotheses or international typologies. In the absence of a clear understanding of risk, regulators will tend to impose AML/CFT controls which are more onerous than required, simply to “play it safe”.

General incapacity to formalise. AML/CFT controls require financial institutions to make information on clients available to the state if required (FATF Recommendation 4). When a regulator attempts to use AML/CFT controls to gain information which will assist it with a general (non-AML/CFT) drive to formalise the economy, notably to combat tax evasion and extend its tax base, the results can be perverse. This is one of the key stumbling blocks with the implementation of the AML law in Pakistan. Unless the state has a strong enough revenue authority or other state agencies to back up its attempt with general law enforcement, clients who do have the option to use unregistered service providers may choose to do so rather than risk being included in the tax net.

5.3. THE STRUCTURE, CAPACITY AND INCENTIVES OF FORMAL FINANCIAL INSTITUTIONS

In all five countries it was observed that formal financial institutions tend to apply AML/CFT controls more conservatively than intended by the regulator. Consequently, where the regulator delegates discretion (e.g. on alternative documents allowed for verification) to financial institutions the result will be to limit rather than extend the categories of documents accepted for verification purposes. This behaviour is an entirely rational response to the structure of large financial institutions where the risk parameters are normally set by a central compliance function for implementation by frontline staff. In an environment where mistakes can lead to vast penalties and costs for the institution (and in some cases even for the compliance officer personally), the compliance officer will be reticent to delegate discretion to inexperienced front office staff members. The risk of criminal or civil liability can also alter the cost-benefit equation of particular markets, making lower-income market segments less attractive.

5.4. LARGE-SCALE USE OF INFORMAL FINANCIAL SERVICES

All of the countries in this study have extensive provision of financial services operating beyond the effective reach of regulation and supervision. Such informality is symptomatic of existing (non-AML/CFT) barriers to entry for informal financial institutions and their users, or simply a matter of choice. Yet, their very existence creates vulnerability for the imposition of AML/CFT controls to lead to even great financial exclusion. The dynamic works in two ways. Firstly, the availability of informal alternatives where the cost of usage and the hassle factor caused by AML/CFT controls are absent makes it easier to opt out of the formal sector. The availability of informal alternatives therefore increases the elasticity of formal sector usage. Secondly, AML/CFT controls make it more difficult to opt in from both an access and a usage point of view. Imposing AML/CFT controls will further increase existing barriers to joining the formal sector for clients who already find it difficult or inconvenient to do so.

5.5. LINKAGES TO INTERNATIONAL FINANCIAL MARKETS

The openness of an economy to international financial markets, both through cross-border commercial relationships and transactions, as well as foreign ownership of domestic institutions will influence the levels of AML/CFT controls implemented in that economy. Where domestic financial institutions are owned by foreign institutions, they are invariably required to adhere to group standards for AML/CFT compliance. These standards are by definition not tailored to facilitate domestic financial inclusion. A good example is Mexico, where foreign-owned banks indicated difficulties to apply group standards designed for investment banking activity to essentially retail operations in-country. Applying AML/CFT controls generated by foreign owners or correspondents can therefore limit financial inclusion. This problem can be limited by the domestic regulator developing and communicating a sound risk-based AML/CFT policy which will strengthen the hand of the local compliance officer of an international financial group in his deviations from head office standards.

5.6. FAILURE TO DEVELOP DOMESTIC AML/CFT POLICY

The negative impact on financial inclusion of the drivers highlighted in 5.1 to 5.5 is invariably exacerbated if no explicit domestic AML/CFT policy is developed which considers all these drivers. In the absence of such comprehensive policies, AML/CFT regimes tend to be driven by law enforcement perspectives rather than seeking to achieve a balance between law enforcement and financial inclusion. The problem can be compounded if the financial policy-maker or regulator has limited research capacity or insufficient mechanisms exist to consult with the financial sector. The limited impact of the implementation of the AML/CFT regime in Indonesia was indeed a result of careful consideration and extensive consultation with financial institutions.

6. OBSERVED IMPACTS AND MITIGATING RESPONSES

In this section we summarise the key findings of the impact of AML/CFT on financial inclusion. These impacts will be described within the inclusion framework outlined in Section 2.3, identifying particular impacts on access, usage and other supply-side features.

6.1. NON-AML/CFT FACTORS AFFECTING INCLUSION

AML/CFT regulation is not the only factor impacting on financial inclusion. In recognition of this, the impact of AML/CFT regulation on inclusion was evaluated within the context of broader regulatory and market dynamics. As noted in Section 2.3, the presence of other barriers to inclusion does not remove the imperative to minimise barriers resulting from AML/CFT regulation. It merely confirms that a holistic approach is required to support inclusion.

The most prominent non-AML barriers to inclusion found in the sample countries were:

Affordability. Without exception, affordability was found to be the most significant barrier to inclusion for transaction bank accounts in all the countries reviewed. Significant proportions (Indonesia 75%, Kenya 95%, Mexico 64%, Pakistan 85%, and South Africa 33%) of the adult populations in the respective countries are excluded from access to transaction bank accounts due to the cost thereof relative to their income. For remittances, affordability also presents significant constraints in South Africa and Kenya where the transfer of small amounts[31] could cost as much as 37% and 17% respectively[32] of the amount transferred. The extent of exclusion is reflected in the significant informal remittance markets in these countries relative to that of the other sample countries with lower formal remittances charges. Of course, it is not only the absolute cost, but also the cost relative to informal alternatives that determines the level of informal channel use. Although Indonesia, Mexico and Pakistan had much lower formal channel costs, they still showed significant use of informal channels at least in part due to the relative cost and convenience of using informal channels.

Non-AML/CFT regulatory barriers. In addition to affordability, a number of explicit barriers were created by non-AML/CFT regulation. Regulation in Kenya and South Africa limits international money transfers to banks or their agents, thereby limiting competition. This is clearly reflected in the remittance charges (noted above) for these countries which far exceed the other sample countries where these regulatory restrictions do not apply. Furthermore, regulations across all five sample countries effectively prohibit financial institutions from opening accounts or conducting transactions for undocumented migrants. This affects an estimated 2.5-4.1m undocumented migrants in South Africa and at least 800,000 in Kenya.

Doorstep/usage barriers. Although not easily quantifiable, the hassle factor of dealing with formal institutions, cumbersome processes and negative perceptions were found to be a significant deterrent to using formal financial services, particularly where convenient informal alternatives were available. Despite the Pakistan government's extensive efforts to encourage formalisation by incentivising lower costs and improving service delivery, the relative burden of dealing with formal MTOs remains a deterrent to using formal financial services. At least 50% of flows (estimated to represent 75% of transactions) remain informal. In addition, the poor perceive traditional banks as institutions for the rich. New micro-finance bank, Tameer Bank, is making inroads in the urban unbanked markets simply by

[31] Based on estimate of average amount sent by lower-income households.

[32] As noted in Section 2.3, quantification of the degree of exclusion as result of affordability is more complicated for remittances than for bank accounts as the cost also relates to the value of the transaction and not only the sender's level of income. As a rule of thumb, remittances costing more than 10% of the value transferred were considered as exclusionary. This was the case for South Africa and Kenya.

welcoming poor clients into their branches and softening the doorstep/application barriers. This is despite the fact that their charges are the same or higher than traditional commercial banks.

The observed barriers created by AML/CFT on access, usage and market efficiencies are noted below.

6.2. AML/CFT IMPACT ON ACCESS

Access barriers refer to features of the AML/CFT controls which explicitly exclude potential client groups.

Undocumented migrants. The requirement by AML/CFT regulation for foreign citizens to provide documentation proving legality of stay excludes undocumented migrants[33]. This affects undocumented migrants Kenya. The same problem in the US, at least in relation to Mexican citizens, was mitigated by allowing Mexican immigrants to legally access the formal banking system by means of the Matricula[34] consular identity card without requiring proof of legality of stay. In this way, the use of informal channels was disincentivised, enabling information on the transfers to be captured in the formal financial system and made available to law enforcement authorities.

Inability to prove residential address. Customer due diligence (CDD) regulations requiring address verification as additional means of establishing client identity exclude large groups of adults who are unable to provide such details. In Kenya, it is estimated that as much as 95% of adults will not be able to prove their residential address as required in the proposed AML bill. In South Africa at least 30% of adults were at risk of being excluded by the specification of address verification in the initial formulation of the CDD requirements. This was mitigated by an exemption removing the requirement for address verification for specifically defined low-risk transactions[35]. In Indonesia the information on the KTP identity card includes the address of the individual. Despite potential problems with the integrity of the identity card, AML/CFT regulation accepts this as best available and sufficient verification of identity and address. Client profiling was added to the CDD process to support the deficiencies of the identity system.

Difficulties with client re-identification. The requirement to apply CDD processes to existing clients can also prove exclusionary, especially if it proves difficult to obtain documentation from them. In such cases, notably Pakistan, regulators have allowed financial institutions to verify the identities of existing clients against reliable third party databases. This is proving difficult in Mexico due to a legal prohibition on banks accessing the Mexican voters' identity database (the most extensive identity database in that country). Mexican banks now face penalties for failing to re-identify existing clients who do not produce the prescribed documentation. In South Africa the re-identification challenge was dealt with by allowing financial institutions more time provided that they implement a risk-based process which places the initial focus on re-identifying high-risk clients and then dealing with lower risk clients.

Access-friendly adjustments to CDD in the UK. The experience of the UK illustrates that similar problems are experienced by developed countries. The UK regulator recently refined its AML/CFT systems in order to, amongst others, minimise unintended impacts on inclusion. The UK found that the banks were sometimes too conservative in their application of client due diligence procedures and that this may have impacted on access to financial services. The Financial Services Authority (the UK regulator) in 2006 amended the AML/CFT control system by implementing a risk-based approach. This approach was complemented by industry guidance. In terms of the new system regulated institutions must determine their AML/CFT controls on the basis of their analysis of the risks that they face. Risk

[33] As noted in Section 6.1, the restrictions upon undocumented migrants can also be contained in other financial sector regulation, such as exchange controls. However, even if such regulation was abolished, the necessity to prove legal identity could still remain as part of AML/CFT controls.
[34] See Box 2 in Appendix E
[35] See Appendix E.

management is not an exact science and the FSA acknowledged that risks may be misjudged and failures may occur. The FSA therefore stated on record that enforcement action would be unlikely when a financial institution is abused for AML/CFT purposes, if it can prove that it acted reasonably to prevent such abuse and that its decisions were informed by industry guidance and other relevant facts. This aimed to remove what the FSA termed the “fear factor” on the part of banks, which resulted in overly conservative application of regulation. The success of the new system in facilitating access has however yet to be established.

It is important to note that all of the above impediments to access can be minimised through transaction-based exemptions for low-risk, low-value accounts and transactions without undermining sound risk management. These are discussed in Section 7.7.

6.3. AML/CFT IMPACT ON USAGE

Although not explicit barriers, usage factors were found to be significant deterrents to the use of formal financial services in the countries reviewed. AML/CFT regulation contributes to existing usage barriers by increasing the process and documentation requirements. This fuels distrust and increases inconvenience relative to informal options.

The proposed Kenyan AML/CFT law requires clients to provide proof of residential address. Recognising that this may not be possible for a large proportion of adults, the regulation creates an alternative whereby residential address can be verified through a letter from a government official. While this provides an alternative, it also creates a significant process burden which fuels the “fear of officialdom” and is likely to discourage use of formal financial services. In South Africa, documentation requirements in general have been found to be a significant contributor to the doorstep barrier intimidating low-income consumers looking to enter the formal system. Resistance to documentation in Pakistan is also fuelled by the extent of tax evasion and informality. In Indonesia, the increased documentation burden created by requiring information for profiling is partly mitigated by bank staff assisting clients to complete the forms. This is possible because of the lack of cost awareness and sensitivity found amongst Indonesian banks, a feature not found in any of the other countries. While laudable, a closer reflection on the cost and profitability of low-income clients is likely to discourage banks from providing such support.

As with the access barriers, it is important to note that all of the above impediments can be minimised by transaction-based exemptions for low-risk, low-value accounts and transactions without undermining sound risk management. These are discussed in Section 7.7.

6.4. AML/CFT IMPACT ON MARKET EFFICIENCIES

This category of impacts operates at the level of the FSP and impacts on the nature and extent of services being offered to lower-income clients and the competitive dynamics in the market.

Severing relationships between formal and informal/unsupervised. The combined effect of potentially significant financial implications of contraventions of AML/CFT laws (criminal penalties, reputational damage and potential civil liability) and limited profit opportunities tends to undermine the business relationships between formal FSPs and informal or unsupervised FSPs.

The USA, with its large immigrant population, is one of the largest remittance sending countries in the world. As such, the state of access to formal financial services (most notably remittance transfer services) is of utmost importance to the livelihoods in a host of developing countries dependent on remittance inflows from the USA. Such services are however (unintentionally) undermined by the impact of AML/CFT controls on the ability of money services businesses (MSBs) in the United States to access a bank account, which they require for their day to day operations. Though AML/CFT regulations do not require banks to close MSB accounts, they do require banks to apply due diligence and to assess the ML/FT risks posed by MSB accounts. Banks were uncertain how to respond to their MSB-related obligations and, to avoid the risk (and cost) many banks proceeded to close all MSB accounts. In reaction, the USA's FIU (FinCEN) issued a guidance note allowing banks the scope to classify MSB accounts as high or low risk (based on a specified set of criteria) and stating explicitly that accounts need not be closed, even where MSBs are classified as high risk. The guidance did however not still banks' fear of criminal, as well as potential civil, liability. They have furthermore experienced the costs associated with risk assessment and monitoring as prohibitive. Thus the tide of MSB account closures has not, as of yet, been stemmed. This is of concern as MSBs are direct competitors to the banks in the remittance market and serve a large proportion of the lower-income migrant market. The closure will therefore probably impact on affordability and availability of financial services for the poor.

A similar dynamic is unfolding in the relationships between commercial banks and *centros cambiarios* in Mexico. The *centros cambiarios* are effectively unsupervised (though included in regulation) and several commercial banks look upon the risks posed by these institutions as too big for comfort. They are accordingly severing their relationships with these institutions which often provide essential "last mile" services in the remittance channel.

In contrast, in Indonesia the impact of AML/CFT regulation on the relationship between traditional banks and small BPRs ("peoples banks") has been limited. This is at least in part due to the positive and pro-active relationship between the regulator and the FSPs. As was noted above for the UK, pro-active and explicit guidance combined with a system that does not insist on zero failure, removed the "fear factor" on the part of banks and avoided an overly conservative implementation of the regulation.

Increased transaction cost of small, low-risk transactions lead to withdrawal from low-income market. In a similar manner, the increased process and documentation requirements imposed by AML/CFT risk render low-income transactions unprofitable. In particular, the requirement to obtain and store hard copies of client identity documentation has proved to be prohibitive. Had this requirement been enforced in South Africa, this would render the average low-income remittance value (R500) unprofitable. This could represent as much as 80% of formal low-income remittances through banks in South Africa. This impact has also been mitigated in Mexico by exempting low-value, low-risk transactions from some of the more costly requirements. Mexican regulation removed the need to open a physical file for or to re-identify clients whose accounts fall within specified limits: the account balance must not exceed $3,000 and transaction volumes must not exceeding $10,000 in any given month. In the absence of this exemption, Banco Azteca, one of the fasting growing banks in Mexico targeting lower-income consumers through the Elektra retailer network, would have had to increase its minimum balance requirements on its savings accounts significantly and a large proportion of its current clients would not have been able to open an account. Since their entry in 2002, Banco Azteca has grown to become the second largest retail bank (in terms of number of accounts) in Mexico with 10m accounts held by 4m clients.

Prevents or delays the introduction of new models and technologies. In Pakistan, Indonesia and Kenya the AML/CFT regimes prohibit non-face-to-face client origination thereby preventing the introduction of mobile banking models relying on non-face-to-face origination to reduce cost. In addition to this prohibition, the burden of dealing with AML/CFT regulation has discouraged and delayed the entry of new business models into particular low-income markets. In Mexico, some non-bank MFIs have delayed extending their lending models to include deposit-taking due to the increased regulatory/compliance burden and risk of criminal liability they face under AML/CFT regulation. In South Africa, representatives of the FIC and some supervisory bodies insist that identification documents should not only be sighted but should also be copied and those copies retained. This requirement undermined the roll-out of Wizzit bank's cell phone model where origination is done by mobile agents who do not have ready (or cost-effective) access to facilities to make copies of documents. Wizzit is an innovative, completely cell phone-based bank explicitly targeting the rural and unbanked population and one of the few competitors in the concentrated retail banking market.

Contrast the experience of the largest two cell phone operators in the Philippines (Globe and Smart Communications) who have both launched mobile payments initiatives. While Smart's model is linked to a bank account, G-Cash operates independently of a bank and essentially uses a system of "e-money" transfers. Both models incorporate transaction limits and require identification for any cash withdrawal/deposit. The AML/CFT controls of this system were approved by the regulators. In developing their models and controls, both companies worked closely with the regulators to devise a working solution that does not undermine the flexibility or cost-effectiveness of the mobile payments service, yet meets the AML/CFT requirements. In this way, the Philippines regulator facilitated the introduction of new business models and technology while managing the AML/CFT risks.

Regulatory bias against small institutions. Small and/or recently formalised FSPs face particular challenges in complying with the operational and systems requirements of AML/CFT regulation.

In Kenya the proposed inclusion of SACCOs, MFIs and even informal MTOs under the proposed AML/CFT regulation will require dramatic changes to the way in which these institutions are run, which is likely to stretch their already limited resources. Given the systems and operational requirements, many (particularly the informal providers) will simply not be able to comply. In light of the need for their services and limited enforcement capacity, these institutions may not be forced to close but will be forced further underground. In Mexico, centros cambiaros and other smaller and informal FPSs were unable to comply with the initial standard of AML/CFT operational and systems requirements extended across all FSPs. The Mexican regulator subsequently adjusted the regulations to reflect institutional differences, but the requirements on smaller institutions remain onerous. At the same time, the adjusted regulations resulted in different regulation for institutions conducting the same transactions, thereby creating an unlevel playing field. Furthermore, the regulator staggered the implementation of regulation focusing implementation primarily on the large formal institutions and, thereby, allowing time for the smaller institutions to comply. However, given the requirements on large FSPs, they are starting to close the accounts of smaller unsupervised institutions due to the risk of criminal and other liability under the AML/CFT laws. Even though not directly enforced, AML/CFT regulation is, therefore placing significant pressure on smaller FSPs.

Unlike the case for usage and access barriers, transaction-based exemptions may only provide partial relief for the above-mentioned supply-side impacts. Institutional requirements/barriers will remain a problem and needs to be addressed by regulation.

7. TOWARDS GUIDELINES

7.1. GOAL AND PRINCIPLES

The **goal** of these guidelines is to support developing countries in implementing effective AML/CFT controls that meet international standards whilst at the same time promoting financial inclusion.

AML/CFT controls are aimed at (1) combating the abuse of financial systems by persons laundering proceeds of crime and (2) combating the funding of terrorists and terrorist activity. The FATF Forty Nine Recommendations establish a single minimum international standard for action. Countries are urged to implement these recommendations but are allowed some leeway to design the detail of the AML/CFT systems according to their particular circumstances and constitutional frameworks. In practical terms the recommendations have four objectives: (1) To ensure that countries implement equivalent laws and structures to combat ML/FT; (2) to ensure that financial institutions and certain non-financial businesses and professions take prescribed steps to prevent the use of their systems for ML and FT; (3) to make information available to the state to support action against those who engage in ML/FT and, (4) to increase international cooperation in this regard.

The objective with financial inclusion is that individual consumers, particularly low-income consumers currently excluded from using formal financial sector 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. Financial inclusion is one of the cornerstones of an effective AML/CFT system. Without a sufficient measure of financial inclusion, a country's AML/CFT system will only safeguard the integrity of a part of its financial system. Measures that ensure that financial services are formalised, regulated, accessible and used extensively therefore increase the reach and effectiveness of the AML/CFT controls.

The following general **principles** should guide the design of a national AML/CFT regime that supports financial inclusion:

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

7.2. GUIDELINE 1: DEVELOP A POLICY

Before an AML/CFT regime is enacted or even if already enacted, the domestic financial sector policy-maker or regulator should consider the interaction between imposing AML/CFT controls and financial inclusion. Policy makers should guard against adopting templates or regulations imposed in other jurisdictions without first considering the appropriateness and potential impact of those regulations in their own jurisdictions. It is important to consider financial inclusion in the policy-making process, but ideally the policy should be comprehensive and should also give consideration to other relevant factors such as existing and expected crime patterns, law enforcement, regulatory and compliance capacity, undocumented migration and market and social development conditions.

The rest of these guidelines are intended to support such a policy-making process in respect of issues relating to financial inclusion.

7.3. GUIDELINE 2: FOLLOW CONSULTATIVE AND FLEXIBLE APPROACH

The effectiveness of AML/CFT controls and their impact on financial inclusion depend on the extent to which limited domestic resources are targeted at domestic ML and FT risks. Getting the balance right will require regulators to consult on an ongoing basis with the key interest groups. These include FSPs, both registered and unregistered, law enforcement agencies, as well as other national agencies, notably those responsible for the national identification infrastructure. However, it is important to note that consultation with FSPs is likely to yield information on the market currently served. In all of the countries reviewed, this would be limited to a small proportion of adults and mostly high-income individuals. The regulator needs to ensure that consultations also include those not currently served to ensure a better understanding of the potential impact of AML/CFT regulations on those who are excluded from financial services.

7.4. GUIDELINE 3: ASSESS AND DEFINE RISK

Responsibility: A country's AML/CFT system should address the domestic ML/FT risks within the framework set by the FATF Recommendations. An assessment of the domestic ML and FT risks must be performed. This assessment must be performed by the financial sector policy-maker, relevant regulators, and law enforcement and intelligence agencies, drawing upon information provided by the agencies concerned as well as formal and informal financial and trade-based institutions and designated non-financial businesses and professions. This risk assessment will inform the government's AML/CFT as well as law enforcement policy but will also assist individual financial institutions to identify and manage their institutional AML/CFT risks more effectively.

Risk of money laundering: ML risk can be identified with reference to categories of clients, business relationships (or financial products) and transactions. The risk levels of financial institutions that focus on particular categories of clients or transactions can be similarly identified. The following risk considerations, amongst others, are relevant from a financial inclusion point of view:

- Lower value transactions pose a lower risk than higher value transactions;
- Domestic (in-country) transactions would often pose a lower risk than transactions with a cross-border element;
- Transactions or institutions which do not link to the formal payment system hold lower risk for the financial sector than transactions or institutions which are linked to the system.

Although the assessment of the relevance and scale of these considerations within a country can draw on international experience and precedents, it is important to consider the risks attaching to particular categories of domestic financial institutions, transactions and clients within the context and with the information available in that country. Risk should also be viewed in a strategic context. New business models, such as mobile phone banking, may introduce an element of AML/CFT risk, but at the same time utilise systems that are as capable if not more capable than traditional banking systems to identify suspicious transactions. Moreover, these models are able to increase financial inclusion in many countries, thereby increasing the scope and effectiveness of the AML/CFT system. The policy maker may therefore decide to embrace an element of risk in order to develop a more secure system. If such a decision it taken, it would be appropriate to limit that element of risk by requiring the adoption of appropriate controls and the setting of transaction limits.

Risk of financing of terrorism: Similar risk categorisation has yet to emerge for FT risks. The most generally-applied barometer of the risk of FT remains the identity of the parties to the transaction. It is submitted that the identification of such high risk persons is the duty of the state and relevant intergovernmental institutions.

Identify risk framework of resultant priorities: The identified risks must be mapped to financial sub-sectors, institutions, transactions, client categories or other relevant characteristics (e.g. geographic area) to produce a risk framework and resultant priorities for regulation and control. At the outset, this will probably be quite a rudimentary framework. However, as experience is gained with implementation, the framework will be refined. Moreover, the domestic and international ML and FT risks will not remain static. The framework will therefore evolve over time.

Feedback loop to guide evolution: A feedback loop should be established from financial institutions, law enforcement agencies and the FIU to inform the policy-maker whether the AML/CFT controls imposed actually supports the risk-management objectives of the AML/CFT regime and what further adjustments can be made to facilitate financial inclusion.

7.5. GUIDELINE 4: IDENTIFY EXCLUDED AND VULNERABLE GROUPS

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

The causes of exclusion are normally threefold:

Access denied: Many, particularly poor, people cannot obtain financial services that are affordable, usable and appropriate to their financial needs. Factors that may exclude individuals from being able to use a particular product can include the physical distance from service points, the cost of using the product, exclusionary terms, such as minimum balances imposed by financial institutions, or regulatory barriers imposed by the state. The latter could include a prohibition on undocumented migrants from using formal financial services or the necessity to prove a residential address with third party documentation not available to a household.

Attractiveness of services: In some cases individuals decide against using a particular product even if they are not explicitly excluded. This usually rational decision can, amongst others, be based on the cost of the formal product relative to the cost and convenience of the informal alternative (which is often the case with remittance products), the simple hassle of gaining access to the formal product (such as providing multiple documents to comply with AML controls before an account can be opened), or a prevailing transaction culture, such as exists in cash-based economies.

Financial institutions are discouraged from providing services to excluded groups while informal providers are prevented or discouraged from entering the formal sector: Market efficiency is affected by many factors, such as anti-competitive practices, onerous compliance burdens, or a reticence on the side of regulators to facilitate new business models and technologies. To the extent that financial services providers remain beyond the supervisory reach of the state, their clients remain excluded (and their identity and transaction information unavailable to the state for AML/CFT control purposes). Excluded groups may also include institutions that may be excluded from formalisation in the same way that individuals are prevented from accessing formal financial services.

7.6. GUIDELINE 5: ASSESS RESOURCE ENVELOPE

The imposition of AML/CFT controls which cannot be implemented within the domestic resource envelope tends to increase financial exclusion without contributing to effective AML/CFT risk management. Even a rudimentary assessment of this resource envelope will contribute to limiting the exclusionary impact. The following questions regarding the resource envelope are relevant from a financial inclusion perspective:

Regarding the capacity of financial services providers: What is the nature of their systems, for example, is it electronic or manual, can they apply transaction and product restrictions such as daily transaction limits; can they monitor transactions through the application of artificial intelligence; what information do they currently have about clients (not only electronic, since common bond institutions may have very good information about clients simply through personal relationships); what are their reporting capabilities; what is the nature and capacity of their compliance function; does their staff capacity allow them to apply discretion and judgement on AML/CFT risks; is the legal and regulatory environment so strict that institutions will impose stricter controls where the law gives them a discretion to determine the relevant controls?

Regarding the capacity of the financial sector regulator(s): What are the mandate, staff complement, systems capacity, skills set and budget of the respective regulators; which consultative mechanisms are available to the policy-makers/regulators; if an FIU already exists, what is its capacity; which alternative public institutions, such as revenue authorities, can assist to supervise categories of financial institutions not currently supervised; are there current policy priorities which could complement or detract from the imposition of AML/CFT controls (such as a strong privatisation drive in the banking sector)?

National identification systems: Are there national or other identification systems which could facilitate the verification of clients; what are their coverage, integrity and accessibility?

Given the (1) assessed risk framework and resulting priority areas for the imposition of AML/CFT controls, (2) the levels of financial inclusion and its causes, as well as (3) the resources actually available to implement AML/CFT controls within the economy, an AML/CFT regime can then be crafted to achieve the twin objectives of controlling ML/FT and extending, or at least not inhibiting, financial inclusion.

Two approaches may assist in the design of an AML/CFT system that supports these objectives:

- Firstly, apply reduced controls to lower-risk transactions, clients and institutions serving these. Guideline 6 provides more details on the design of such reduced controls.
- Secondly, where the resources of the economy do not allow for effective control of all areas posing material risk from the outset, sequence the implementation of controls across sub-sectors or categories of institutions so that the best levels of AML control under the circumstances is achieved while the supervisory reach of the state is actively extended. Guideline 7 outlines potential approaches to sequencing.

7.7. GUIDELINE 6: REDUCED CONTROL FOR LOWER-RISK TRANSACTIONS

Limited risk-scaling for CFT risk. Before proceeding with guidelines on the risk-based implementation and sequencing of regulation, it is important to note that guidelines 6 and 7 focus primarily on ML rather than FT controls. None of the countries studied have developed a sophisticated risk-scaling model for the design of risk-based FT controls. A risk-based approach to FT is complicated by a number of factors, for instance, more must be known about FT typologies to construct a general model; even small value transactions can present FT; and money from legal sources may be used for FT purposes. No generally-accepted model for FT risk-scaling has emerged and the FATF, having acknowledged the benefits of a risk-based approach to FT, is still continuing with work in this regard. In the countries reviewed, controls are mainly structured around the monitoring of client and third-party identity against lists supplied by the government and international organisations. In addition, attention is given to transactions that are linked to countries and territories with a higher FT risk profile.

Risk-based ML controls. Reduced controls seek to control a lower level of ML risk effectively and proportionately. The level of risk should be determined by the assessment conducted as part of guideline 3. When reduced controls are designed it is important to consider, particularly, those factors that inhibit access to and usage of financial services. These typically include the inability or difficulty for clients to provide documentary evidence to verify identity or residential address; compliance costs for financial institutions flowing from systems requirements; and CDD and record-keeping obligations (notably a requirement to keep physical records, especially for once-off transactions). In some low-risk cases, the risk may justify the adoption of reduced controls.

It is important to note that where reduced controls are applied as suggested in the examples below, transactions must be monitored for abuse and to allow for on-going tailoring of the regulation.

Examples of reduced controls that may address the following inclusion barriers (especially when applied in combination) include the following:

Documentation and verification barrier: Verification that requires more than sight of one relevant and generally available identification document fuels the hassle barrier for clients and will exclude vulnerable groups who do not have the necessary documentation.

Allow the use of appropriate verification documentation that is generally available. A framework that allows clients to verify information using any of a range of verification documentation that is reliable and generally available to the poor, will facilitate financial inclusion.

Simplified verification for low-value transactions or products. Limited or simplified verification requirements may be set for low-value transactions or for products which limit transaction values to specified thresholds, especially where such transactions do not have a cross-border element (where attempted transactions exceed these thresholds, full verification should be required before further transactions can be processed).

The cost and burden of verification procedures is particularly problematic for low-income clients. In most cases those clients also maintain small account balances and low transaction profiles. In one example, a country established through review of bank information that low-income accounts have transaction and balance profiles that are far below risk thresholds (e.g. account balances of less than US $100) and that transactions are generally restricted to the country concerned. With this information, the country could impose a transaction and balance threshold that is sufficient to facilitate the majority of low-income transactions but conservative enough to control ML abuse. Products and accounts that are structured around these thresholds could then be exempted from the more onerous standard verification requirements that apply to ordinary, non-limited accounts and products. Provision could be made for standard verification requirements to apply if a client with such an account or product wanted to transact above the threshold.

Focus on profiling, particular where the national identification system is absent or weak. Where national identification systems are absent, fragmented or lack integrity and cannot support client verification processes, limited or simplified verification procedures may be counterbalanced by more extensive client profiling that support monitoring of activity to identify deviations from the profile supplied.

In one example, a countries with a weak identification systems accepted the national identity document as means of verifying identiy but compensated for its deficiencies by requiring FSPs to collect (but not verify) further information to construct a more detailed client profile. Such information may include: nature of employment, expected levels of income, purpose of account, address, etc. In this way, the regulator has avoided imposing significant costs on the FSP that would have been incurred had they been required to build an alternative identification system. At the same time, it created a useful profile that can be used to monitor for suspicious transactions as well as for building better client relationships. The government could then initiate longer term programmes to improve the national identification system.

Verification through 3rd party databases. Allow financial institutions to verify client information against reliable third party databases accessed independently by the financial institution instead of compelling them to only accept documentary proof submitted by the client. The effectiveness of this control will depend on the availability, accessibility and quality of databases of third parties such as credit bureaus.

This approach proved effective in an example of a mobile bank where the account opening procedure was conducted over the phone (i.e. non face-to-face). The FSP in question collected the necessary client information but instead of requiring clients to submit a copy of their identification document, the details where verified against a third party database.. This measure was also combined with an account threshold to limit the risk. Where the clients wanted to exceed the threshold, they had to provide the standard verification documentation. In a different example FSPs where allowed to re-identify clients by comparing their client information with a government identity database. The database allowed for online and batch processing, enabling banks to conduct the re-identification process efficiently and within a relatively short period of time.

Costly MIS systems: Imposing requirements to implement advanced MIS systems will impose significant costs on the industry and bias against small players.

Flexibility on MIS requirements. Allow a control framework that relies on paper-based or simplified systems rather than advanced electronic management information systems, if the former is cheaper or more manageable and affordable for the relevant FSPs. In one example, the AML/CFT regulations were designed to allow FSPs the flexibility to use simpler or even paper-based systems as long as they meet the reporting requirements and can demonstrate that appropriate risk management can be done by using these systems. This allowed smaller FSPs who individually served a small client base, often on a very personal level, to use simple electronic or paper-based systems whereas larger FSPs could benefit from using appropriate electronic systems to deal with their larger client bases

Record-keeping costs: Requiring FSPs to retain paper copies of verification documents results in significant costs to construct and maintain document management systems that provide little benefit for risk management or client relationships.

Streamlined record-keeping. Allow reduced or streamlined record-keeping, for example allowing verification documentation to be scrutinised and noted rather than copied and allowing electronic record-keeping. In one country FSPs are required to verify clients' identity through sight of the relevant identification documents. However, FSPs are not required to retain a copy of the document or open a physical file for the client if the transaction balances remain within a defined threshold. Instead FSPs can simply capture the details electronically for monitoring purposes. For a particular FSP targeting low-income clients this enabled them to manage low-balance accounts and low-value transactions on a viable basis and grow to become one of the largest FSPs in the market (in terms of client numbers). The records are, however, sufficient to control ML risk and to facilitate investigations and prosecutions where required.

Delaying or prohibiting the introduction of new technologies and business models (e.g. m-banking[36]): Uncertainty regarding the nature and implication of new business models and technologies often results in regulators following the conservative approach of prohibiting such technology.

Embrace new technologies while limiting risk. Where regulators are confronted by new technologies or business models for which the ML risks are unknown, market development can be facilitated by limiting the functionality of new products (for example by capping the value of transactions and/or prohibiting cross-border transactions utilising the new technology) whilst monitoring usage to determine and assess the actual risks presented. This manages the risk and utilises the benefit of new models that often include advanced MIS systems that could facilitate detailed monitoring and reporting at low cost.

This approach has benefited mobile banking models in a number of countries. In one example, the regulator created a tailored regime to allow a mobile phone-based remittance system. Risks were managed by introducing account restrictions and by implementing systems to monitor the transactions against client profiles. Given the advanced electronic platform used, this could easily be achieved at relatively low cost. The fact that this product is targeted at the lower-income market allowed the setting of fairly low thresholds and restrictions which limits the risk while still allowing the typical transactions to be conducted on this account. The standard regulation required face-to-face origination but the regulator allowed origination through agents of the FSP to facilitate the use of retailer and other distribution networks. This flexible approach has allowed for the emergence of a large low-income remittance system.

In another example non-face-to-face origination of mobile bank accounts where allowed as long as account restrictions were imposed, cross-border transactions prohibited and sufficient monitoring conducted to control ML abuse. In addition, this was combined with the use of third-party databases for verification of client identity as noted above. This allowed the mobile bank to manage client origination efficiently and at low cost to leverage the benefits of their technology.

7.8. GUIDELINE 7: RISK-BASED SEQUENCING OF AML CONTROLS

Risk-based sequencing. The sequencing approach acknowledges that all countries should strive to meet the FATF standards, but accepts that the domestic resource envelope of some countries may not allow full and effective controls to be imposed on all relevant transactions and institutions all at once. The level of controls imposed may then have to be scaled to the capacity of the regulator and the institutions involved. Levels of control will normally be higher for those institutions that are well-regulated and may initially be rudimentary for those institutions that have not been subjected to comprehensive regulation. Sequencing and scaling may be appropriate strategies but only if they are coupled with a framework to manage an increase in the required capacity to ensure that the international standards are reached. Increases in capacity should be accompanied by increased levels of control until the desired levels have been reached.

Levels of AML control. Potential levels of control are the following:

- <u>Coverage of institutions</u>, which entails basic registration of the providers of financial services. Registration ensures that these providers become visible to the supervisor and their information

[36] Assessing and managing the AML/CFT risk in mobile banking models will be dealt with in more details in a forthcoming World Bank paper focusing on this topic (due for publication at the beginning of 2008).

accessible to state agencies. At this stage AML/CFT controls are not yet imposed and the institutions are not yet supervised to ensure effective compliance. This is the first step for institutions which have not been publicly regulated and/or supervised previously. This approach was followed by one country where regulation had to be extended to money transfer operators but the state lacked the regulatory capacity to enforce compliance and the regulated entities did not have the ability to implement comprehensive AML/CFT controls. The country therefore used its existing regulatory capacity and required money transfer operators to register with the tax authorities for AML/CFT purposes.

- Traceability of clients and transactions, requiring institutions to follow basic client identification procedures (even though verification may be limited), to keep standardised client and accounting records, and to ensure that those records are available to regulators and investigators.. This level may be appropriate for community-based institutions, or institutions with no previous experience of a compliance function. In one example, the regulator submitted second tier community-based banks to limited regulation but required them to keep certain records which could allow for traceability of transactions if this would be required by law enforcement authorities.
- Profiling, verification and monitoring, which requires profiling of clients, more extensive verification of client identity, and the pro-active monitoring of transactions for suspicious activity. This level is appropriate for most institutions with a history of financial sector supervision.
- Enhanced verification and interdiction is possible where the national identification system and capacity of financial institutions enable verification with high levels of integrity to be performed and suspicious transactions can be interdicted by the state before they are carried out. This is the highest level of AML/CFT control and requires extensive capacity to be implemented.

Along this continuum of AML controls the regulator should attempt to maximise effectiveness by ensuring that as much information as can reasonably be expected is available to the state. This includes the filing of STRs to the FIU as well as the supply of information to facilitate the management of the sequencing and scaling strategies. For example, banks dealing with MSBs which are only registered (coverage level), can be required to report volumes of transactions to the regulator. Such information can highlight priorities for stronger controls. The duty to report STRs can be imposed already at the first or second level of control, if the country can ensure the necessary training and systems to facilitate the filing of such reports by the institutions concerned.

Safeguard formal institutions: The sequencing approach is likely to increase financial exclusion where it encompasses business relationships between well-supervised financial institutions and providers of financial services which are subjected to lesser AML controls. This is so because the well-supervised institution could face both civil and criminal liability as well as reputational damage if ML and CF risks materialise in its less supervised client (for example MSBs holding accounts with formal banks). Unless the regulator explicitly limits the potential liability for the well-supervised institution, these institutions will have an incentive to sever the business relationships in question.

Explicit regulation required: FSPs often adopt very conservative compliance procedures to protect themselves against ML and FT risks. If they are given the discretion to impose reduced controls for lower-risk transactions they may decline this option and apply the standard controls. The tendency to opt for a conservative approach strengthens a country's AML/CFT system but may undermine its efforts to increase financial inclusion. To limit financial exclusion, the level of controls required for low-risk clients and transactions should therefore be made explicit by government. Clear exemptions may prove more effective than a discretion-based approach.

7.9. GUIDELINE 8: PROMOTE MARKET-BASED REFORMS FACILITATING FORMALISATION

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

Formalise informal providers: The policy instruments available to achieve this objective will depend on the market structure and existing regulation in an economy. A first step can be the creation of a favourable registration regime with lower entry requirements for particular categories of financial institutions (including micro-finance organisations) especially those serving low-income groups. This could be made more attractive by a structural or technical support program for institutions preparing to register.

Migrate users of informal services to formal providers: This challenge is particularly acute in countries with large informal outflows or inflows of migrant remittances. Policy initiatives that can be taken include:

- Facilitating the use by undocumented migrants of formal financial services;
- Encouraging formal financial services to meet the demand characteristics of users of informal financial services, such as a code of conduct that approximates the service levels of informal providers;
- Reducing the differential between the official exchange rate and the kerb rate;
- Support and benefits to migrants who use formal remittance channels;
- Encouraging new lower-cost and more convenient models, such as mobile banking.

The national revenue authority has a clear interest in the migration of users of informal financial services to formal channels. However, an explicit or implied link between the imposition of AML/CFT controls and extending the tax net could have the unintended consequence of discouraging participation in the formal sector and thus increase financial exclusion. This is especially the case where tax evasion is widespread.

7.10. GUIDELINE 9: DEVELOP IDENTIFICATION INFRASTRUCTURE

If a country's national identification infrastructure and other private databases lack coverage, integrity or is not easily (and cost-effectively) accessible to financial institutions for verification purposes, the state should address the deficiencies. The following initiatives could be taken by the government:

- Provide for legal access by private financial institutions to existing databases, at a fee if necessary,
- Facilitate electronic access to existing databases;
- Provide for and fund the establishment of new databases, such as credit information databases, and ensure that sufficient mandatory information are kept in these databases to facilitate the verification of identity for AML/CFT purposes;
- Mandate electronic linkages between existing isolated identification databases and provide for a common national identification number;
- Increase the integrity of existing databases where this is lacking;
- Move to smartcard based national identification systems which facilitate verification of identity using biometric information.

In the meantime AML/CFT controls should not impose duties on financial institutions to create or duplicate such databases. Designers of controls should also be sensitive to the difficulties of verification under these circumstances. Client profiling that supports monitoring of transactions and especially identification of activity inconsistent with the profile may be an appropriate control while processes are implemented to improve identification infrastructure.

APPENDICES

APPENDIX A: SUMMARY TABLES OF COUNTRY FINDINGS

GENERAL FEATURES OF AML/CFT REGULATORY REGIME

General	South Africa	Kenya	Pakistan	Indonesia	Mexico
Status of AML/CFT regulation	• Financial Intelligence Centre Act (FICA) passed in 2001 and compliance provisions operative since 2002) regulations passed 2002 (including original version of Exemption 17), first guidance notes issues in 2004); • Exemption 17 amended in 2004 to better suit the requirements/nature of low-income clients. Current version still does not include cross-border transfers. • FICA in the process of being amended in 2007.	• AML/CFT law not yet in place. The Proceeds of Crime and Money Laundering (Prevention) Bill (2006) has been gazetted for introduction to the National Assembly (Gazette Supplement No. 77, Bills No. 27, November 2006). Regulations have not yet been published. • Basic AML regulations passed under the Banking Act (Prudential Guideline 12 CBK/RG/12, Sep 2000). More comprehensive guidelines issued in Jan 2006 (Prudential Guideline 8, Jan 2006). Both guidelines only applied to institutions regulated under Banking Act (i.e. commercial banks). • Guidelines do not protect banks from civil liability if client confidentiality is breached in reporting suspicious transactions.	• Draft of bill approved by cabinet in 2005. Yet to be approved by parliament. • Reporting of suspicious transactions to Anti-Narcotics force (ANF) originally imposed through Control of Narcotic Substances Act (1997). • National Accountability Bureau established through National Accountability Ordinance (1999) and requires reporting of suspicious transactions by financial institutions. • Basic KYC regulations under Banking Ordinance (covering banks and money exchange companies) and Insurance Ordinance (covering insurers, stock brokers and dealers, trusts, leasing companies, charities, NGOs and other non-financial institutions). • Slightly less onerous regulations for microfinance banks. • No explicit AML/CFT regulation covering PostBank or CDNS.	• Bank Indonesia issued KYC regulations in June 2001. These were found to be insufficient and Indonesia was listed on the NCCT list in the same month. • In response, Law 15 of 2002 Concerning the Crime of Money Laundering, which criminalised money laundering was passed, creating reporting and record-keeping obligations for financial institutions and established the PPATK as FIU. • This was amended by Law 25 of 2003, improving money laundering control by broadening STR duties, removing previous minimum threshold for STRs and by criminalising terrorism. • Another round of amendments are currently underway that will increase the power of the PPATK and extend reporting requirements to a number of non-financial businesses. • Indonesia was removed from NCCT list in 2005.	• Money laundering criminalised in 1996 under Article 400 BIS of the Federal Penal Code. Money laundering is defined generally in the Penal Code and predicate offences are not listed. A maximum penalty of fifteen years and a fine of up to 5,000 days' minimum wages can be imposed. In the case of a money laundering offence being committed by a government official, the penalty increases by 50%. • CFT was criminalised in September 2006 through an amendment of Article 139 of the Federal Penal Code.
Money laundering criminalise d	• Originally criminalised for drugs in 1992. Extended to proceeds of any crime irrespective of value by Proceeds of Crime Act in 1996. • Prevention of Organised Crime Act (POCA) was passed in 1998	• Criminalised under Anti-Narcotics and Psychotropic Substances Act, 1994.	• Some components of money laundering criminalised in 1997.	• Law 15 of 2002 Concerning the Crime of Money Laundering criminalised money laundering.	• 1996
Funding of terrorism criminalise d	• Protection of Constitutional Democracy against Terrorist and Related Activities (POCDATARA) Act passed in 2004.	• Not yet criminalised. Anti-terrorism bill tabled in 2003, but rejected due to human rights concerns.	• Criminalised in 1997 through Anti-Terrorism Act	• Law 15 of 2003 Concerning Terrorism criminalised terrorism as well as financing of terrorism. In addition, Law 15 of 2002 Concerning the Crime of Money Laundering, as amended by Law 25 of 2003, lists the financing of terrorist activities as one of the predicate offences for money laundering. terrorism	• Currently in process. Draft legislation that will modify Article 139 and incorporate Article 148 into the Federal Penal Code to criminalise international terrorism and the financing of terrorism is currently being finalised

General	South Africa	Kenya	Pakistan	Indonesia	Mexico
Member of regional body	• Became FATF member in 2003. Held presidency in 2005/2006.	• Member of ESAAMLG	• Member of APG	• Member of APG	• Became FATF member in 2000; Mexico also a member of the Caribbean Financial Action Task Force and a member of the South American Financial Action Task Force. It holds membership in the Egmont Group and the OAS/CICAD Experts Group to Control Money Laundering
National identification system	• Wide coverage, although some concerns about integrity of the system exists. • Estimated that only 5% of the eligible adult population does not have an identity document.	• By law, Kenyan citizens over the age of 18 must have and carry a national identity card issued by Office of the National Registrar of Persons. • 15.6m adult Kenyans out of 17m people have one. • Cards are issued free of charge and carry the name, date of birth, gender, thumbprint, and place of birth of holder.	• Comprehensive national identity system managed by National Database and Registration Authority (NADRA). • 52m adults (65% of the adult population) have been issued with Computerised National Identification Cards (CNICs) since the system became operational in October 2001. • On average, 25,000 new cards being issued per day	• Indonesia has a widespread, though not uniform, identification infrastructure. • Mandatory for all married people or people over the age of 17 years to have an identity card, known as a KTP, and to carry it with them at all times. • Possible for a person to have more than one valid KTP, with different identification numbers. Easy to falsify KTP or to obtain KTP corruptly. • Indonesia has no single national identification number, has up to 40 public institutions issuing some form of acceptable identification, each with its own database and system.	• Federal Electoral Card, administered by the Federal Electoral Institute (IFE), an autonomous public organisation, the main form of identification. • In 2006, around 71m Mexican citizens (95% of those eligible to vote) were registered on the electoral roll and also had a valid voting ID-card (IFE, 2006). • Card is provided free of charge and mobile units of the IFE service even very remote rural areas. • Banks and other financial institutions do not have access to database on which Federal Electoral Card information is stored.
Foreign ownership of banking sector	• Barclays Bank (based in UK) has controlling stake in ABSA, one of the "Big Four" banks.	• Foreign-owned Barclays and Standard Chartered holds 16% and 11.5% of market share, respectively.	• 11 foreign banks operating in Pakistan • The largest (in terms of assets and deposits) being Standard Chartered and Citibank.	• 11 foreign banks with branches in Indonesia.	• Foreign ownership of Mexican banks exceeds 75% of banking sector assets • Prominent foreign-owned banks include HSBC, BBVA Bancomer, Banamex and Santander.
Extent of informality	• In 2002/03, informal economy comprised 29.5% of GDP. • 24% of economically active population was employed in informal sector in 2006.	• Large informal sector, accounting for between 70% and 94% of the economically active population.	• Estimated that 50% of GDP is derived from the informal market. • 65% of non-agriculture workers employed in the informal sector. • Average ratio of tax revenue (direct and indirect) to GDP of 9.5% is very low. • Only 1.5m tax payers out of total population of 80m.	• Estimated 11 million small and micro businesses and a further almost 32 million “productive poor” (individuals selling goods) most of whom can be expected to operate in the informal sector. • Small tax b base. Out of adult population of around 144 million, less than 20% are registered as tax payers, as few as 3 million people (2% of adults) file tax returns.	• 28% of those employed could be classified as working in the informal sector • Only 4-5m tax payers out of 15m registered tax payers paying tax.
Informality of financial services	• Estimated 80,000 to 100,000 burial societies (informal insurers) in South Africa, while contributions to stokvels (ROSCAs) totalled almost $1 billion in 2004. • Up to 42% of remittances to SADC estimated to be sent through informal channels.	• Size of the informal market is not documented, but the CBK estimates that informal flows are “at least as large” as formal ones.	• Estimated that 50% of the value (as much as 75% of transactions) of inward remittances to Pakistan flow through informal channels.	• Informal remittance market estimates vary from $2bn (somewhat smaller than the formal remittances market) to $12bn (about four times the formal remittances market).	• 6,000-7,000 centros cambiarios (small money exchange business) operating in Mexico. • Although required to register, process only recently started. At the moment, few are registered.
Key features of AML/CFT regime	• Complications experienced due to re-ID process. Solved by introducing risk-based exemption allowing banks to follow risk-sensitive approach to prioritising re-ID • Exemption 17 tailored to bank accounts and mainly national transactions and still does no resolve problems for cross-border remittances	• Regime extended to SACCOs, MFIs, Postbank and "informal" FSPs. • No differentiation between capacity of different FSPs. • No risk-sensitive exemptions for low-value, low-risk clients or transactions.	• Facilitative approach to formalising remittance providers. • National savings scheme not covered under AML/CFT regime. • No re-ID for Post Bank.	• Good relationship between FIC and bank sector result in the creation of regime that is aligned with realities and capacity of the financial sector. • Regime utilises available ID system, despite its flaws and did not pass on cost of identification to banking sector. Support this with profiling. • Nominal regulation of BPRs. • Exemptions for lower-risk transactions.	• Initial blanket regulation inserted under various acts (regulation following institutional model). • Cajas de ahorro would be unable to comply with systems requirements. • Exemptions for lower-risk transactions (may be too lenient). • Nominal regulation of centros de cambiarios.

BANKING ACCOUNTS: CURRENT LEVELS OF ACCESS AND USAGE

Banking	South Africa	Kenya	Pakistan	Indonesia	Mexico
INDICATORS					
Access %	**67%**	**5%**	**15%**	**Best case 45%, worst case 35%**	**36%**
Usage %	**46%**	**19%**	**8-11%**	**Best case 29%, worst case 20%**	**at most 25% (Mexico City)**

BANK ACCOUNTS: NON-AML/CFT FACTORS IMPACTING ON ACCESS, USAGE AND MARKET EFFICIENCY

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Affordability	• Most restrictive access barrier: 33% of adult population estimated to be unable to afford a transaction account.	• Affordability found to present biggest access barrier: estimated that 80% of adults are unable to afford a basic savings account and 95% are unable to afford a transaction account. • Competition is increasing with entry of some commercial banks, SACCOs and MFIs into low-income banking (deposit-taking) market.	• Affordability and minimum balance requirements found to present biggest barriers to transaction and basic bank accounts respectively. • Estimate that 85% of adults cannot afford a transaction account and 90% cannot meet minimum balance requirements of free basic bank account.	• 52% of adult population cannot afford savings account with basic transaction functionality. • 75% of adult population cannot afford savings account with full transaction functionality (including a debit order and an inter-bank EFT transactions).	• Affordability key access constraint excluding 64% of economically active population. • Figure likely to be higher for total population.
Proximity	• Cost implication of travelling to bank included in affordability estimates. • 17 branches per 100,000 adults	• Less profitable bank branches in rural areas have been closed over the last decade. • 85% of branches in urban areas, but 60% of population rural. • Postbank is only real player with rural network.	• May be limitation for commercial banks but Post Office has wide reaching branch infrastructure. • Large unbanked groups in close vicinity of bank branches (even in urban areas), suggest that proximity is not the primary deterrent to being banked.	• 20% of adult population estimated to be excluded on basis of proximity. • This would have been significantly higher had it not been for BRI Unit Desas and the distribution network provided by Pos Indonesia.	• No quantification possible.
Eligibility	• No significant impacts identified. • Minimum balances do not restrict access and banks do not require proof of income for low-income accounts.	• High opening and minimum balance requirements estimated to exclude 25-30% of adults, but new players are starting to break the pattern (some requiring zero opening balance).	• 90% of adults do not have access to free basic bank account due to restrictive minimum balances. • Balance on normal transaction account less restrictive.	• 90% excluded on basis of opening balance (if average balance across banks is used); reduces to 45% excluded (if lowest opening balance is used (BRI)) • 55% estimated unable to afford required on-going balances.	• Quantification not available, but not likely to exceed affordability barriers.
Regulation (non-AML/CFT)	• No significant impacts identified for SA citizens. Identity document required as standard procedure, but widely available. • Between 2.5m and 4.1m undocumented migrants excluded due to inability to produce valid ID and required work permits (work permit required under section F3.2.2 of Exchange Control Manual).	• High interest rates provided on government bonds have traditionally discouraged banks to seek profit from higher-risk, lower-income areas, contributing to low usage levels from the supply-side. • Changing market conditions and government policy emphasis on access is slowly shifting attitude towards low-income banking.	• Regulation requires banks to offer free Basic Bank Account.	• No barriers identified • Identification document is the only statutory requirement and is widely available.	• No evidence to suggest that this present a barrier.

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Usage:	• Banks negatively perceived by the poor who tend to view banks as institutions for high-income people.	• Suspicion of formal banking sector and claims of low service levels to low-income clients may contribute to low usage. • Usage however for the most part in line with access, thus low usage explained by access barriers rather than individual choice/preference.	• Usage discouraged by unfriendly attitude of commercial banks towards the poor. • Resistance to documentation due to tax evasion and fear of officialdom discourages use of formal products. • Little need for bank account due to limited functionality and general "cash comfort". • Previous banking crisis has undermined trust of the banking system and resulted in preference to save in assets/property (e.g. jewellery • Electronic payments also significantly more expensive than cheques and cash, which discourage electronic transactions.	• Tax evasion generally considered discouraging to use of formal sector products. • Low financial literacy and "hassle factor" associated with filling out forms also discourage use of formal products but this seems to be less pronounced in Indonesia than in other countries. Hassle factor is reduced by bank staff in some cases helping with completing forms and only requiring KTP for verification of all details. • Electronic payments also significantly more expensive than cheques and cash, which discourage electronic transactions.	• Distrust of banks after financial sector crisis. • Bank accounts may seem affordable relative to income, but poor value proposition: Client looses money by putting into bank
Market efficiency:	• Relatively concentrated nature of retail banking sector may impact on affordability. Competitive inquiry currently underway. • Government goal of access expansion (to which industry is committed under the Financial Sector Charter) has prompted products aimed at low-income market and revision of AML/CFT regulation to allow exemption for low-income products, thereby increasing offering to this segment.	• Enabling environment framework being introduced for SACCOs and MFIs. Especially SACCOs are emerging as competitors to banks - positive implications for affordability, proximity, etc. via enhanced competition.	• Legislation to create a separate regulatory framework for MF banks and thereby create a tier of banks to serve the lower-income market. • Payment system currently has limited functionality increasing the cost of electronic transactions and undermining the value of a transaction account.	• Regulation creates multiple tiers of banks. While not part of a coordinated and explicit access policy, this does allow room for players that serve the lower-income market (e.g. BPRs). • Payment system currently has limited functionality increasing the costs of electronic transfers relative to cheques.	• Banking crisis of 1995 prompted a contraction of credit extension and a focus on systemic stability, undermined individuals' trust in banking sector and led to 75% foreign ownership of banking sector. This may aggravate the impact of AML/CFT on access as described below • High concentration of banking sector may undermine competition. Banks not targeted at low-income population, "simply too much market in-between". • But new entrants (e.g. retailers applying for banking licence) and popular fin sector actively targeting low-income market.

BANK ACCOUNTS: AML/CFT IMPACT ON USAGE, ACCESS AND MARKET EFFICIENCY

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Usage	• Usage may be disincentivised due to administrative burden. Exemption 17 (see below) has however countered this tendency. • Efforts to encourage tax and exchange control compliance through an amnesty agreement was undermined by requirement of FICA on financial advisor to report identity of such individuals to the tax FIU. This problem was resolved by creating a temporary and limited exemption from such reporting duties.	• Minimal impact on use of formal financial services to date, because: (1) limited scope of AML/CFT measures under Banking Act (to date only commercial banks subjected to AML/CFT regulation) and (2) exclusivity of formal financial services (only serve small, high-income group). • Alternative address verification through letter by official is provided but this increases the hassle factor and cost significantly, opens up opportunities for graft and discourages use because of fear of officialdom. • Requirement to verify identity through these additional measures will also irk consumers whose culture dictates that identity is proven by an individual's "word" and will be insulted by not accepting this.	• Large extent of tax evasion and informality means that increased documentation component under AML/CFT is likely to discourage use of formal products. • Verification of identity over and above national ID card discourages use of formal products by increasing hassle factor.	• AML/CFT documentation (e.g. expanded forms) may discourage use of formal channels, but most information would have been asked for even in the absence of AML/CFT. • Identity card is a standard requirement even in absence of AML/CFT.	• Incentive to use may be impacted, should KYC be perceived as a drive to document the informal economy.

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Access	• At least 30% (but up to as much as 56%) of the population cannot provide proof of address by means of a utility bill as required under AML/CFT legislation. Without Exemption 17, this meant that these individuals would have been excluded from the formal financial system. • Difficulties in meeting re-identification deadlines could have resulted in 80% of bank accounts being frozen. Given the systemic and business risk to the banking sector, the deadline was extended in the final hour by the minister and a risk-based approach introduced.	• AML/CFT regulation may soon present larger barrier than affordability. AML/CFT bill's requirement to verify address with utility bill will exclude 95% of the population (an estimated 20% have address, but only 5% can prove this with a utility bill). • Alternative verification by a government official means that KYC requirements do not present an absolute barrier for those who cannot verify identity by providing a utility bill. As noted above, this alternative is likely to discourage usage of formal financial services. • 1m undocumented migrants will be excluded from the formal financial system.	• Limited impact to date due to absence of comprehensive law. Guidelines not yet clear on sanction. • Re-identification risks freezing significant proportion of accounts. At the time of this report, no official agreement had been reached on extending the deadline. • Necessity to produce national ID card excludes 35% of population, but roll-out of cards exceeds that of bank accounts.	• No impact currently. Widely available identity card only form of verification needed in practice. • Re-identification could have caused problems but this was mitigated by the risk-sensitive approach adopted and flexibility on timelines • No evidence that AML/CFT regulation is leading to the severing of ties between banks and lesser or unregulated financial institutions (BPRs, BKDs, etc.). This is partly due to explicit guidance provided by the PPATK on the treatment of these accounts.	• Little direct impact, as any potential impact is exceeded by the affordability impact.
Market efficiency	• By making it difficult to introduce new low-cost, non-face-to-face banking technologies (e.g. mobile banking), it is preventing new models entering and competing for this market as well as incumbents to adopt such technologies • Supervisory requirement to obtain paper copy of ID has been a major constraint to Wizzit's role-out using mobile sales agents. • AML/CFT does not present a barrier to informal financial entities holding bank accounts (e.g. stokvels/burial societies - no evidence that KYC is resulting in account closures or difficulties).	• Additional requirements (KYC, re-ID, systems, etc.) on FSPs not previously covered under AML regime (Postbank 1m, SACCOs 2.2m, MFIs 500k clients of whom at least 2m will not have a commercial bank account) will undermine their ability to provide their services. Will impact particularly on low-value, low-risk transactions. • The likely pressure on SACCOs and MFIs will be in direct conflict with the enabling regulatory framework government is trying to create through the introduction of the SACCO Societies Bill, 2006, and Deposit-taking Microfinance Bill, 2005). Onerous requirements on MFIs and SACCOs (irrespective of their products or their clients) may force them to exit or go deeper underground. The result will be to further limit competition. • No exemption of small value, low-risk transactions means that these transactions will bear the full compliance costs while adding little in terms of risk management. This will disincentivise the provision of low-income services. • Going forward, the requirement for face-to-face origination of bank accounts may undermine the introduction of new technologies such as cell phone banking. Current regulation will allow agent banking (e.g. using retail stores).	• Differentiated AML/CFT regulatory burden (stricter on commercial banks than MF banks, no requirements currently on CDNS or Post Bank) may allow these institutions to enter the low-income market but also creates an unlevel playing field where these institutions compete in the high-income market. • Going forward, the requirement for face-to-face origination of bank accounts may undermine the introduction of new technologies such as cell phone banking. Agent-based banking is allowed.	• Systems requirements are flexible (guidance notes explicitly accept both paper and electronic-based MIS) and does not bias against smaller institutions. BPR sector not targeted for enforcement and no pressure on commercial banks to close BPR accounts. • Going forward, the requirement for face-to-face origination of bank accounts may undermine the introduction of new technologies such as cell phone banking. Current regulation will allow agent banking (e.g. using retail stores).	• Impact on institutions (see indirect access impact described above): conservative compliance with AML/CFT by banks leads to severance of ties with smaller, less regulated institutions. • Concerns that especially cajas will not be able to comply, thereby forced to exit (thereby increasing concentration) or operate informally. Thus "blanket" application of AML/CFT may undermine certain tiers of the financial sector. • The costs of AML/CFT legislation may delay entry into deposit-taking services.

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Impact mitigating steps taken by country	• Impact mitigated by explicit access policy objective. This was motivation and driver behind Exemption 17 and on-going changes to limit the impact of the AML/CFT regulation • Exemption 17 lifted requirement to obtain and verify residential address information in respect of most low-income clients (balance < R25,000 (+/-$3,500) and transactions(< R5,000 per day (+/- $700)) and not exceeding R25,000 per month). • Directive from SA Reserve Bank (Banks Circular 6/2006 issued on 13 July 2006) regarding non-face to face account acquisition also allowed cell phone banking and origination within the transaction limits of Exemption 17 (in addition daily transaction limits where set at R1,000/$130, which is lower than other transactions under Exemption 17 and identity numbers had to be verified against third-party databases) to limit risk. • To avoid re-identification crisis, deadline was extended by minister by means of a risk-based exemption that allowed banks to identify and prioritise high risk accounts for re-identification). • Potential problem with FICA undermining tax and exchange control amnesty was resolved by creating a temporary and limited exemption from such reporting duties.	• None as of yet.	• Reduced requirements for MF banks	• A focus on up-front identification combined with account monitoring (rather than strict verification) served to prevent impact. • Central Bank mitigated potential impact on usage by launching advertising campaign aimed at educating the public as to the need for AML/CFT and its being standardised across FSPs. • Flexibility around systems requirements (allowing manual and paper-based systems). By emphasising traceability rather than real-time detection, unnecessary expenditure of advanced systems have been avoided. • Guidance provided by central bank avoids impact (e.g. AML/CFT has not lead to the closure of BPR accounts) • Realistic re-identification plan that was tailored to each bank and allowed risk-sensitive approach.	• Use of thresholds has allowed authorities to limit negative impact on access • US$10,000 threshold for the reporting of relevant transactions. • Physical client files only need to be opened for transactions exceeding $10,000 in a month or account balances exceeding US$3,000.

REMITTANCES: CURRENT LEVELS OF ACCESS AND USAGE

Remittances	South Africa (significant sending volumes)	Kenya (significant sending volumes)	Pakistan (mostly receiving)	Indonesia (mostly receiving)	Mexico (mostly receiving)
INDICATORS					
Access %	• No estimates available, but likely to be very low. • Undocumented immigrants (estimated number between 2.5m and 4.1m) excluded since they do not have access to valid ID documents required for financial transactions.	• No estimates available, but likely to be very low. • Cost of 12-17% for a formal sector remittance will be unaffordable for a large proportion of people.	• No formal estimates available. • Depends largely on conditions in sending country. • On receiving end, access does not seem severely constrained, exceeds usage. • Undocumented immigrants and refugees (e.g. on Afghanistan border) excluded from sending money through formal channels.	• No estimates available - access constraints more likely to be on sending country side than receiving end in Indonesia.	• No estimates available, but seemingly very high.
Usage %	• No estimates available, but likely to be very low. • Estimate that 48% of domestic remittances and 42% of inter-SADC remittances are sent via informal channels. Preferred informal channel is to use Taxi drivers or friends/relative as cash couriers.	• Between 15% and 30% of households estimated to rely on (domestic and foreign) remittances with rural households being on the higher side. • More than 60% of remitting adults report using family/friends or other informal transfer mechanisms for domestic transfers. • 21% report to use sambaza airtime transfer product	• $4.5bn estimated to flow in through formal channels. • At most, 50% of remittances received through formal channels.	• $3bn estimated to flow through formal channels. • Estimates of informal channel usage vary between 40% and 80% of total inflows	• Formal channel usage estimated at 90%

REMITTANCES: NON-AML/CFT FACTORS IMPACTING ON ACCESS, USAGE AND MARKET EFFICIENCY

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Affordability	• Affordability is single largest barrier. • No quantification available, but estimated to be an absolute barrier to using formal channels for most remitters.	• Due to limited competition, formal sector remittances are expensive and unlikely to be affordable for lower-income households wanting to do small transfers (12-17% of value remitted) vs. 3-4% in informal market.	• Unlikely to be restrictive - as 70% of formal remittances are through bank transfers, costs are not excessive. • Explicit government subsidy of costs on formal inflows through banks where it is converted to domestic currency.	• No absolute exclusion identified. • Cost of formal channels not as high as in some of the other countries, but could still be up to three times more expensive than informal.	• Unlikely to be prohibitive, judging from high formal usage and the fact that costs have decreased significantly recently.
Proximity	• Distribution network of formal channels limited to bank and post office network. Thus proximity may partly explain preference for informal channels.	• Due to limited competition, proximity likely to be a barrier, but no formal estimates available. Informal hawala and other channels much more wide-spread and flexible.	• May be limitation for commercial banks but Post Office has wide reaching branch infrastructure and MTOs have wide reaching agent system. • Large use of informal mechanisms, even in close vicinity of formal channels, suggests that proximity is not the primary deterrent.	• Up to 20% may be excluded due to proximity. • Formal remittances exclusively linked to bank and postal services, thus proximity estimate mirrors that of banking sector.	• Unlikely to be significant.
Eligibility	• No significant impacts identified.	• No significant impacts identified.	• No significant impacts identified.	• No significant impacts identified.	• No significant impacts identified.
Product features and terms	• No significant impacts identified. Minimum transfer requirements not restrictive (less than R10 or about $14)	• No significant impacts identified.	• No significant impacts identified.	• No significant impacts identified.	• No impact identified.

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Regulation (non-AML/CFT)	• Undocumented migrants cannot use formal financial system (ID barrier). Forex controls stipulate that only individuals that are in country on a legal basis (resident, legal migrant) can send money. Immigration status checked by financial institutions in terms of Immigration Act and reports filed with authorities. • Exchange controls limit cross-border flows and place identification requirements independently of AML/CFT.	• Cross-border remittances limited by Central Bank Act to those with banking license/special CBK license. • Significant barrier to entry and formalisation of money transfer operations. • Result in costs which are significantly higher than the informal channels.	• Government support for Pakistanis abroad also incentivises use of formal channels.	• None on receiving side. • On sending side, those without a valid passport or work permit will be excluded.	• No impact identified.
Usage:	• Trust and convenience (not related to access barriers) are among the reasons noted for a preference for informal channels. • Informal transfers using taxis is estimated to cost 10% (on average transfer value of $75). This is much lower than the 35% charged through formal channels and also more convenient.	• Relative cost is big incentive to use informal channels. • Other usage factors such as trust, convenience and tradition also discourages use of formal channels.	• Low usage appears to be largely a result of choice, rather than explicit access barriers. • Although formal channel costs have reduced significantly, informal channels will still be less expensive. • Hassle factor of dealing with banks cannot compete with convenience of dealing with informal channels. • Fear of officialdom and documentation (e.g. for tax purposes) discourages use of formal channels. • Value proposition of formal channels not sufficient to change long-standing habit/culture of using informal channels.	• Incentives to use formal channels may be impacted by remitters' preference to stay "underneath the radar screen", be it due to illicit activities, or because of suspicion of the formal financial sector. • Prevalent migrant worker labour practices (e.g. use of unregulated labour brokers) may also disincentivise usage of formal sector.	• No apparent impact, as usage is very high.
Market efficiency:	• Strict foreign exchange rules (in regulations to Currency and Exchanges Act, 1933) reduce competition and leads to increased prices. Only banks (or operators partnering with banks) are allowed to conduct cross-border remittances. Given that it requires at least $35m in capital to obtain a bank license, this reduces competition. In addition, regulation prohibits the bulking of transactions leading to higher costs of managing transactions. • Average value of MoneyGram transfers (outside of CMA) estimated to be around $300. Remitting $75 (the average remitted within the SADC region) using MoneyGram, will cost just more than 35%. This suggests that it is beyond the reach of the low-income market. • Low-income "Mzansi" money transfer products have been launched for domestic and CMA transfers, but have not yet proven successful.	• Only banks allowed to conduct remittances transactions. Restricts competition and increases prices.	• Deliberate government attempts to draw remittances into formal sector and improve the efficiencies of the formal channels. • Regulatory framework has been set up to facilitate formalisation of informal money transfer operators. • The result is increased competition, lower formal sector costs and faster transfers. All of this has facilitated an increase in the use of formal channels.	• Only banks and Pos Indonesia allowed to conduct remittances transactions. Restricts competition and increases price. • Banks do not generally serve lower-income market, but this inefficiency is mitigated by the fact that remittances can also be sent/received via BRI and the Pos Indonesia - which account for the widest distribution network.	• No apparent impact.

REMITTANCES: AML/CFT IMPACT ON ACCESS, USAGE AND MARKET EFFICIENCY

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Access	• Address verification remains a barrier for walk-in remittances (Exemption 17 not extended to remittance products). • Confusion around keeping copies of client documentation raises costs for some institutions with knock-on effects on access. • The need for an official identity document excludes undocumented migrants from formal remittance services.	• Requirement to prove identity and legality of stay for even small amounts excludes undocumented migrants (estimated to be at least 800k).	• Impact unlikely to be significant. • CNIC sufficient proof of identity for sending and receiving transactions. Do not require verification of address details as part of CDD process.	• No evidence of impact. $10,000 threshold for KYC applied to walk-in clients (though FSPs tend to ask for ID card as standard procedure in any case) up to December 2006.	• No direct impact - threshold of US$3,000, versus average remittance size of US$400 implies little exclusion due to KYC. • Potential indirect impact via severance of relationships between banks and cajas, as well as severance of ties between banks and money services business in the USA (the largest source of remittances to Mexico).
Usage	• Identity needs to be verified even for once-off small domestic remittances. • Usage will be discouraged due to inconvenience/mistrust of official procedures. • The availability of convenient and lower-cost informal money transfer mechanisms (particularly for domestic and regional transfers) will increase the elasticity of formal product usage to the introduction of further administration and compliance hassles.	• Proposed AML/CFT regulation requires KYC on all transactions, irrespective of size (including once-off), and requires source of income and identity to be verified by additional documentation, which is not be readily available to a large proportion of the population. A significant proportion of the population will thus have to use the burdensome option of having their income and identity verified by a government official. Administrative burden and overwhelming officialdom is likely to be a significant discouragement to use of formal financial products. • Availability of convenient and lower-cost informal money transfer mechanisms (particularly for domestic and regional transfers) will increase the elasticity of formal product usage to the introduction of further administration and compliance hassles.	• AML/CFT unlikely to have significant impact on usage of formal channels (see below).	• AML/CFT may impact incentives to use formal sector, should remitters want no record of the transaction (be it because of illicit activities, or out of suspicion of government's AML/CFT system).	• No apparent impact, as usage is very high.

	South Africa	Kenya	Pakistan	Indonesia	Mexico
Market efficiency	• No significant impact identified. • This is mostly because a Foreign Exchange regulation has limited players in this market to banks and those who partner with banks. • If these requirements where to be relaxed, the systems and reporting requirements under AML/CFT regulation may present barriers to smaller institutions entering the market.	• Proposed AML/CFT regulation extends to informal money transfer operators. These are unlikely to be able to comply with the requirements. At least half of remittances flows are estimated to flow through informal channels. • Proposed AML/CFT regulation will also extend to transfers of value through airtime transactions. This will require cell phone companies to comply with the CDD, STR and other requirements of the regulation, which is likely to increase costs and create barriers (even if values may be quite small). • Limited capacity of government to supervise may lead to the exclusion of informal MTOs from the banking sector. Given limited regulatory capacity, it will not be possible to supervise informal MTOs as suggested by the proposed AML/CFT law. • The result will be that they will have difficulty maintaining their accounts with commercial banks as they will not be able to prove their compliance and the banks will only be able to audit this at high cost.	• Informal remittance sector is robust and indications are that AML/CFT will not be a successful tool to formalise remittances/close down informal channels; depending on way of implementation, it may even serve to push a larger part of the remittance market underground.	• Commercial banks are currently the only focus of AML/CFT enforcement, thus no clampdown on informal remittance providers as of yet, though FIU has indicated that it needs to be investigated.	• Market efficiency may be impacted over the longer run, should cajas or and other entities who are unable to comply, ties with banks be severed, thereby denying them access to the payment system.
Impact mitigating steps taken by country	• Exemption 17 supported the creation of the Mzansi money transfer products by the banks. Transfers through these products cost around 7%, but is limited to domestic transfers only.	• None as of yet.	• None as of yet.	• $10,000 KYC threshold on once-off transactions prevents impact • Legislation passed for compulsory bank accounts to be opened before migrant workers depart - but cannot affect barriers on the sending side.	• Use of thresholds has allowed authorities to limit negative impact on access - KYC threshold of US$3,000 for walk-in clients.

APPENDIX B: INDONESIA

SUMMARY AND KEY FINDINGS

- Indonesia is a middle-income country with a large informal sector (an estimated 80% of the adult population is not registered for tax purposes).
- The Indonesian financial sector is large and diverse, spanning three tiers of banking services providers. Yet only between 20% and 30% of the adult population use a bank account.
- This is a reflection of low levels of access to such accounts, based largely on the unaffordability of certain bank account requirements to the bulk of the population.
- Indonesia, with its estimated 3m citizens working abroad, is a remittance receiving country. Most remittances probably flow through informal rather than formal channels. This may be a factor of affordability, but no definite estimates are available.
- The country has a widespread identification system. The integrity of the system is however often questioned and no uniform national identity number exists.
- The AML regime has been operative since 2002, with the enactment of an AML law, predated by Bank Indonesia regulations concerning the application of Know Your Client (KYC) principles in 2001. The AML law was amended in 2003. In 2005, Indonesia was removed from the FATF NCCT list, and in early 2006, the FATF decided that it is no longer necessary to monitor the country.
- KYC principles require upfront identification (verified only with the widely available identity card) as well as re-identification of current clients. Re-identification is still underway, but Bank Indonesia is generally satisfied with progress.
- We find that there are no major AML constraints to access, as widely available means of identification are required for verification purposes. Remittances in Indonesia are, similarly, not impacted by AML.
- Monitoring of accounts (via either an automatic or manual system) is required, based on basic profiling information obtained from clients.
- Systems requirements are realistic and flexible and a risk-sensitive approach is followed in terms of enforcement priorities across categories of FSPs and allowed re-identification time lines for various risk profile client groups.
- AML/CFT has not resulted in significant cost increases for FSPs and has not impacted on their incentives to serve the lower-income market.
- The Indonesian system furthermore represents an interesting example in that the AML/CFT regime is regulator-led, rather than enforcement-led and is coordinated across government departments at the ministerial level. A good relationship, based on regular interaction, exists between regulator, FIU and financial service providers.

GENERAL AND MARKET CONTEXT

Economy at a glance

Indonesia is a lower-middle-income country, of which more than half the population live on $2 per day or less. With a population estimated at around 217 million people in 2004 (WDI, 2006[37]), spread over some 6,000 inhabited islands (out of a total of 13,677), Indonesia has a

[37]Some sources, e.g. CIA World Fact Book at a 2005 estimate of 240 million, and Encarta, at a 2004 estimate of 238 million, estimate the population to be much larger. The BPS (Indonesian statistics bureau)'s 2005 population estimate is 222m. We apply the WDI figures for consistency with the other WDI figures used.

per capita GDP (PPP adjusted) of $3,600 per annum and is classified by the World Bank as a lower-middle income economy. About 17% of the population fall below the national poverty line[38] (BPS, 2006). According to the World Development Indicators (World Bank, 2006), 7.5% of the population lived on less than $1 per day (PPP adjusted) in 2002, while just more than 52% lived on less than $2 per day. Approximately 10% of the working age population is unemployed.

Economic growth, bar the Asian crisis experience, has been buoyant. Indonesia experienced strong economic growth (averaging 7.5% per annum) for three decades, before being severely hit by the Asian crisis of 1997/98, which saw inflation reach 57% in 1997 and GDP shrink by more than 13% in 1998 (ADB, 2006). After 1998, growth started to pick up again, with exports fuelled by the large Rupiah depreciation during the crisis. GDP growth in Indonesia averaged 4.2% between 1990 and 2000, despite the contraction of 1997, and achieved an average of 4.6% between 2000 and 2004 (WDI, 2006). CPI inflation steadily decreased from 12.6% in 2001 to 5.1% in 2003, before rising slightly to 6.4% in 2004. 2005 was an outlier, when rising oil prices, in conjunction with a reduction in fuel subsidies, saw inflation rise to 17.1% for the year (Bank Indonesia Annual Report, 2005).

Indonesia has a large informal economy. It is estimated that there are approximately 43 million business establishments in Indonesia, of which only 300,000 are medium to large corporations. The rest is comprised of about 11 million small and micro businesses and a further almost 32 million "productive poor" (individuals selling goods), most of whom can be expected to operate in the informal sector (Bank Danamon research, based on BPS, 2004 data). In line with the large informal economy, the tax base is estimated to be small. Out of the adult population of around 144 million[39], less than 20% are registered as tax payers (ADB, 2005), and role players consulted indicate that as few as 3 million people (2% of adults) file tax returns. Broadening the tax base is an explicit policy goal (Indonesian Directorate-General of Tax, quoted in ADB, 2005).

Banking sector evolution and structure

Crisis results in major re-organisation. Key moments in the development of the financial sector include the nationalisation of formerly Dutch-owned banks during the Sukarno regime (after the country officially gained independence from the Netherlands in 1949), followed by a more market-driven approach during the Suharto regime (1968-1998). A policy of bank deregulation was introduced in 1982 (at which time 93% of total bank assets was owned by 7 large state-owned institutions, of which 5 were classified as commercial banks, one as a savings bank and one as a development bank). Bank deregulation intensified in 1988, causing the number of private banks to more than double, and seeing the private sector's share in total banking assets grow from 24% to 54%, between the end of 1988 and mid-1997 (McLeod, 2003). During the Asian crisis in 1997/1998, the number of private banks halved through mergers and liquidations. Among the failing banks were all of the 7 original state banks as well as the

[38] BPS compiles an urban and a rural poverty line of respectively IDR 143,455 (USD 47.27, PPP adjusted, which amounts to $1.55 per day; or USD 15.60, should no PPP adjustment be made and the average exchange rate for 2006 to date be applied) and IDR 108,725 (PPP USD 35.83, or $1.18 per day; USD 11.82, non-PPP adjusted) per capita per month (BPS, 2004). The poverty line is calculated from the expenditure necessary to buy a daily food bundle of 52 items to fulfill 2100 kcal per capita per day, as well as non-food bundle of 46 items used by the reference population who live just above the poverty line. Therefore we know that about 7.5% of the population lives on less than $1 per day, about 17% live on less than about $1.35 per day (the weighted average national poverty line), and 52.4% live on less than $2 per day. Therefore quite a significant proportion lives on between $1.35 and $2 per day.

[39] According to the World Bank's World Development Indicators (2006), 66% of the population of 217 million are between the ages of 15 and 64. According to this measure, around 144 million people can therefore be classified as "adult".

formerly 10 largest private banks, all of which had to be recapitalised by government. Government’s recapitalisation of the banking sector amounted to an estimated 50% of GDP (Fane & McLeod, 2002).

The effects of the crisis still define the financial sector environment. Central bank policy focuses on stability, good governance and consolidation (mergers and acquisitions are encouraged). Also, as a result of post-crisis restructuring and mergers, many banks have installed expensive new IT systems. This enabled easier implementation of KYC and other AML systems.

Indonesia has a large banking system comprised of various types of institutions. As indicated by Figure 3 below, the Indonesian banking system is structured into three tiers: commercial banks, BPRs (“rural” banks) and microfinance institutions:

- There are currently 131 *commercial banks* (versus 239 pre-crisis) (BSR, 2004), 15 of which hold 80% of all accounts. One of the commercial banks, state-owned BRI, holds 37% of all accounts. Three of the five largest banks, as well as two smaller banks, remain state-controlled, accounting for 30% of total banking assets and 61% of total accounts.
- There are almost 2,000 so-called *BPRs*, or “peoples banks”[40].
- *MFIs*. According to Bank Indonesia records, there are 5,345 village cooperative banks, as well as a number of formal (registered) non-bank microfinance institutions, namely 1,097 saving and loan co-operatives, 1,296 village credit institutions and 850 pawnshops. There are furthermore an estimated 3,043 *informal* cooperatives under Sharia Principles, as well as numerous other (no definite estimates are available) non-regulated/unlicensed MFIs, some of which are deposit-taking (though illicitly so)[41].

[40] Also commonly referred to as *rural banks*, though they are not all located in rural areas.
[41] Many informal sector MFIs are similar, historically, to BPRs, but failed to be licensed after it was proclaimed in the Banking Act of 1992 that rural banking institutions are to obtain banking licenses to become formal BPRs (Bank Indonesia BPR Regulator, 2006). The exact number of such informal institutions and their clients is not known. Though Bapepam-LK, the non-bank financial regulator, plans to incorporate them into the formal sector under a planned new Micro-finance Act, such informal institutions fall below the AML radar screen in the mean time (Bank Indonesia BPR Regulator, 2006).

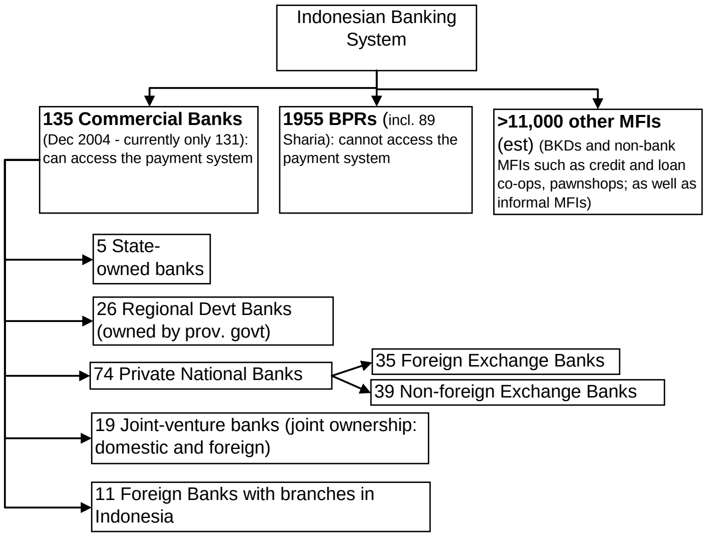

Figure 3. The structure of the Indonesian banking sector[42].

Source: Genesis representation, based on information from Bank Indonesia Bank Supervision Report, 2004 (for commercial bank data) and BPR regulator presentation (for BPR and other MFI data).[43]

Table 1 provides more information on the structure and nature of the Indonesian banking sector, as well as the regulatory set-up of the various parts of the system. (Note that the applicable AML regime is included in the table for the sake of completeness; these aspects of the table will be referred to in the discussion of the AML environment that will follow below.

[42] Note that, though BPRs do not have direct access to the payment system, they can access it indirectly via the accounts that they hold with commercial banks.
[43] One of the largest commercial banks, Bank Rakyat Indonesia, is unique in that it also has 4,600 village units which essentially operate as BPRs, though they are allowed to access the payment system.

Financial sector institutions	Functional definition	Examples	# of accounts (est.)	Regulator	Supervisor	General regulation/ applicable law	Applicable KYC regulations (all subject to AML law 15 of 2002, as amended by law 25 of 2003)	KYC requirements
Commercial banks	Conventional & sharia banks; have access to the payment system and can offer current accounts	Bank Central Asia (private national forex bank); BNI (state-owned bank); Citibank (foreign branch bank); ANZ Panin Bank (joint venture bank); ; 1 bank, BRI's Unit Desas fulfil same role as BPRs.	77m (40% of which are held by BRI)	Bank Indonesia	Directorate of Bank Supervision	Banking Act no.7/1992 as amended by Act no. 10/1998	Bank Indonesia (BI) regulation no: 3/10/PBI/2001 of June 18, 2001 concerning application of know your client principles, as amended by regulation number 3/23/PBI/2001 of December 12, 2001 and again by regulation number 5/21/PBI/2003 of October 17, 2003; guidelines to standards for application of know your client principles are contained in Circular letter of BI no 5/32/DPNP of December4, 2003, concerning amendment to circular letter of BI no 3/29/DPNP.	**Account opening:** Information on name, permanent address, place and date of birth, nationality, occupation, source of funds, reason for the transaction, specimen signature **Verification:** Official identity card, passport, drivers licence **Walk-in clients:** Same, if transaction involves more than Rp100m (+/- USD10,000)
BPRs (bank MFIs)	Deposit-taking and lending institutions with a banking license that are not allowed direct access to the payment system and therefore cannot offer current accounts (debit orders, cheques)	BPR Mitra Dana Utama	6m	Bank Indonesia	Directorate of Rural Bank Supervision	Banking Act no.7/1992 as amended by the Act no. 10/1998	BI regulation number 5/23/PBI/2003 of October 23, 2003 concerning the implementation of know your client principles for rural banks.	As for commercial banks
BKDs (bank MFIs)	Village-owned credit agencies - credit provided by the agency at the village level - management done by elected village representatives	n/a	454,000	Bank Indonesia	BRI on behalf of Bank Indonesia	Banking Act no.7/1992 as amended by the Act no. 10/1998	Unknown	Unknown
Other MFIs: formal	Non-deposit taking MFIs (sometimes do take deposits, but not allowed under their licence).	Non-bank MFIs will typically be classified as either **BKDs, savings and loans cooperatives, Pawnshops** (govt-owned) or **LDKPs** (Village Fund and Credit Institutions - local-govt owned)	970,000 for LDKPs (no figures available for pawnshops or cooperatives)	**Cooperatives:** Ministry of Cooperatives and SMEs **Pawnshops:** Ministry of Finance **LDKPs:** licenced by Governor of each province	Cooperatives: Ministry of Cooperatives and SMEs Pawnshops: Ministry of Finance (Bapepam-LK) LDKPs: local govt level I	**Cooperatives:** Cooperative Act no. 25/1992 **Pawnshops:** n/a **LDKPs:** n/a	No specific AML/KYC regulations - refer to the Minister of Finance-issued KYC requirements as applicable to non-bank financial institutions	No specific KYC requirements - refer to the Minister of Finance-issued KYC requirements as applicable to non-bank financial institutions

Financial sector institutions	Functional definition	Examples	# of accounts (est.)	Regulator	Supervisor	General regulation/ applicable law	Applicable KYC regulations (all subject to AML law 15 of 2002, as amended by law 25 of 2003)	KYC requirements
Non-bank MFIs: informal	NGOs, self help groups, BMT (microfinance based on sharia principles)	Unknown	1,680 for BMTs (the rest not known)	not regulated	not regulated	n/a	n/a	n/a
Non-bank FSPs	Securities companies, insurance companies, etc.	Unknown	Unknown	Bapepam-LK[44]	Unknown	Unknown	Minister of Finance Regulation no. 74/PMK.012/2006 on the implementation of KYC Principle for non-bank FSPs[45].	**Account opening:** Information on name, permanent address, place and date of birth, nationality, occupation, source of funds, reason for the transaction, specimen signature **Verification:** Official identity card, passport, drivers licence **Walk-in clients:** Same, if transaction involves more than Rp100m (+/- USD10,000)
Money changers	Bank or non-bank (in which case a license is required) entities buying and selling foreign banknotes and travellers cheques.	Unknown	Unknown	Bank Indonesia	Directorate of Monetary Management (Division of Monetary Management Administration and Money Changer Non Bank)	Unknown	BI regulation number: 6/1/PBI/2004 of January 6, 2003 concerning money changers.	All customers irrespective of amounts
Money transfer companies	International remittance companies - have to operate in conjunction with commercial banks or Pos Indonesia	Unknown	Unknown	Bank Indonesia (resorts under normal commercial bank regime)	Directorate of Accounting and Payment Systems	Banking Act no.7/1992 as amended by the Act no. 10/1998	BI regulation number 8/28/PBI/2006 of December 5, 2006 concerning money remittance services	Remitting and receiving parties irrespective of amount

Table 1. Structure of the Indonesian financial sector and its regulatory framework.[46]

Source: Genesis Analytics, based on desktop research, information obtained from Bank Indonesia and information obtained in in-country consultations.

[44] "Capital market and Financial Institutions Supervisory Agency" - Merged entity (since December 2005): Capital Market Supervisory Agency (Bapepam) & Director General for Financial Institutions (DGFI), Ministry of Finance. Traditionally, Bapepam was responsible for capital markets supervision, while the DGFI was responsible for the supervision of non-bank financial institutions.

[45] Recently issued regulation (post-Bapepam-DGFI merger) to merge Minister of Finance decree number 45/KMK.06/2003 of January 30, 2003 on application of KYC principles for non-bank financial institutions and Decision of the Chairman of Bapepam number: KEP-02/PM/2003 of January 15, 2003 concerning know your client principles.

[46] Blank cells denote gaps in our current understanding.

The reach of the banking sector

The private commercial banking sector, as well as most state-owned banks, is focused on the middle- to higher-end of the consumer market. Banks believe that there is still scope for growth in this market, with cross-selling increasingly taking place. Only one of the large private banks, Bank Danamon, is explicitly targeting the lower-income market as a growth strategy (with a distinct focus on credit expansion to the micro and small business sector).

There is also no coordinated government policy effort to extend the reach of the banking sector. Government policy on the financial sector is made by the Coordinating Ministry of Economic Affairs. In our consultation with them it was, however, apparent that access to financial services enjoys no explicit policy attention. This was confirmed in our consultations with Bank Indonesia and the various private sector organisations consulted. Government also seems to have moved away from pressuring banks to extend services – while SME lending quotas were imposed in the past, these have now been removed. Indirectly, though, Bank Indonesia attaches some importance to access in stating in its Banking System Policies for 2006 (Bank Indonesia Banking Booklet, 2006) that it wishes to "expand the services network of the banking system … to achieve more widespread coverage of isolated regions".

Yet government does play a role in extending the reach of the financial sector, as one state-owned bank, BRI, dominates the provision of banking services to low-income people. With its roughly 30 million bank accounts, BRI is by far the largest bank in terms of clients. It is state-owned and has its origin as a state initiative to provide credit to small farmers. Apart from offering the normal commercial banking services, it operates 4,600 so-called Unit Desas ("village units"). It is therefore unique among the commercial banks in that it has an explicit mandate to reach out into the rural community and bank the poor – a position in which, BRI claims, it has no competition from the rest of the commercial banking sector[47].

The "lower-income market gap" is furthermore filled by BPRs, though their number of accounts is still limited relative to that of the commercial banking sector. BPRs are distinguished from commercial banks in that they are not allowed to offer cheque or overdraft accounts and are not connected directly to the payment system. A BPR will typically have one or more bank accounts with a commercial bank to access the payment system (BPR regulator, Bank Indonesia, 2006). They offer demand and time deposit accounts as well as micro-credit to their clients and are the most direct competitors of the BRI Unit Desas. There are currently 1955 BPRs (down from about 2,100 two years ago)[48] with about 6 million accounts.

Pos Indonesia serves as a distribution network for banking services, thereby further expanding the reach of the banking sector. There are 207 main branches, 3,404 sub-branches, 264 extension offices, 3,330 mobile postal units and 12,484 other postal facilities. Pos Indonesia claims that these units/facilities span the whole of Indonesia, but the exact geographic distribution was not available. Though Pos Indonesia does not provide any financial services itself, it acts as an agent for the money transfer products of a number of banks and agencies[49]

[47] In 2005, BRI achieved a return on equity of 38%. Therefore it would seem that the lower income market can indeed by lucrative for banks.

[48] As in the commercial banking sector, Bank Indonesia encourages consolidation of BPRs through mergers.

[49] Western Union, Citibank, Bank Niaga and Valuta Pos, and savings products of Bank BNI, Bank BTN, Bank Muamalat and Bank Niaga.

and it acts as a loan collection point for a few banks and BPRs[50]. It also acts as a payment point for government tax, custom duties, Telkom, Telkomsel, Indosat, electricity payments, and a number of other banks and institutions. Of the distribution points, on-line service networks are available at 207 main offices and 906 branches. Of the mobile units, 1,300 are on-line (so-called "e-mobile units").

Despite the fact that BRIs, the BPRs and Pos Indonesia extend the reach to the lower- income market, usage of bank accounts among the Indonesian adult population is low. Bank Indonesia statistics show there to be only 83m bank accounts, comprised of 77m accounts with commercial banks (current, savings and deposit) and 6m BPR accounts[51]. All role players agree that there is a large degree of overlap and that one individual is likely to hold more than one account with a specific bank as well as accounts with more than one bank. Some estimates place the overlap as high as 2.5 to 3 accounts per person. Assuming a more optimistic number of 2 accounts per person, it suggests that the 83 million accounts are held by 41.5 million individuals. *This equates to roughly 29% of the 144m adults using formal financial sector transaction banking services (reducing to 19% if 3 bank accounts per adult are assumed).*

Low usage reflects low levels of access. Our assessment suggests that, at most, 45% of adults have access to a savings account. However, as described above, the usage figure is significantly lower (between 19% and 29%). To arrive at our access figure, we consider four typical drivers of access to banking services: proximity, affordability, eligibility and regulation:

- *Proximity*[52]. Our review suggests that as many as 20% of adults may not be able to access bank services due to the long distances to be travelled to reach a bank. This would have been significantly higher, were it not for BRI Unit Desas and BPRs.
- *Affordability*[53]. We estimate that 52% of adults are unable to afford a savings account (should transaction services be limited to deposits, withdrawals, statement enquiries and intra-bank funds transfers) and that 75% are unable to afford a savings account with full transaction functionality (including a debit order and inter-bank electronic funds transfer) [54].

[50] BRI, Bank BTPN, Bank BBAI, Bank Niaga and BPR Dana.

[51] According to Bank Indonesia records, 98% of all current, savings and time deposit accounts have balances below Rp100m (approximately $10,900).

[52] 78% (just more than 13,000) of all bank branches (commercial, including BRI Unt Desas, as well as BPRs) are concentrated on Java, which is home to almost 60% of the population. This amounts to just fewer than 10,000 people per bank branch. This ratio can range to as high as 39,812 people per bank branch for the Maluka Islands. The ratio on the second most populated island, Sumatra, is 23,628. There are a total of 4 out of Indonesia's 33 provinces that do not have any bank branches. If, adding the Pos Indonesia distribution network, we assume all individuals on Java to be within the banking sector's reach, and about half those not living on Java not to be denied access on the grounds of proximity, it implies that proximity excludes about 20% of the population from the formal financial sector.

[53] Our calculations are based (unless otherwise stated) on average fees (weighted according to number of accounts) associated with savings accounts (that offer unlimited deposits and withdrawals) across a sample of 10 commercial banks.

[54] The measure of affordability applied by Genesis, in line with that used by Finmark Trust, is to say that a household will be able to spend 2% of their monthly income on a banking product. As our $2/day is however an individual income measure, we assume each individual to be able to spend 4% of his/her income on banking (based on the assumption of two income earners per household). If we apply this cut-off level of affordability to the monthly expenses of maintaining a bank account, just the weighted average monthly admin fee associated with a basic type of savings account would approximately equal the affordability threshold of all those (52.4% of the population) living on less than $2 per day, as the income needed to afford the weighted average monthly admin fee would amount to $2.04 (PPP adjusted) per day. Should we add a debit order and an electronic funds transfer, the daily income needed to afford the bank account will amount to $4.80. *Therefore we estimate that all those living on $2/day, plus at least half those living on more than $2/day will not be able to afford such a transaction profile, amounting to at least 75% of the population*. Should "off-us" ATM transactions be added, the transaction profile will become even more exclusionary. Note that these are rough estimates, as we do not have adequate income distribution data at our disposal. These calculations also do not make provision for the further effect of proximity on affordability

- *Eligibility*. Our review suggests that the main determinant of access in Indonesia is the account opening balance required, as more than 90% of the population may not be able to provide the required minimum balance[55]. Should we, however, consider the minimum initial deposit of the most basic, least expensive savings account in the sample, this figure reduces to less than 45%[56]. The minimum maintained balance is generally significantly lower than the minimum opening balance and we estimate that at most 55% of the population will find it difficult to maintain this balance. The banking products under consideration pose few other eligibility requirements. Generally, though "source of funds" and "total income" are required fields in the form that clients need to fill out when opening a bank account, no salary slip or proof of income is required for a non-credit product and people will hence not be excluded on the grounds of being unable to supply such documentation.
- *Regulation (excluding AML)*. We find no major regulatory access barriers in Indonesia. As the discussion below will show, an identity document is the only statutory requirement for opening a bank account and acceptable forms of identification are widely available in Indonesia.

The four access indicators may not fully explain low usage levels. In addition to the elements of access outlined above, many of the role players consulted indicated that other usage factors may also play a role in an individual's decisions to use financial services, even if they technically have access to such services:

- *Tax evasion*. The prevalence of tax evasion may make people suspicious of providing personal information when opening a bank account or of storing their money in a bank account, thereby revealing their true income.
- *Cash-comfortable society*. The fact that most people are "cash comfortable" may mean that they do not have an incentive to open a bank account – people are used to transacting in cash and to saving their money "under the pillow"; insurance and bill payments are also commonly conducted in cash in Indonesia and many companies and even some government departments still pay employees' salaries in cash.
- *Financial literacy and the "hassle factor*". Financial literacy is generally estimated to be low in Indonesia[57]. Low levels of financial literacy may undermine usage of the banking sector, especially where financial sector products are deemed to be complex and difficult to operate, or where people do not perceive a need for formal banking services. The need to fill in KYC forms may be perceived as particularly onerous by the financially illiterate. There may furthermore be a "hassle factor" preventing some people from opening a bank account, for example if they find the opportunity cost associated with accumulating funds to

(costs incurred in reaching a banking outlet). We have furthermore not accounted for the positive effect on affordability of interest earned on deposits. The average interest rate payable could range between 3% and 6%.

[55]A recent World Bank study (De Ferranti et al, 2005) determines affordability (in terms of eligibility requirements) by assuming that a person could set aside one third of monthly income to make an initial deposit and that half of monthly income can be maintained as minimum balance. In the sample of banks used for this study, the weighted average minimum initial deposit would require a person to earn more than $10/day to afford it. Therefore all individuals earning $2 or below would be excluded on these grounds, as well as a substantial proportion of those earning more than $2 per day. We estimate that as much as 90% of the population could be denied access due to the unaffordably high minimum initial deposit requirements.

[56] The "90% excluded" picture may be skewed by the fact that we took the weighted average minimum initial deposit requirements over a sample of 10 banks. Should we take the most basic product available, namely a BRI account without an ATM card, to which it can be assumed that the poor and rural will have ready access (though proximity may still be a factor), the picture changes significantly and the monthly income (PPP adjusted) needed to afford the product will be only $1.64 per day. Therefore we estimate that between 55% and 60% of the population could have access to such an account without finding the minimum initial deposit requirement unaffordable.

[57] This finding was conveyed during in-country consultations, though no research reports were quoted. Building financial literacy was also identify as a key issue during the recent World Bank Bilateral Remittance Corridor Analysis mission to Indonesia.

open an account and of spending the time to fill in the necessary forms form too high. In our consultations it was however indicated that bank staff will assist clients in filling out forms that that this may therefore reduce the hassle factor.

The role of remittances

Indonesia is a labour surplus country and about 3 million Indonesians legally work abroad. The country is therefore a net receiver of remittances. In 2005 there were 3.1 million Indonesian migrant workers legally/formally working abroad, typically on 2 to 3 year contracts in the Middle East and the rest of South-East Asia. In excess of 80% of these migrants are female and most work as domestic helpers (World Bank Jakarta Office, 2006). Should illegal migrant workers be included, this number may be substantially higher. A recent Asian Development Bank study[58] estimates there to be between 3.8 million and 5 million Indonesian migrant workers (in total). All (legal) migrant workers are required to use the services of an employment agency to provide them with training and placement. Many workers also use an employment broker/mediator as go-between with the agency. These brokers often lend them the money required for training, lodging, travel documents and the journey abroad. This creates a dependency which may result in abuse and has been noted as cause for concern.

Indonesian migrant workers send money home via a variety of channels. The following table depicts possible means used to send money to Indonesia:

Category	Channel	Money transfer method
Formal/regulated channels[59]	Banks	Account-to-account transfers
	Money remittances companies (in partnership with banks or post-office)	Walk-in clients - cash deposit abroad and cash pick-up locally
	Post Office	International Money Order - via post office links with 14 other countries.
Informal/unregulated channels (includes informal channels' usage of formal financial system)	Personal	Bring cash back in person
	Personal	Ask a friend to bring back cash
	Bulked informal remittance transfers	Agent abroad bulks up informally received remittances, sends via financial system to recipient agent, who distributes informally to recipients; this may or may not be linked to employment brokers, or may take the form of a hawala-like system.

Table 2. Remittance channels to Indonesia

Source: Genesis Analytics, based on desktop research and consultations.

Though all Indonesian migrant workers are required to open a bank account before departure, many still prefer to use other means of remitting money home. Since July 2006, it is mandatory for prospective migrant workers to open a bank account via their employment agencies before departure (personal communication from Depnakertrans, 2006). There are however indications

[58]This study examines remittance flows within South East Asia and covers Indonesia, Malaysia and the Philippines (as net receiving countries), as well as Hong Kong, China, Japan, Malaysia and Singapore on the sending side. It is based on surveys (with a target sample of 500 per country) and interviews administered in each country during the first half of 2005. The Indonesian survey covered 550 remittance recipient households from the main migrant worker source provinces. The document states that “due to budget constraints the [Indonesian] survey employed a small number of respondents, thus experiencing a higher margin of error” (ADB, 2006: 69).

59By law, formal cross-border remittance services can only be provided through commercial banks or the post office (Pos Indonesia). Non-accountholders using money remittance services provided by banks in partnership with money remitters such as Western Union are classified by banks as “walk-in clients”.

that many workers do not necessarily use these accounts, but would prefer other, often informal, means. This may be related to preferences, the use of informal labour brokers, or, often, to the fact that workers (especially those working abroad informally) may find it difficult to access a bank account or formal remittance channels in the sending country):

- More often than not, the worker will be indebted to the broker/agency and be forced to send a proportion of earnings to the broker, at least for the first few months, after which the practice is often continued. At a fee, the broker will typically deliver the balance of the money (after deducting the loan payment) to the family. Though the transfer to the broker may be through the banking sector, the disbursement to family members typically takes place in cash.
- It is furthermore common practice for overseas workers to send cash home via a returning friend, or to save up cash and bring it home in person (contracts normally have a duration of 2 years).
- Particularly in the Middle East, where it is against social norms for female domestic workers to go out by themselves, workers would tend to ask their employer to remit money home via the employer's bank account or via a money transfer agency, or would use the employer's driver to send cash to the broker or agency's agent in the destination country (PPSW, 2006; World Bank, 2006).
- In addition, informal remittance service providers may make use of the formal system. This happens where an unlicensed/informal money remitter abroad, who is often an agent of a mediator/broker domestically, bulks remittances and then transfers the money via the banking system to an agent in Indonesia, who then distributes the cash to recipients for a fee.
- The ADB study (2006) also quotes the use of small Indonesian shops abroad to remit money (a hawala-type system), though its use does not seem to be pervasive.

Informal remittances may therefore be significant. The official estimate is that total inward remittances for 2005 amounted to $2.9bn (Depnakertrans[60], 2006). The exact size of the market is, however, not known, as this figure excludes those flowing through informal/unregulated channels. Estimates of the total remittance market (inclusive of informal remittances) vary, and imply that the informal remittance market may vary from $2bn (somewhat smaller than the formal remittances market) to $12bn (about four times the formal remittances market):

- Depnakertrans (quoted in ADB, 2006) estimates the potential volume of total annual remittances (assuming that the 3.1 million migrant workers remit between 70% and 90% of their salaries) to be US$ 7 billion.
- The ADB study (2006) quotes banking institutions as estimating total remittances (including those flowing through the informal market) to amount to between $9bn and $15bn per year (based on the estimate that there are between 3.8 million and 5 million migrant workers remitting around US$200-250 per month).

The fact that usage of the formal remittances market appears to be low may be a function of low access and/or preference:

[60] Department of Manpower and Transmigration

- *Relative cost may be lower for informal channels.* The discrepancy between total remittances and formal remittances may be a factor of affordability, but it is difficult to define a cut-off level of affordability for remittances, as the affordability of a remittance product can best be gauged relative to its alternatives. Little evidence is available on the relative costs of informal versus formal channels[61]. According to anecdotal evidence supplied by one of the large Indonesian banks, relative affordability would seem to vary according to the type of formal channel used: formal sending can be just as expensive as informal sending, but could also be three times more expensive.
- *Proximity is unlikely to be a major consideration*. As formal remittance services are linked to the banking sector (and postal network), the same proximity arguments will hold as for transaction banking. The convenience of the broker delivering the money to a person's house may however be a consideration in favour of informal channels.
- *Regulation – a hassle factor, rather than an absolute access barrier.* AML requirements on the receiving end would not seem to influence remitters' choice of informal vs. formal channels. Under the Indonesian AML regime, KYC only needs to be applied to walk-in clients conducting transactions in excess of Rp100m (roughly $10,900[62]). In practice, however, the formal remitters require that an identity card be shown and a form be filled out as standard procedure. Some service providers use comprehensive forms that compel the client to provide profiling data to the service provider. These forms include questions on the person's occupation, source of funds, etc. Therefore there will be a "hassle factor" that may prompt a worker to rather use an informal channel.
- Illegal Indonesian overseas workers[63] would automatically be excluded from formal remittance channels, as they would not be able to show the necessary documentation (a work permit and passport) in the sending country (should such requirements be in place).
- *Preference, convenience, the need for speedy delivery, or pressure from employment brokers may outweigh access and regulatory considerations in channel choice.* The advent of compulsory bank accounts may erode the share of the informal market, but actual usage of such compulsory bank accounts is not assured, especially where product features, cost or proximity do not fit the remitter's needs (as noted above). If banks with a large rural footprint could link remittance services with micro-loans to help migrant workers to go abroad, that may break the dependence on the brokers/local sponsors. There are early indications that banks are starting to see the remittance channel as a starting point for micro-credit[64].

Identification infrastructure

Indonesia has a widespread, though not uniform, identification infrastructure. It is mandatory for all married people or people over the age of 17 years to have an identity card, known as a KTP, and to carry it with them at all times (Depkominfo, 2006). It is possible for a person to have more than one valid KTP, with different identification numbers, should one of the following scenarios apply:

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[61] The few estimates contained in the World Bank Jakarta Office Indonesian Migrant Workers report (2006) would suggest that informal remittances are not much less expensive than formal remittances. This however depends on the sending country.

[62] At the average exchange rate for 2006 to date.

[63] It is estimated (ADB, 2006) that there are between 700,000 and 1.9m Indonesians working abroad illegally.

[64] CEMFIOWS (the Centre for Indonesian Microfinance and Overseas Working Studies) advocates the link between microfinance and remittances (Alam, 2006).

- The KTP is an identity card issued in a person's district of residence. Should a person move, a new KTP is issued without withdrawing the previous KTP.
- One person may also have various KTPs with different versions of his or her names on it. It is common practice in Indonesia for a person to have a single name (rather than a first and last name). The single name will be indicated on the KTP. Some persons may however elect, often based on religion, to add another name to their single name. It is then possible to have a second KTP denoting both the first and the last name. These two KTPs would not be linked to each other.

To add to the complexity, all sources consulted indicated that it is easy to falsify the KTP or to obtain a KTP corruptly.

There is no single national identification number. The KTP is furthermore not the only form of official identification in Indonesia. According to the Department of Communication and Information Technology ("Depkominfo", 2006), there are up to 40 public institutions issuing some form of acceptable identification, each with its own database and system (e.g. driver's licenses, passports, etc). A person may hold several forms of identification, each with its own identity number. These forms of official identification are not linked to one another, making the banks' task of correctly identifying a person difficult.

Initiative to create single identification number. In reaction to this problem, the Department of Communication and Information Technology is developing a national identification number. This number is to be inserted into all the systems of the various institutions currently issuing identification documents and will provide the mechanism to link the different forms of identity documents of a particular person. Thus, though the issuing structure will remain fragmented (no centralised system is planned for the moment, e.g. via a single national identification card), each person will be assigned a unique national identification number which will be reflected on all the official identity documents. The use of biometrics will also be encouraged. Depkominfo has indicated that it plans to roll this system out by 2008[65].

AML/CFT ENVIRONMENT

The development of the AML/CFT system

In the late 1990s, Bank Indonesia and the Ministry of Justice began to consider money laundering laws for Indonesia. In June 2001 Bank Indonesia issued its regulations regarding the application of know your client principles. Unfortunately the progress was not deemed sufficient to prevent Indonesia's listing by the FATF as one of the Non-Cooperative Countries and Territories in June 2001. The Indonesian government immediately responded by undertaking to adopt and implement a comprehensive AML/CFT system as a matter of urgency. In 2002, Law 15 of 2002 Concerning the Crime of Money Laundering was therefore enacted. The 2002 Law criminalised money laundering and created reporting and record-keeping obligations for FSPs. It also established the Indonesian financial intelligence unit, the *Pusat Pelaporan dan Analisis Transaksi Keuangan* (the "PPATK"). A number of staff members of Bank Indonesia were seconded to the PPATK to establish the new agency and by late 2003 the PPATK was operational.

[65] Note: In testing the potential of this system with other role players, it was however met with some scepticism, as it was stated that there have been previous attempts at a national identification system, to no avail.

The money laundering control law was improved in 2003 when the Law 15 of 2002 was amended by Law 25 of 2003. The 2003 Law made a number of changes to the new AML/CFT framework. For instance, it broadened the duty to report suspicious transactions by dispensing with the previous minimum threshold of Rp500 million (approximately $54,400) and it criminalised the financing of terrorism. Another amendment to the Act is currently being prepared. If adopted, it will increase the powers of the PPATK and extend the reporting obligations to a number of non-financial businesses.

In 2005, the FATF deemed the progress that Indonesia made sufficient to remove it from the NCCT list and, in February 2006, the FATF decided that is was not necessary to continue with special monitoring of Indonesian progress in this regard.

The AML/CFT system – an overview

The Indonesian AML/CFT system is characterised by the *key offences*, *key role players and key control obligations* that are normally encountered in a system of a country that committed itself to compliance with the FATF requirements:

Laundering and terrorist financing offences. Money laundering offences can be committed in respect of the proceeds of 25 types of predicate offences, including smuggling, corruption, financial crime, environmental crimes, taxation offences and other offences for which the prescribed penalty is at least 4 years imprisonment. The law also defines assets that are employed to support terrorist activity as proceeds of crime. The maximum penalty for a money laundering offence is Rp15bn (about $1.74m) and 15 years imprisonment. A corporation can be held liable if the crime was committed by its managers or their agents on behalf of a corporation. If convicted, the penalty that may be imposed on the corporation is the maximum fine plus 1/3 (one third). In addition, its business licence may be revoked and it may be dissolved. A number of convictions for money laundering have been handed down but no financial institution has yet been prosecuted for a failure to comply with its AML/CFT control obligations.

Key role players. On a broad government level, the Indonesian AML regime is coordinated by a ministerial-level coordinating committee. The key role player on the operational side is the financial intelligence unit, the PPATK, but Bank Indonesia, Bapepam-LK and the private sector forum of compliance directors also play important roles.

- A **National Coordination Committee on Anti-Money Laundering** (the "Komite TPPU") was established in terms of Law 25 of 2003 to coordinate the government's AML/CFT activities. The Committee is chaired by the Coordinating Minister for Politics, Law and Security. The Coordinating Minister for Economic Affairs acts as deputy chair. The head of the PPATK is the secretary of the Committee. Other members are the Minister of Foreign Affairs, the Minister of Justice and Human Rights, the Minister of Finance, the Head of the Police Force, the Attorney General, the Head of the National Intelligence Agency and the Governor of Bank Indonesia. The Committee has working groups consisting of the heads of the government agencies that implement aspects of the AML/CFT policies and laws.

- The **PPATK's** main function is to receive and analyse suspicious[66] and cash transaction reports[67]. If the PPATK believes that there are sufficient grounds to warrant further criminal investigations, they hand the matter to the police to investigate. If the investigation reveals possible offences, the police will hand the matter to the Attorney General's Office for a decision regarding a possible prosecution[68]. It also has the right to audit regulated financial service providers for their compliance with the AML/CFT law.
- **Bank Indonesia** (and **Bapepam-LK** as the Ministry of Finance's non-bank financial institution and capital markets supervisory agency) provides guidance to the regulated institutions in respect of their statutory duties and also monitor compliance with these duties as part of their general functions. Bank Indonesia has, for instance, given guidance (contained in regulations, circulars and guidelines) to banks, rural banks and money changers on various obligations. In 2003, the Minister of Finance issued a decree on the application of know your client principles by insurance companies, pension funds and financing companies, and the chairman of Bapepam published a decision on the same principles for security companies, investment advisors and related custodian banks. These provisions were recently merged in a Minister of Finance Decree (74/PMK.012/2006) to state the principles for KYC for all non-bank FSPs as covered by the combined jurisdiction of the merged entity Bapepam-LK[69].
- The **Communication Forum of Bank Compliance Directors** ("FKDKP") is an industry initiative upon which all commercial banks' compliance directors are represented. They meet to discuss issues of mutual interest and the forum has helped to standardise some of the compliance practices in the industry. The forum also interacts with PPATK, Bank Indonesia and other role-players on cross-cutting issues.

Financial service providers must comply with the standard control obligations such as client due diligence, record-keeping and reporting. The framework for the AML/CFT control duties in Indonesia was created by the regulation on know your client principles that Bank Indonesia issued for commercial banks in 2001[70]. AML/CFT control measures are imposed on all "providers of financial services[71]", defined as banks, rural banks, mutual fund managers, insurance companies, foreign exchange traders and Pos Indonesia (refer to Table 1 for a summary of the anti-money laundering regulatory framework as applicable to the various components of the Indonesian financial sector.):

- Such providers must report any suspicious transactions ("STRs") within three business days after the suspicion was formed.
- In addition, *all cash transactions* (not only suspicious transactions) in excess of a threshold amount of Rp500 million (roughly $54,400) are to be reported within fourteen business

[66] By 31 May 2006, the PPATK had received 4,566 ("STRs"). 4,421 STRs were filed by 109 commercial banks and one rural bank while 145 STRs came from 37 non-bank financial institutions.

[67] By May 2006, more than 1,7 million cash transaction reports were filed with the PPATK.

[68] The PPATK has voiced its frustration publicly about the handling of the reports and the lack of progress that were made with some of the matters that it reported to the law enforcers. Some progress has however been made. By 31 May 2006, 419 cases have been referred by the PPATK to the police and the Attorney General's Office, resulting in 30 convictions. A further 30 prosecutions were in progress.

[69] Refer to Table 1 explaining the recent merger of Bapepam, as capital markets supervisory agency, and the Directorate General for Financial Institutions as non-bank financial institution supervisory agency, into Bapepam-LK, the capital markets and financial institutions supervisory agency.

[70] Amended in 2001 and again in 2003. In 2003 the Bank issued a Guide to Standards for Application of Know Your Client Principles to provide further guidance to banks.

[71] According to Article 1.5, Law No. 25 of 2003.

days[72]. The cash transaction reporting ("CTR") duty may be onerous and the Act therefore exempts a number of transactions from the reporting ambit[73].

- Providers of financial services must also meet the other general money laundering control obligations such as client identification and verification and record-keeping (collectively referred to in the Indonesian legislation as "know your client" duties). These duties are detailed in various regulations and decrees and are discussed in more detail below.

Know Your Client duties

The regulations require all commercial banks to adopt a client acceptance policy, and policies and procedures on client identification, account and transaction monitoring and related risk management issues. The client acceptance policy is required to follow a risk-based approach and guide the bank to refuse services to persons who are deemed to be unsuitable for having dealings with the bank.

"Know Your Client Principles" are defined in the regulation as principles applied by a bank to establish (and verify) an existing or prospective client's identity, to monitor clients' transactions (by means of profiling) and to report suspicious transactions (as flagged on the management information system). The duties are essentially the same for commercial banks, rural banks, money remitters and non-bank FSPs, though contained in separate regulations issued by Bank Indonesia[74] (the first three) and the Ministry of Finance (non-bank FSPs)[75]. In the discussion to come, we will unpack the KYC duties in terms of: (i) upfront identification and verification (and re-identification), (ii) profiling, and (iii) system requirements.

Upfront identification and re-identification

Non-face-to-face origination of bank relationships is not allowed. If banking will be done electronically, telephonically or by correspondence the bank must first meet with the prospective client. That meeting may take place between the prospective client and a bank employee or between the client and another party representing the bank.

Banks are required to establish a prospective client's identity. In this regard, Law 15 of 2002 compels the person to provide his or her complete and accurate information by filling out the relevant forms of the bank and by attaching supporting documents. The regulations require the bank to examine the supporting documents to establish their authenticity. This examination may include an interview with the prospective client. After sighting the original document, the bank is required to keep a copy of the identity document. In the case of an individual client, the following information must be provided:

- the client's identity, including name, permanent address, place and date of birth and nationality;
- information about the person's occupation;

[72] International travellers carrying cash in excess of Rp100m ($10,870) also need to report the fact to Customs and Excise.

[73] Transactions with the government and salary and pension payments are, for instance, exempted. In addition, the head of the PPATK may also exempt other types of transactions from the CTR obligations.

[74] In 2003 Bank Indonesia issued a regulation that extended the client due diligence requirements to rural banks. In essence, rural banks are required to comply with the same control duties that commercial banks must meet. Bank Indonesia issued a regulation concerning money changers in 2004. The latter provides for the licensing and regulation of money changers and imposes Know Your Client duties on them. The effect of these instruments is that these non-bank financial institutions must comply with the Know Your Client principles that apply to a commercial bank.

[75] The recent Minister of Finance regulation no.74/PMK.012/2006 states the KYC principles applying to the institutions covered by the merged Bapepam-LK (all capital markets and non-bank financial institutions).

- a specimen signature; and
- information on the source of funds and reason for the transaction.

The identity must be verified by an identity card (KTP), driver's licence or passport. Should the person's permanent address differ from the one reflected by the identity document that was provided, a document providing information on the permanent address will also be required. The information about a person's occupation must include the address and the line of business of the employer.

KYC and remittances. Until 2006 money remitters were not required by law to KYC walk-in clients that remitted or received an amount below Rp100m ($10,870). This was a liberal exemption as the average remittance amount is estimated to be about $250. The PPATK and Bank Indonesia indicated, however, that they urged remitters to implement the KYC principles also in respect of walk-in clients who engaged in transactions below the statutory threshold. In practice many banks and remitting companies adhered to best practice despite this statutory exemption. Practices differed from company to company, but generally a sender of money was required to furnish his or her name, place and date of birth, occupation and information on the source of funds. Key information was verified by comparing it with the information contained in the sender's KTP or passport. These standard procedures were applied to every remittance, irrespective of the amount involved. However, in 2006 Bank Indonesia introduced a regulation requiring all new money remitters to be licensed and all existing money remitters to apply for licences before 31 December 2008. In this new regime licensed money remitters are required to identify and verify the identities of all remitting and receiving parties. The Rp 100m exemption to the KYC requirements has fallen away, thereby aligning the practice and the law in this regard.

The 2001 regulations also require a limited re-identification process. If the bank did not have the required account opening documents for a particular existing client, the bank was given six months after enactment of the regulation to obtain them. Most of the larger banks were not able to meet this deadline. In 2003, the regulations were amended to make it clear that they must refuse to conduct transactions with and/or terminate business dealings with an existing client that did not meet the re-identification requirements or that used an account contrary to the purpose stated when it was opened. The re-identification processes of major banks are still continuing and are being closely monitored by Bank Indonesia.

The account opening documents must be maintained for a period of not less than five years after the account was closed.

Profiling

The regulations require a bank not merely to identify a prospective client before entering into dealings with the person but to request information on the purpose and objectives of the dealings that the client wishes to conduct with the bank and other information that will enable the bank to profile the person. Banks are required to maintain client profiles that reflect at least the following information concerning the client:

- the client's occupation or line of business;
- the client's amount of income;
- information on other accounts held;

- the client's normal transaction activity; and
- the purpose for which the account was opened.

In practice, most of the regulated institutions have a standard client engagement form that must be completed by a prospective client for profiling purposes. The form differs from institution to institution. In general, the form requires a client to furnish the relevant data by ticking the appropriate box.

The regulations require a bank to update its client data if the information that was furnished at the account opening stage changed.

Systems requirements

The regulations require banks to have a management information system that can effectively identify, analyse, monitor and provide reports on the characteristics of transactions undertaken by its clients. The system must allow the bank to trace each individual transaction. Characteristics of transactions to be monitored include the nature of transactions conducted by the client and the nature of the overall relationship that the client has with the bank. Since the initial requirement was expanded in 2003, banks are also required to monitor clients' transactions and to identify any suspicious transactions. This should be done by either a *manual* or *an automatic* system. Account entries are required to be monitored periodically. Entries must be compared with the client profile to identify discrepancies. Transactions must be monitored at the time they take place in order to identify any possibility of a transaction being incompatible with the client's profile[76].

Banks are required to appoint special officers to handle high risk clients, including Politically Exposed Persons, and suspicious transactions.

Compliance and supervision

Bank Indonesia and Bapepam-LK have taken various steps to fulfil their functions and have done compliance audits in respect of the entities that they supervise. They have also shown themselves responsive to the needs of supervised entities[77].

Bank Indonesia's assessment and management of compliance. In 2004, Bank Indonesia adopted a new assessment methodology in respect of AML/CFT compliance by commercial banks. This methodology is used to manage banks toward full compliance with their statutory duties. In essence, the Bank audits a bank's compliance with its AML/CFT duties and then rates it on a scale of 1 (excellent) to 5 (poor). This rating is calculated into the soundness rating of the bank. If the rating is 5, the bank faces additional administrative sanctions. In such a case, a commercial bank's soundness rating may, for instance, be downgraded; certain of its high risk business activities may be frozen; and it may even result in an order for the dismissal of the management of the bank. By June 2006, the first round of assessments had nearly been

[76] This implies that it will be difficult to comply with this requirement, should a bank only have a manual monitoring system, unless front-end staff are trained to detect suspicious transactions as they occur.

[77] Banks, for instance, reported to Bank Indonesia the fact that many clients were highly suspicious about the new information that banks required. The Bank responded by launching a public awareness campaign to encourage clients to cooperate with the AML/CFT measures by providing complete and accurate information. All forms of media including television and magazines were utilised in this campaign. This initiative was warmly appreciated by the banking community who reported a change in attitude by their clients.

concluded. The majority of commercial banks received a rating of 3 (fairly good) and none were rated 5 (poor). Large banks are still struggling to re-identify their existing clients. The Bank uses the rating system to put pressure on such banks to show reasonable progress in this regard.

KEY FINDINGS

We find that, though usage of transaction banking is low in Indonesia, there are no major AML constraints to access, as widely available means of identification are required for verification purposes. Remittances in Indonesia are, similarly, not impacted by AML. Indonesia represents an interesting example of where government, at the same time as working for the removal of the country from the NCCT list, "did things right" so as not to undermine access to the financial system. Below, we expand on the key findings regarding the interplay between AML/CFT and access in Indonesia.

KYC does not have massive impact on access to financial services

Use of widely available identification documents prevents impact on access. The document that is generally presented for identification, as well as verification, is the KTP. As all adults have at least one KTP and carry it with them at all times, the need to produce a KTP has not proven problematic. Where banks ask for additional identification, e.g. a driver's license, or request a reference letter or letter from the employer, this is beyond what is required by regulation – though the PPATK did indicate that they encourage best practice to exceed the baseline requirements[78]. The "hassle factor" is largely removed in that bank staff assists clients to fill out the client identification form and, as most clients are used to conducting their banking in a branch, the need to visit a branch for re-identification is generally not regarded as onerous.

Threshold approach avoids impact on walk-in clients (e.g. for remittances[79]). Prior to December 2006 institutions were not required by law to apply KYC to walk-in clients remitting or receiving an amount below Rp100m ($10,870). The average remittance amount is estimated to be about $250 (about Rp 2.3m at the average exchange rate for 2006). The law therefore did not impede the vast majority of remittances. In practice however most money remitters performed KYC processes. This became a regulatory requirement for licensed remitters after December 2006. However, for the same reasons outlined above, the requirement to submit to KYC procedures and in particular the need to produce a KTP has not been experienced as problematic.

Profiling compensates for the low integrity of the KTP

KTP integrity is questionable. As explained earlier, it is possible for a person to have more than one valid KTP (or other form of identification) not linked to one another by a common identify number, because KTPs are not issued centrally and various institutions issue acceptable forms of identification. It is also easy to obtain a KTP through corruption or to falsify it. Therefore the integrity of the verification system is questionable.

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[78] The PPATK has indicated to us that it has a best practice focus in which banks are encouraged to implement measures over and above that strictly speaking required by law. The legal requirements (e.g. with regard to identification and verification) are therefore regarded as the baseline that can readily be implemented, with a step-wise increase of the standard to make the system more efficient. We could however not identify any specific policy or guideline in this regard.

[79] For those remittances sent via account to account transfers, the findings for transaction banking services outlined above apply.

KTP is accepted for KYC purposes because it is the best available means of identification. The PPATK and Bank Indonesia are aware of the issue but take the view that the KTP, in the absence of better alternatives, has sufficient integrity in the majority of cases for it to be used in the current system.

Profiling compensates for lack of KTP integrity. Banks are required to use the information obtained from the interview and the KYC form to build a profile of the client and his/her expected transactions. The lack of identification reliability is mitigated by the fact that the KYC form records answers to a variety of questions aimed at profiling a client, such as a person's occupation, amount of income and expected transaction activity. This information is retained but not verified. Fraudulent applications will either be flagged because it exceeds a risk threshold or will keep the criminal to a profile limiting his/her transactions (as transactions deviating from the profile will be flagged as STRs). It is to be expected that criminals will not have the discipline to keep their transactions within the profile. Profiling is, therefore, a useful enhancement to the limitations of upfront identification using the KTP.

Initiative to improve the ID system. As discussed, a government initiative has been launched to improve the integrity of national identification in Indonesia. Until such time as the National Identification Number project is implemented successfully, the authorities believe that it is practical and realistic to use the KTP as the main verification document, combined with a focus on profiling.

Realistic & flexible systems requirements

Understanding of bank sector has led to the establishment of realistic rules and system requirements. It would seem that the AML regime was designed in such a way as to understand and use existing bank systems and minimise additional costs to banks[80]. To monitor clients' accounts for suspicious transactions, legislation stipulates that banks are required to have a management information system in place. It does, however, not dictate that these systems should be electronic and of a particularly advanced nature[81]. Advanced electronic systems may be prohibitive for small players and unnecessary, given the risk such players pose. The regulators are therefore flexible in allowing less sophisticated/manual systems that meet basic regulatory requirements. In applying this flexibility, they furthermore emphasise the audit/traceability role of account monitoring, rather than real-time detection capability[82].

Risk-sensitive approach

Realistically-managed re-identification process. When the deadline set for re-identification was reached and it was apparent that re-identification had not been completed yet, Bank Indonesia requested banks to draw up an action plan to indicate how they plan to re-identify remaining clients. Progress with re-identification and general KYC implementation is monitored each year and forms an input into a bank's management rating. An inadequate KYC rating will impact on

[80] As noted in the discussion of the effects of the Asian Crisis, post-crisis mergers have implied that many banks have recently-revamped IT systems and have therefore not needed to incur any additional KYC-induced costs.

[81] According to the 2003 guidance issued by Bank Indonesia, the system can either operate manually or automatically.

[82] As explained by the head of the PPATK (2006): "No country can prevent bombings by doing financial analysis. What we can do is backward analysis. Once the bomb explodes, and the police find a lead, we can trace their financial transactions. So, our function is more to facilitate the police investigation."

a bank's soundness rating and, should the overall rating be unacceptable, Bank Indonesia has the sanction to remove management under the "fit and proper test". Flexibility and cooperation is therefore combined with a strong sanction in such a way as to enhance the efficiency of the system.

Risk-sensitive approach used to accommodate constraints faced by banks. In their re-identification action plan, banks are required to re-identify higher-risk clients first. Therefore a risk-based implementation process is followed that is sensitive to the management reality of banks and in which banks are allowed the space to manage their compliance programmes according to the money laundering risk posed by various client categories.[83]

Threshold amount set for KYC of walk-in remittance clients represents a risk-sensitive rule. The level of the threshold is however quite high and exempts most remittances from AML requirements.

Given limited resources, regulatory attention is focused on higher risk institutions

Similar KYC requirements on commercial banks and BPRs. The requirements for client identification, verification and client profiling, are essentially the same for BPRs as for commercial banks (though worded slightly differently in the English versions of the two applicable regulations). According to the BPR we consulted, it is standard procedure for clients to show their KTP and fill out a client identification form[84].

Compliance enforcement/monitoring however not focused on BPRs. In practice, indications are that compliance with the KYC regime is more strictly monitored in respect of commercial banks than in respect of BPRs. This is, firstly, due to the limited auditing resources of the PPATK – it is virtually impossible to cover all of the almost 2,000 BPRs[85]. Secondly, the PPATK has stated that it does not prioritise BPRs as they are not regarded as posing high money laundering risk. The chairman of the PPATK is quoted in a recent interview in the Jakarta Post (2006, as posted on the PPATK website) as saying that commercial banks are most compliant (110 out of 130 commercial banks report suspicious transactions to the PPATK), but that only one BPR has reported to them. This is not regarded as problematic, as "rural banks are not a priority because money laundering rarely takes place there" (PPATK, 2006)[86].

On-going management of compliance addresses problems as they arise

Initially, clients regarded KYC requirements as bank-specific. Some clients have expressed reluctance to supply source of income information as required on the KYC form, especially

[83] Bank Indonesia has given the majority of banks a 'fairly good' KYC implementation rating. All banks interviewed indicated considerable progress with re-identification, tough none has achieved it in full.

[84] It is argued that KYC has not placed any additional burden on BPR clients, as they are used to coming into the branch to conduct their banking business and only a limited number of BPRs have ATMs in any case. Therefore no difficulties were encountered in re-identification. Where clients may find it difficult to fill out long and complex forms, BPR staff members typically assist them. This was confirmed in our interview with Bank Indonesia's BPRs supervision department.

[85] The Bank Indonesia BPR supervision division indicated to us that they do not monitor BPRs' AML compliance, as that is the domain of the PPATK.

[86] The fact that BPRs are "classified" as low-risk could make them vulnerable to money laundering abuse, in which case the lack of monitoring of such institutions may be of concern. However, the PPATK has indicated that the total asset base of the BPRs is only 1.4% of the banking sector and that BPRs conduct limited banking business (cannot offer current accounts, offer remittance services or access the payment system) and therefore pose lower money laundering risk. The decision not to focus on BPRs was explained to the FATF reviewers, who concurred (email communication from Chairman of PPATK, 10 November 2006).

should they be suspicious of having to declare all income for taxation purposes. Clients therefore moved to banks perceived as having lower requirements. Thus the need to create public awareness of the necessity for KYC became apparent.

Bank Indonesia addressed this problem by launching a media campaign. This campaign explains the need for KYC and informs the public that all banks will require the same information of clients. It was launched in 2005, will be running until the end of 2006, and entails radio, television and printed press advertising. Not only does the campaign serve to standardise practices across banks by influencing client expectations, but it also prevents damage to banks, should clients regard their KYC requirements as onerous and decide to close an account and try to open an account with another bank. The FSPs consulted stated that they have been greatly aided in their KYC efforts by this regulator initiative.

Limited AML impact on informal financial service providers' relationship with the formal financial system

Informal financial service providers often have accounts with the formal financial system. There was no indication from the banks and regulators consulted that AML impacts on informal financial service providers, though one would expect that their heightened transaction volume and values will be picked up by banks as suspicious transactions in their KYC and profiling procedures of the owner/operator of such a business. A case in point is the so-called "table banks" that bulk remittances from abroad, which are then sent to Indonesia, or informal MFIs that have bank accounts themselves.

A conservative approach by banks may result in closure of accounts simply due to uncertainty. *This phenomenon has not been encountered in Indonesia*. None of the banks consulted indicated the need to close existing client accounts. This can mainly be ascribed to the clear guidance provided by the PPATK. Informal MFIs/financial service providers may also "prevent detection" in conducting transactions with banks due to the fact that:

- the AML Law only requires a cash transaction report for a transaction exceeding Rp500m ($54,400);
- non-accountholders are only subject to KYC for daily transactions above Rp100m ($10,870);
- accountholders only need to provide tick-of-the-box source and size of funds information (without verification).

AML legislation has not resulted in significant cost increases for banks

Limited direct cost implications for banks. None of the banks consulted reported high direct costs related to the implementation of AML. Following the crises, most banks have recently made large IT system investments and the additional cost of account monitoring functionality is not regarded as significant. Some banks have even indicated that the implementation of the AML regime has *lowered* their costs, as Indonesia's previous NCCT listing increased their cost of credit and made the procedures imposed on them to do business with correspondent banks more onerous.

Absence of cost accounting per market segment has limited impact on access. None of the banks consulted have furthermore calculated the additional per-transaction or per-account opening cost incurred due to AML (in terms of staff time, transaction analysis, etc). This may be due to the current bank practice of overall, rather than market-segment-specific, cost accounting[87]. As banks do not measure transaction cost per income group, they have not experienced an increase in the cost of serving the lower-income market[88] and have therefore experienced no disincentive to serve this market segment.

The success of a bank regulator-led regime

The development of the KYC regulations and AML regime was bank regulator-led. Internationally, the greatest push was often from the law enforcement side. In the Indonesian case, however, most PPATK personnel were originally Bank Indonesia or Bapepam-LK staff members, who understand and have close interactions with the banking and non-bank financial sector.

Good relationship between banks and Bank Indonesia as the regulator, as well as between banks and the PPATK. The PPATK holds regular working group discussion, bringing together role players from Bank Indonesia, Bapepam-LK, the law enforcement agencies and private sector players to facilitate interaction and learning. As described above, Bank Indonesia has also assisted banks by launching its public awareness campaign.

A coordinated AML regime reduces compliance costs

The implementation of the AML regime is enhanced by the fact that it is coordinated on a high level through the TPPU Committee (National Coordinating Committee for the Prevention and Eradication of Money Laundering Crimes), chaired by the Minister for Political and Security Affairs. As all relevant agencies and government departments are brought together through this committee, it could serve to ensure coherence and buy-in from role players across the spectrum.

On the compliance side, there is once again coordination in the form of the Compliance Forum ("FKDKP"), which gives banks the opportunity to standardise compliance procedures and systems, thereby facilitating compliance-officer expertise that is not bank-specific. This may greatly reduce training costs, should there be churn of staff between banks. This coordination is strengthened through the working group sessions held by the PPATK, where all role players are represented, as well as through the Bank Indonesia advertising campaign, which builds client expectations regarding consistency of requirements.

[87] Clients are segmented for marketing purposes, but not for strategic cost accounting.
[88] Where minimum balance requirements have been increased, this has been in reaction to a frustration with dormant accounts, rather than due to concerns about the profitability of lower value bank accounts.

APPENDIX C: KENYA

SUMMARY AND KEY FINDINGS

- Banking access levels are low: only about 19% of adult residents use some form of savings or current account while, from an affordability perspective, only 5% have access to a transaction bank account. The fact that usage exceeds access suggests that most of these individuals will only use a bank account to receive payments/remittances and not for transactions. This conclusion corresponds with the findings of the FinAccess survey completed in 2006.
- Kenyans rely greatly on incoming remittances, though the poor are not well serviced by the formal remittance market. High regulatory barriers to entry into the formal remittance sector means formal sector costs are high and most of the poor rely on informal remittance mechanisms, including taxis, buses, couriers and hawalas. High formal sector costs are, however, likely to decrease with new innovative money transfer products, such as M-PESA, being launched in the Kenyan market.
- AML and CFT legislation has not yet been enacted. A task force has written an AML bill, which was gazetted during 2006 and a changed version re-gazetted during April 2007.
- Some AML regulation already exists in the form of prudential guidelines for banks. They have had a minimal impact on usage until recently because clients who can afford bank accounts (and remitters who can afford to use formal mechanisms) are generally able to meet KYC standards. However, the low-income market is increasingly starting to use bank accounts. For example, the low-income bank, Equity Bank, had a client base of 1.1m individuals in April 2007.
- It is difficult to accurately assess the future impact of the new AML bill as it has not yet been finalised. However, the policy of the task force has been not to adopt a risk-sensitive approach. The Bill (in its current form) will impact on virtually every type of financial institution, activity and transaction, regardless of AML risk, which will heighten impact unnecessarily. The impact is likely to increase as the banking and remittance markets extend beyond current high-use markets.
- KYC processes currently have a mechanism to avoid absolute exclusion – referees such as existing clients of the relevant financial institution, government officials or religious leaders are able to vouch for individuals' addresses and sources of income. Although it will thus not create an absolute barrier for low-income clients it will create significant inconvenience and extra cost in respect of "proving" address and source of income and is likely to discourage usage of bank accounts.
- Compliance with the AML/CFT bill will increase costs for FSPs, especially for non-commercial bank institutions, like Postbank, SACCOs and MFIs that are less able to fulfil the requirements of the AML rules. As is evident from the draft regulations to the Microfinance Act of 2006, no special exemptions are planned for the clients of deposit-taking MFIs with respect to KYC requirements.
- The AML/CFT bill will also regulate informal MTOs. It is unlikely that they will be able to comply. KYC of walk-in remittance clients may incentivise the use of informal channels. This is likely to significantly decrease the usage of formal services.

GENERAL AND MARKET CONTEXT[89]

Country at a glance

Poverty and informality characterise the Kenyan economy. Kenya has the most significant economy in East Africa which is recovering following a period of recession during the early

[89] Kenya shillings are converted to dollar values by using the Ksh/$ exchange rate of 72.96. This is the average exchange rate for 2006 up until the end of October 2006 (taken from http://www.oanda.com/convert/fxhistory).

2000s. The gross domestic product growth rate for 2005 was 5.8%, up from 0.6% in 2002 (Central Bank of Kenya, 2006:4). The country is characterised by a large informal sector, which, according to two estimates (Market Intelligence, 2005:46 & FAO, 2001), accounts for between 70% and 94% of the working population. High levels of poverty are prevalent, with 23% of the population living on less than $1 (PPP) a day (Ksh999/month[90]) and 58% living on less than $2 (PPP) a day (Ksh1997/month[91]) (World Bank, 2006[92]).

Kenya has a small but vulnerable immigrant population. The Kenyan population consists of 33m individuals, of whom 17m are adults (over the age of 18). The Office of the National Registrar of Persons estimates there are 1m foreigners in Kenya of whom 0.8m are present without legal documentation. Undocumented migrants arrive mostly from Uganda, Somalia, Rwanda, the Democratic Republic of Congo, Sudan and Ethiopia.[93] There are also four refugee camps on the Somali and Sudanese border. The biggest of these houses over 100,000.

A national identification infrastructure exists. By law, Kenyan citizens over the age of 18 must have and carry a national identity card issued by the Office of the National Registrar of Persons. 15.6m adult Kenyans out of 17m people have one.[94] The cards are issued free of charge and carry the name, date of birth, gender, thumbprint, and place of birth of the holder.

According to the national post office (POSTA), fewer than 20% of Kenyans have a formal physical residential address and only a quarter of these could probably produce a utility bill (i.e. 5% of the population).[95]

The banking sector structure

The private commercial banking sector is diversified. There are 42 commercial banks licensed in Kenya. The biggest players[96] are:

The partially government-owned Kenya Commercial Bank which has 17.9% of market share;

- the privately and foreign-owned Barclays and Standard Chartered with 16% and 11.5% of market share, respectively;
- the Co-operative Bank, which holds the accounts of 90% of savings and credit co-operatives (SACCOs) in Kenya and is owned by SACCOs or SACCO members with 8% of market share; and
- the National Bank of Kenya (22% owned by government) which accounts for 6% of market share (Market Intelligence, 2006:21).

Postbank has the largest account base. Operating alongside the commercial banks is the government-owned Kenya Post Office Savings Bank (Postbank) which has the largest number of accounts in the country with around 1m active accounts (savings only) plus another 1m inactive accounts. Postbank has the widest network with 75 branches and outlets in 340 post offices, giving it a reach well beyond the commercial banks. The focus of Postbank has been

[90] The $/day figure takes account of Purchasing Power Parity, therefore a person earning Rs999 per month would be able to buy goods and services equivalent to $1/day ($30.4/month), even though it only amounts to $13.7 per month (i.e. Ksh999/72.96) should no PPP adjustment be made.
[91] As per the previous footnote, the $/day figure takes account of Purchasing Power Parity, therefore a person earning Rs1997 per month would be able to buy goods and services equivalent to $2/day ($60.8/month), even though it only amounts to $27.4 per month (i.e. Ksh1997/72.96) should no PPP adjustment be made.
[92] Reflecting 1997 data.
[93] Interview with the Office of the National Registrar of Persons, 1 September 2006
[94] This is the official figure based on an interview with the Office of the National Registrar of Persons, 1 September 2006
[95] Interview with POSTA on 30 August 2006
[96] Measured by total assets

low-income savers, especially in rural areas. Postbank invests most deposits in government paper and also holds accounts with, amongst others, the National Bank of Kenya.

Commercial banks and Postbank have separate regulatory regimes. Commercial banks operate under the Banking Act, 1995 and are regulated and supervised by the Central Bank of Kenya (CBK). The Banking Act limits deposit-taking from the public to institutions holding a banking licence.[97] The minimum capital requirement to obtain a banking licence is Ksh250m ($3.5m). Section 54 of the Banking Act exempts Postbank from the Act. Postbank operates independently under the Kenya Post Office Savings Bank Act, 1978. Postbank is not regulated by the CBK, though it does report to the Ministry of Finance. It is not obliged to comply with the prudential guidelines relating to money laundering (described below) and, as a result, a situation has arisen where Postbank's AML compliance is lower than that of commercial banks. For example, Postbank's KYC requirements are weaker – they require sight of a national identity card but not documents proving or verifying address or source of income. Commercial banks, by contrast, are required in terms of the prudential guidelines to ask for all three. In addition, the Postbank does not keep all records required of commercial banks, nor does it does monitor or report suspicious transactions. Commercial banks are required to do so.[98]

SACCOs are important non-bank players. Savings and credit co-operatives (SACCOs) provide supplementary service to those who are already banked, and also play a role in providing basic savings and loans services where banks do not reach. According to the CBK there are about 3,600 active SACCOs in Kenya with 2.2 million members.[99] Some SACCOs are very large - up to 85,000 members - but all SACCOs are similar in that they are formed around a common bond. In urban areas this bond is usually professional, for example, one SACCO will serve civil servants, another lawyers, another taxi drivers and so on. Rural SACCOs tend to be formed by farmers who are self-employed rather than salaried but who do nonetheless share a common bond e.g. all are coffee farmers, tea farmers or so on. A new member of a SACCO, once vetted for membership, buys a "share" in the SACCO and after a set period, usually six months, can borrow up to three times the deposited share. SACCOs open a bank account with a commercial bank in the name of the SACCO to bank the members' payments, thereby providing some members who do not have a direct personal bank account with an indirect link to the formal banking system. Approximately 1.4m members of SACCOS and MFIs in Kenya do not have their own bank accounts and would only have indirect access to a bank account through their SACCO or MFI (FinAccess, 2006). About 90% of SACCOs hold their accounts with the Co-operative Bank.[100]

SACCOS are emerging as competitors to banks. SACCOs are registered in terms of the Co-operative Societies Act[101] with the Ministry of Co-operatives, and in terms of this act, are limited to doing business with their members. They cannot offer deposit services to the public at large. However, some SACCOs recently started to offer their members so-called Front Office Service Activities (FOSAs), which are more sophisticated "banking-like" services like a personal savings account and personal loans approved quickly and at competitive rates. In addition, FOSAs are offered through bank-like counter services, with banking-related charges. So while FOSAs are technically only offered to members there is an obvious temptation for SACCOs to

[97] Section 16 (1)
[98] Interview with A. Nyambura Koigi, MD, Postbank on 30 August 2006
[99] Interview with CBK on 31 August 2006
[100] Interview with Co-operative Bank on 31 August 2006
[101] Chapter 490 of the laws of Kenya

offer services to non-members or to sign up new members with a marginal common bond. There are 120 SACCOs offering FOSA services.

Enabling regulatory framework being introduced for SACCOs. A bill, the SACCO Societies Bill 2006, is currently being drafted to improve the governance and supervision of SACCOs. It aims to establish a new authority, the SACCO Societies Regulatory Authority, under the Ministry of Co-operatives, to regulate and establish prudential regulations for FOSA SACCOs.[102]

Enabling regulatory framework has been introduced for MFIs. It is estimated that there are approximately 50-100 MFIs with a total client base of 600,000-800,000 individuals (Kashangaki, 2007). Currently, microfinance institutions (MFIs) provide only credit services to their clients and are unregulated. A small number of MFIs (currently two) are seeking to become deposit-takers in their own right. The Microfinance Act, No. 19 of 2006 was passed in December 2006. The Act allows for MFIs that meet certain requirements to become deposit-takers and be subject to prudential regulation. MFIs that may feasible transform to deposit-taking institutions account for about 400,000 members. These deposit-taking MFIs will be regulated and supervised by the CBK, while the Minister for Finance will prescribe regulations to govern the non deposit-taking micro-finance institutions. Although the regulations have been drafted (including a set of regulations titled the “Deposit taking Proceeds of Crime and Anti Money Laundering Regulations”), they had not yet been finalised in August 2007.

In addition to FSPs already described, Kenya also has some informal FSPs. These include rotating savings and credit schemes (ROSCAs) and village banks. They are not regulated in any manner.

The various FSPs discussed in this section, as well as their governing legislation and AML/CFT obligations that apply are summarises in Table 3, below.

[102] Section 28 (g) of SACCO Societies Bill, 2006

Financial sector institutions	Number	Example	# of accounts	Regulated/supervise d by	General regulation/ applicable law	Applicable AML/CFT legislation	Applicable KYC requirements
Commercial banks	42 commercial banks licensed in Kenya	Barclays	Unkown	Central Bank of Kenya (CBK)	Banking Act, 1995	In 2000, CBK issued prudential guidelines under Banking Act setting out basic AML rules for commercial banks. Draft AML bill has been published. Draft CFT bill published in 2003, but withdrawn.	Identification by identity document, proof of address and source of income required.
Postbank	n/a	n/a	1 m active accounts, plus another 1m inactive accounts	Not regulated by CGK, though it does report to the Ministry of Finance	Kenya Post Office Savings Bank Act, 1978	Postbank is exempted from the prudential guidelines that apply to banks. Currently no legislation applies.	None currently
Savings and Credit Cooperatives (SACCOs)	3,600 active SACCOs, some having members of up to 85,000; total membership base of 2.2m	Unknown	Currently not taking deposits; 1.4m members do not have their own bank accounts and would have access via the bank account of their SACCO	Registered with the Ministry of Co-operatives	Co-operative Societies Act (Chapter 490 of the laws of Kenya)	None currently. AML draft bill will apply once enacted.	None currently
Micro-finance institutions (MFIs)	Approximately 50-100 MFIs with a total client base of 600,000-800,000 individuals	Kenya Woman's Finance Trust (KWFT)	Institutions that could feasibly become deposit-taking institutions have total membership base of 400,000	Central Bank of Kenya	Provide credit services. However, the Microfinance Act, No. 19 of 2006, allows for MFIs licensed under the act to also take deposits.	None currently. AML draft bill will apply once enacted.	None currently. However, the draft regulations to the Microfinance Act indicate that the same KYC requirements will apply to MFI clients as to clients of commercial banks (see above).

Table 3: Kenyan deposit-taking institutions and applicable legislation

Source: Genesis Analytics, based on desktop research, information and information obtained in in-country consultations

The reach of the banking sector

To date, commercial banks have not targeted the lower-income market. Commercial banks have traditionally shown little interest in lower-income clients. The high interest rates on offer in the government bond market in the 1990s (at their peak T-bills were returning a rate of around 70%) afforded banks comfortable margins without having to focus too much on intermediation and there was little need to move business into new, higher-risk or lower-profit areas. Less profitable (lower-income) clients were thus excluded by stringent account opening and minimum balance requirements, high operating costs in the form of monthly flat fees (which remain in place today) as well as the closure of some rural bank branches.

The result is low levels of usage. A consequence of that period is that few Kenyans use a bank account. Of the total Kenyan population of 17.4m, 19% or 3.3m have a bank account (FinAccess, 2006).

Affordability excludes 80% of adults from banking services[103]. The low usage of bank accounts can be explained by access barriers. Even basic accounts are not affordable to the majority of the population. We estimate that a client would need a personal monthly income of Ksh2,800 ($38) to afford a basic savings account,[104] while he or she would need a personal monthly income of Ksh19,418 ($267) to afford a transaction account.[105] Given that 58% of the population lives on less than Ksh1,997 per month ($27), we estimate that only 20% of adults could currently afford a basic savings account and that no more than 5% of adults could afford a transaction accounts.

Proximity contributes to lack of access. The last decade was characterised by a closure of less profitable bank branches, especially in rural areas. In 1997 there were 695 branches countrywide; today there are 532 (Central Bank of Kenya, 2005:35; Kabbucho, Sander & Mukwana, 2003:3) and 85% of these are located in urban areas in a country where 60% of the population live in rural areas. This has left commercial banks with a truncated reach into poor rural markets. For this reason, Postbank, operating through the extensive outlets of the national post office (POSTA), is an important financial link for the rural poor.

Eligibility criteria also contribute to lack of access. In addition, a number of commercial banks impose high opening and minimum balance requirements on their clients, which lower-income clients find difficult to meet. This model has been broken, however, as banks start to move into lower-income markets. Equity Bank, for instance, has zero opening or minimum balance requirements on its savings and current accounts. It is estimated that 25-30% of the population are excluded due to high opening or minimum balances.

In addition to the access drivers, certain other factors are also likely to impact on usage of bank accounts. These are factors that tend to discourage usage of bank accounts, but do not form absolute access barriers and include factors such as paperwork and hassle to which people

[103] The measure of affordability applied by Genesis, in line with that used by Finmark Trust, is to say that a household will be able to spend 2% of their monthly income on a banking product. However, as we only had personal income data available, we assume that there are two earners per household and that an individual will therefore be able to spend 4% of personal income on a transaction bank account.

[104] We took a weighted (by number of branches) average of the monthly charges on the cheapest savings accounts offered by four banks serving the low-income market (Co-operative Bank, NBK, Equity Bank and Postbank). The average cost of a savings account was Ksh112/month. Personal income to afford a savings account would be Ksh2,797 (using the 4% rule described in footnote above).

[105] We took a weighted (by number of branches) average of the monthly charges on the cheapest transaction accounts offered by four banks serving the low-income market (Co-operative Bank, KCB, NBK and Equity Bank). The average cost of a transaction account was Ksh777/month. Personal income to afford a transaction account would be Ksh19,418 (once again using the 4% rule).

are subject when opening a bank account, the opportunity cost of opening an account (time spent) and the potential intimidating nature of banks to low-income clients.

A new attitude to low-income banking is emerging

Changing market conditions enticing some commercial banks to rethink the low-income market. Although the access picture described above is not healthy, the attitude towards lower-income banking is shifting, albeit slowly. Access is now recognised as an explicit policy goal by the Ministry of Finance. It is listed as an objective of the Economic Recovery and Poverty Reduction Strategy Programme and formed a key driver of the impetus to create the new Microfinance Act. In addition, the banking market is more competitive for a number of reasons. Firstly, there has been a dramatic fall in T-bill yields (down to around 8% currently (Central Bank of Kenya, 2006:4)), putting an end to the "armchair banking" described above. Secondly, capital requirements have been halved and state-owned banks partially privatised, creating more competition. Thirdly, as described above, SACCOs and MFIs are starting to operate in the banking space. Finally, new entrants like Equity and K-Rep banks are entering the lower-income market (see below). Combined, these factors are churning up the competitive waters, influencing some commercial banks to reassess lower-income market strategy.

New entrants stir up the market. The path into the low-income-market is being cut by two relative newcomers, Equity and K-Rep banks. *Equity Bank* started out as a rural mortgage finance company and grew into a building society and then into a bank. It now bases its strategy on serving the informal sector by providing affordable and simple products. A 2005 banking survey found that on average, established banks charge about Ksh800 ($10) per month for services. This compares poorly to the Ksh40 ($0.5) charge by Equity Bank (Market Intelligence, 2005:46). During April 2007, Equity Bank had more than 1m clients and asserted to have captured 31% of all account holders in Kenya (Muiruri, 2007). *K-Rep Bank* emerged as a bank in 1999 after starting out as a microfinance institution. It has retained its focus on the client base previously served as a MFI and also attracted new clients, mostly low-income earners and those not in formal employment earning less than Ksh5,000 ($69) per month.

Mainstream banks testing low-income products. Some "mainstream" commercial banks are also looking at lower-income business. At least two low-cost products have been launched: Kenya Commercial Bank released the Simba account and National Bank of Kenya launched the Taifa savings product.[106] The marketing tagline for Taifa ("*Finally an account you can afford*") hints at the problems people have faced in the past with finding affordable accounts.

The money remittance market

In terms of formal remittances, Kenya is a net receiving country. The view of the CBK is that through the formal sector, at least, Kenya is a strong net remittance receiving country. This concurs with information provided by agents of MoneyGram and Western Union, reporting that the ratio of inflows to outflows in their business is somewhere between 85:15 and 98:2.[107] However, data on volume flows is weak; there is little centralised data as balance of payment statistics on remittances are not kept by the CBK. One indication given in 2003, by the Daily Nation newspaper who quoted the Minister for Finance and Planning stating that, based on

[106] Both these accounts have very few charges (e.g. no monthly service fee) and affordable opening and minimum balance requirements, which make them suitable to the low-income market. The Taifa savings product, however, seems a more appropriate product for the low-income market than the Simba account in that the Simba account only allows four withdrawals per year. Once this is exceeded the account is automatically converted to a transaction account with normal charges.

[107] Interviews with Co-operative Bank on 31 August 2006 (MoneyGram); and Postbank on 30 August 2006 (Western Union)

statistics of transfers through Western Union, Kenyans in the United Kingdom send more than Kshs50bn ($690m) to Kenya every year, while those in Germany remit up to Kshs30 million ($410,000) a month (Kabbucho, Sander & Mukwana, 2003). The majority of incoming remittances appear to arrive from the United States, United Kingdom, Germany and Canada.

Kenyans rely strongly on incoming remittances. A report by the Tegemeo Institute in 1998 found that a third of Kenyan households rely on remittances to support their financial needs (Kabbucho, Sander & Mukwana, 2003:4). Incoming money transfers are used mostly for family support in respect of food and hospital expenses and school fees. Similarly, a report by Microsave Africa in 2003 estimated that 30% of the rural population rely on some form of money transfer system for receiving remittances from family members working elsewhere (though not necessarily abroad). The recently released FinAccess (a financial services usage survey in Kenya) found that in the twelve months preceding the survey completed in 2006, 17% of respondents received an internal transfer from persons in Kenya, 3% received money from outside Kenya, 17% sent transfer within Kenya nad only 1% sent money outside Kenya (Financial Sector Deepening Kenya, 2007). The main sending countries were the United Stats of America, the United Kingdom and Uganda (Financial Sector Deepening Kenya, 2007).

Among low-income users, incoming remittances for family support have been estimated at between Ksh500 and Ksh10,000 ($6.9 to $137) per month, which compares to the estimates of school fees of between Ksh10,000 and Ksh50,000 per term ($137 to $685) (Kabbucho, Sander, Mukwana, 2003).

Outflows are important too because of the relatively large number of Kenyans who study abroad and rely on family support during their studies. The main outbound countries, according to the CBK and MoneyGram and Western Union agents, are the United States, United Kingdom, India and Uganda.

Refugees rely on remittances. Kenya has borders with three countries that are or have recently been at war, namely Sudan, Somalia and Ethiopia. Refugees from these conflict areas have found shelter in Kenya and in 2004 there were nearly 240,000 refugees in Kenya (UNHCR, 2004). Some of these refugees rely on remittances for financial and food support. In the Dadaab refugee camp on the Somali border, it has been documented that Somali refugees rely heavily on remittances sent to the camps (using the hawala system) from relatives in the United States, and monthly or occasional transfers of dollars are vital for daily survival as well as dealing with contingencies (Horst, 2006).

Regulation limits competition. While the banking sector faces increasing levels of competition, the same is not true for the money transfer market. The Central Bank of Kenya Act limits the cross-border remittance of funds to those holding a banking licence or special CBK-issued licence. Thus, only commercial banks, Postbank and POSTA can engage legally in cross-border money transfers. To obtain a banking licence, a capital outlay of Ksh 250m ($3.5m) is required. This is beyond the capacity of small and medium informal MTOs, and even the larger, global MTOs like Western Union and MoneyGram operate in Kenya only off the back of the licence held by a commercial bank or POSTA. Information is not available on what it would cost a small or medium MTO to enter into a partnership with a bank, but it is doubtful that commercial banks would see smaller, less formal MTOs like one-man hawalas as profitable MTO partnership opportunities. In other words, the extant money transfer rules oblige small and medium informal MTOs to either obtain a banking licence or to partner with a bank, in order to enter the formal market - competition in the formal sector is this limited.

New innovative remittance products being introduced to market. During 2007, the Vodafone/Safaricom mobile money transfer service, M-PESA, was piloted for remittance transfers between the United Kingdom and Keny. The product allows the sender to transfer money either via mobile phone or a secure internet site. The fund can be received in either a bank account or via the recipient's mobile phone in the form of a voucher and a special PIN allowing the recipient to exchange the voucher for cash at a participating airtime vendor or other agent (Vodafone & Citigroup, 2007). The product was developed with funding received from the UK government Department for International Development's (DFID) Financial Deepening Challenge Fund (Vodafone & Citigroup, 2007). According to recent media reports, the M-Pesa will charge almost half of what other players in the Kenyan remittance market charge (see below) (Aron, 2007).

Lack of competition, until recently, means the formal transfer market is relatively expensive (or limited to certain destinations). Sending a transfer from a commercial bank via the SWIFT system will cost from Ksh1,500 ($21) up to Ksh2,500 ($34) flat fee. In addition, this service is limited to account-to-account transfers. Western Union and MoneyGram, primarily servicing urban centres, take as much as 12%-17% commission (of the total value of the transfer) on small transfers. This is significantly more expensive than the cost of informal mechanisms, which mostly charge less than 5% (see below). POSTA offers a relatively good-value money order service of 5% commission, but this service is only available to remit money to and from the East African Community (Uganda and Tanzania) and from South Africa. The delivery is relatively slow (three days).

Cost of formal remittances fosters informal market. Low-income remitters are discouraged by the cost of formal sector services and tend to rely on informal services. The size of the informal market is not documented but the CBK estimates that informal flows are "at least as large" as formal ones.[108] Informal money remittances move both into and out of Kenya but there is little information on the size of these flows and the ratio between inflows and outflows.

There are at least three ways to move money informally. They are:

- *Cash carrying.* A remitter can carry funds across the border personally or arrange for the driver or bus conductor to do so. This costs 3%-10% (of the total value of the transfer) depending on the transfer amount, or, if carrying funds personally, the price of a fare. The transfer is obviously limited to the destination and route of the bus.

- *Transport companies.* The second way is to send money with a bus or courier company. Bus companies like Akamba and Scandinavian and courier companies like Securicor are well established businesses and a trusted means for domestic remittances. They operate outside of the law. Although it is not stated policy to move money across the border – as it would be contrary to the money transfer rules – sending money in parcels to Uganda or Tanzania can be arranged surreptiously and by several accounts is a reliable and popular means of moving cash to these neighbouring. Commission is 5% or less and delivery occurs overnight. Obviously, transfers cannot be made to destinations further afield using this method.

[108] Interview with Central Bank of Kenya staff on 31 August 2006

- *Hawala.* Hawala is run as part of an informal network of traders in nearby countries and are based on ethnic links where trust and peer enforcement are strong. The most common hawala links are with Somalia, Sudan and Dubai. Hawala is a cheap (3% to 4% commission[109]) and instantaneous method of moving money. Hawala is widely used by the poor, especially in rural areas where Western Union/MoneyGram and banks do not reach or are considered too expensive. Hawala is also used in conflict areas where there are no banks – for instance, in the Kenyan refugee camps on the Somali and Sudanese border. Hawala is also used by businessmen to move money quickly and cheaply and is a lubricant of trade in East Africa and the Horn region.

Access outlook for remittance sector. Although the CBK has shown an interest in improving the remittance systems in Kenya and recognises the role to be played by remittances in development, the current laws restrict participation to licence holders and increase the cost of formal options. Low-income users are badly serviced by the formal sector, especially following the partial closure of rural bank branches, or are excluded by the cost. They are obliged to use the more risky (but well trusted) bus and courier service (which operate cross border service in contravention of the law), or to transfer money with a friend, taxi driver or to use the hawala system – all of which are open secrets in Kenya. In one respect the access outlook is improving. POSTA is reportedly set to launch an instant money transfer service (<15min) in partnership with Afripayments, which will charge about 7% to 9% commission on small transfers (therefore less than Western Union and MoneyGram).[110] This partnership will provide an opportunity for more poor people to make use of a formal channel. The access benefits will derive both from cost (this is cheaper than Western Union/MoneyGram or Swift mechanism) and proximity (POSTA outlets are wide-spread).

THE AML/CFT ENVIRONMENT

AML legislation not yet enacted. Kenya is a member of ESAAMLG[111] and has committed itself politically to enact laws and regulations that comply with international AML/CFT standards. In addition, FSPs are under pressure from international correspondents and headquarters to put best practice AML/CFT standards in place. Thus, there is significant pressure mounting on the government to bring the FATF recommendations into law.

CFT legislation not yet enacted. An anti-terrorism bill which includes clauses criminalising terrorist financing was tabled in parliament in 2003. It was withdrawn under protest from human rights' groups and parliamentarians who felt that the Bill unfairly infringed on human rights, particularly those of the Muslim community. It is unlikely to be re-introduced without significant amendments. No timeline has been given for this.

In 2001, the so-called Charterhouse Affair highlighted the need to introduce stronger AML legislation. A suspicious deposit of Ksh2bn ($28m) was made with Charterhouse Bank. It was reported to the authorities and duly frozen. The client challenged the legality of the freezing in court. Although the client would not say where the money had come from, the court ruled that the deposit should be returned as it was not against the law as it stood for a depositor to refuse to explain the source of funds. The funds were duly released and, shortly thereafter, withdrawn from the bank.

[109] Interview with Mohammed Waldo, MD, Sandi Consulting (a remittance consultant) on 20 August 2006
[110] Interview with Caroline Cherotich, Director, Afripayments and Enoch Kinara, POSTA, on 30 August 2006
[111] The Eastern and Southern African Anti-Money Laundering Group (a regional FATF-style body).

Some AML regulations passed under Banking Act but not all institutions covered. In 1994, money laundering was criminalised in anti-drug legislation.[112] Then, in 2000, the CBK issued prudential guidelines under the Banking Act setting out basic AML rules for commercial banks.[113] From this time on, banks began to implement practices and procedures to comply with their AML obligations. In January 2006, the CBK issued new and more comprehensive prudential guidelines relating to money laundering.[114] The prudential guidelines apply to all institutions licensed under the Banking Act[115] with the exception of Postbank. The guidelines require banks to:[116]

- Identify their clients when establishing a business relationship (e.g. opening an account) or undertaking a one-off transaction (e.g. walk-in remittance business). (An individual client must produce an official record capable of establishing his or her identity such as a birth certificate, passport, national identity card or driver's licence. In addition, the client must provide a current residential address verified by a utility bill or a referee (banks have some discretion as to who is an appropriate referee) as well as verify employment or source of income (banks also have some discretion here). Where the client has been banked previously, he or she must also produce a written confirmation of this from his or her prior bank).
- Report all suspicious transactions relating to money laundering to the CBK.
- Obtain and retain records for seven years regarding the source of funds and detail of transactions in order to enable the identification of unusual or suspicious transactions and reconstruct individual transactions.
- Train staff on a regular basis in the prevention and detection of money laundering.
- Establish adequate internal control measures to assist in the detection of money laundering activities.

When the guidelines were drafted wide consultation took place and most banks we interviewed report they are now largely compliant. One troublesome issue for banks has been potential liability for breach of confidentiality should they disclose client information to third parties, including the state. Banks who honour their reporting duties fear that they are exposed to civil liability for breach of a client's confidentiality. The AML bill has thus been drafted to provide banks with statutory protection for breach of client confidentiality.

Task force appointed to prepare AML bill. In 2003, government constituted a 14 member task force under the lead of the Ministry of Finance to prepare an AML bill. Members of the task force which is still in operation at the time of writing include a wide variety of government bodies, regulators, law enforcers and the Kenyan Bankers' Association.[117] The task force consulted widely and drew on much international precedent, including the Commonwealth model law, the South African Financial Intelligence Centre Act and the Australian AML laws. It also took advice from a panel of AML experts drawn from the United Kingdom, United States and South Africa. These experts seem to have been qualified in law enforcement or AML security and the issue of access ostensibly received little attention. An AML bill[118] has been drafted and was gazetted in 2006 in the Kenya Government Gazette for introduction to the

[112] Anti-Narcotics and Psychotropic Substances Act, 1994
[113] Prudential Guideline 12 CBK/RG/12 (September 2000)
[114] Prudential Guideline No. 8 (January 2006) which superceded Prudential Guideline 12 CBK/RG/12 (September 2000)
[115] That is, any person or institution accepting deposits from the public.
[116] Part 4.1 of Prudential Guideline No. 8 read with Part 4.3.1
[117] Other members of the task force are the ministries of Finance, Foreign Affairs, Immigration, Trade and Industry, the Presidency, the Central Bank, insurance officials, the Capital Markets Authority, the Kenya Revenue Authority, the police, intelligence services, the Kenyan Corruption Commission and the Attorney-General's office.
[118] The Proceeds of Crime and Money Laundering (Prevention) Bill, 2006

National Assembly.[119]. A changed version of the bill was gazetted in April 2007. According to local commentators it is unlikely to become law before the elections in late 2007/early 2008.

Functional approach extends regulation to a much broader range of institutions. Whereas the prudential guidelines apply only to institutions licensed under the Banking Act, the application of the draft AML bill attaches to a variety of *activities* and so widens the net considerably. It applies to all FSPs conducting any one of thirteen listed activities, including:

- accepting deposits and other repayable funds from the public;
- lending, including consumer and mortgage credit;
- transferring funds or value by any means including both formal and informal channels; or
- underwriting and placement of insurance.[120]

In other words, the Bill, in its current form, will apply not only to all banks and Postbank, but all SACCOs[121], all MFIs, all money remitters formal or informal, all insurers and all cell phone transfers, as well as any other institution engaging in the list of thirteen activities. The Bill also applies to certain designated non-FSPs, viz casinos, precious stone dealers, car dealers, and professionals viz lawyers, accountants and estate agents.[122] This net is cast exceptionally wide, and certain functions or institutions may be excluded in the regulations which are still being drafted. At the time of writing, however, we were informed by the task force that no exemption was planned for any particular function or institution (even where the risk of money laundering is low).

Creation of an FIU: The Bill establishes a new regulatory entity, the Financial Reporting Centre (FRC) and reporting institutions will be required to monitor and report to the FRC all suspicious transactions, as well as all cash transactions exceeding $5,000.[123]

Stricter KYC requirements introduced. The Bill requires reporting institutions to KYC a client who seeks to enter into a business relationship with it or carry out a single transaction or series of transactions in the following manner (according to the task force this includes an obligation to re-identify *existing* clients – though no deadline has yet been set for such re-identification):

- *They must obtain the client's identity* by means of a national identity card, passport, birth certificate, drivers' licence, or other official means of identification as may be set forth in the regulations and keep either a copy of the document itself or information as would allow a copy of it to be obtained.[124]
- *They must maintain records of all transactions for at least seven years*.[125] Records kept must be sufficient to identify the name, physical and postal address, and occupation of each person conducting the transaction or on whose behalf the transaction is being conducted, as well as the method used to verify the identity of the person.[126] By implication, this suggests the institution must collect records proving address and occupation. The Bill does not go any further to explain how addresses must be verified but discussions with the task force indicate that the regulations will probably provide that a client produces a utility bill in the client's name, or a reference from a government official

[119] See Kenya Government Gazette Supplement No. 77 (Bills No. 27), Nairobi, 30th October 2006
[120] Clause 2
[121] It is important to note that as traditional members of SACCOs generally join these institutions for access to credit, AML/CFT regulation could complicate the provision of credit services unnecessarily.
[122] Clause 2
[123] Clauses 42 (1) and 42 (3)
[124] Clause 43 (1) (a) read with 44 (1) (b)
[125] Clause 44 (1) (b)
[126] Clause 44 (3)

verifying address. Similarly, the regulations will probably require clients to obtain and verify the client's source of income by means of a letter from his or her employer, or, where the person is not formally employed or is self employed, by means of a letter obtained from a government official which certifies his or her occupation and source of income.[127]

Policies and procedures: In terms of the draft bill an accountable institution would be required to establish and maintain internal reporting procedures in respect of reporting suspicious transactions.[128]

Conveying monetary instruments to or from Kenya: A person intending to convey a monetary instrument, which definition includes coins and paper currency cheques and money orders, of more than $5,000 (or its equivalent in Kenyan shillings) must declare it at the port of entry or exit.[129] Failure to do so constitutes an offence.

Draft AML/CFT regulations to Microfinance Act have been released. The draft AML regulations to the Microfinance Act of 2006 were released during 2007 for public comment. These regulations, in their current form, impose exactly the same KYC requirements on potential new clients as the Bill. No exemptions or lower requirements thus apply to deposit-taking institutions serving the low-income market.

KEY FINDINGS

The general economy

There are exceptionally low levels of formalisation in Kenya. This is the case for both the banking sector where only 19% of the adult population use a bank account and also for the remittance sector where no fixed data is available, but for which there are clear signs of a well-used informal sector that is at least as large as the formal remittance sector. It has been estimated that between 70% and 94% of the working population functions in the informal sector.

The impact of AML measures on usage of financial services

Minimal impact on usage to date, because of limited scope of AML measures and exclusivity of formal financial services. The prudential guidelines apply only to banks. Therefore, SACCOs, MFIs and the Postbank have not been subject to AML rules as set out in the prudential guidelines. In commercial banks, affordability and eligibility criteria have been set so high that clients who meet these criteria tend to be able to meet the KYC requirements as well. Likewise, with respect to money remittances, the high prices in the formal sector have limited use of these services to those clients who are able to provide the necessary KYC documentation. These practices have a more severe impact on access than the AML measures.

The potential impact of AML measures on access to and usage of bank accounts

To date, the task force has not adopted a risk-sensitive approach and this is likely to have a negative impact on access and future usage. The AML bill has not yet been finalised and regulations have not yet been drafted, which makes it difficult to assess its potential impact accurately. However, in the interests of providing an analysis we assume that the Bill is passed

[127] A copy of the draft regulations were not available, but during the course of an interview on 31 August and in a follow-up telephone interview on 26 October 2006, the task force explained what they are likely to include in respect of KYC.
[128] Clause 45
[129] Definition of Monetary Instrument in Clause 2 read with Clause 12 (1) and (3) and the Third Schedule.

as it stands in which case *every* institution offering a form of financial service will have to comply with the prescribed AML controls. Certain functions or institutions may, in due course, be excluded by regulations but the task force gave no indication of such intention at the time of research. Thus, even institutions where the risk of money laundering is relatively low will have to comply with the full set of AML obligations, which will greatly stretch their resources. For example, SACCOs fall under the Bill as it stands, but SACCOs are closed membership organisations operating around a common bond. Members are usually known to each other, and in most cases a new member must be vouched for by a number of other members before being accepted. For urban SACCOs, contributions are also usually taken from a payroll. Thus the risk of laundering money through a SACCO would be limited. Similarly, an MFI that engages only in lending with no deposit-taking would fall within the scope of the Bill even though the risk of money laundering would be negligible. Furthermore, the draft regulations that have been issued under the Microfinance Act that would apply to deposit-taking MFIs licensed under this Act also do not display a risk-sensitive approach. The KYC requirements that apply to deposit-taking MFIs are exactly the same as thos contained in the Bill.

The impact of AML measures on usage is likely to increase as the market develops. However, our general assessment is that the proposed Bill will have an increasingly negative impact on access and usage. As we have seen, a new interest in the lower-income market is emerging, and in time we expect this dynamic to push down the cost of banking, making it affordable for a new class of client who will struggle more with the AML requirements than current clients. This is also pertinent for clients of Equity and K-Rep- Bank who are generally of lower-incomes.

KYC will not create an absolute barrier for low-income clients but it will create inconvenience and extra cost. The Bill contains less flexible KYC requirements with less flexibility for FSPs than the prudential guidelines. The requirement to produce an identity card will not be a great barrier because 15.6m out of 17m adult nationals in Kenya have one and those without can obtain one free of charge. More problematic will be address verification. It was indicated that verification will need to comply with strict standards and that a utility bill or a reference from a government official will probably be required). We estimate only 5% of the population could produce a utility bill.[130] As a result, low-income clients will probably have address (or "living location" where there is not address) verified by a government official. In practice this will increase the "inonvenience cost" (especially if officials end up using this bureaucratic reliance to extort payments) and is likely to discourage rather than encourage clients from accessing formal financial services. Likewise, the requirement to verify source of income will increase inconvenience and cost in the same way.

KYC will create an absolute access barrier to bank accounts and formal money transfer services for at least 800,000 undocumented foreigners. Only 0.2m out of the 1m foreigners in Kenya would have appropriate documentation to access financial services in terms of the AML rules. Those without such documents will face an absolute barrier to access (roughly 0.8m people). Though this may seem relatively small number, the impact on this group is significant because of their social and economic vulnerability. Furthermore, it must be noted that this amounts to almost a third of the current banked market.

AML compliance requirements will increase costs for FSPs, especially for non-commercial bank institutions. Though all banks will experience an increase in compliance costs with the introduction of the Bill, these will be relatively small for commercial banks. Interviews with commercial banks confirm that they are mostly already in compliance with the AML

[130] Interview with POSTA on 30 August 2006

requirements though some additional costs will be incurred in improving storage systems, acquiring additional compliance staff and improving monitoring systems. In contrast, non-bank FSPs have not yet been forced to face up to AML, including SACCOs, MFIs and, in particular, Postbank. Postbank is currently not on the same footing as commercial banks with respect to AML. If the AML bill extends duties AML to the Postbank[131] it will be in for an enormous institutional shock, as will its clients. The task of re-identifying 1m poor and rural clients, re-obtaining copies of records, and complying with reporting duties will be expensive and traumatic. Its (mostly lower-income) clients are likely to find it harder than commercial bank (mostly middle and high-income) clients to obtain the necessary KYC documentation. Accounts for which the identity of the accountholders cannot be verified will probably have to be closed. Whether Postbank will be able to afford the increased costs and still provide cheap savings products is in question. No exemption for Postbank is currently planned. If (non-FOSA) SACCOs and MFIs are included under the Bill, they will also face tremendous institutional shocks to become compliant.

Pressure will also come from commercial banks for non-bank FSPs to comply. Pressure on Postbank, SACCOs and MFIs will not only come from the Bill but also from the commercial banks who hold their accounts, for instance, 90% of SACCOs hold their accounts with Co-operative Bank, and Postbank holds an account with NBK. If non-bank FSPs cannot meet the compliance requirements of the banks, banks may choose to close down these account to safeguard their reputation and risk. Such a course of events is not certain, but in a worst case scenario up to 3.2m people could lose their link to the formal banking system.[132]

Impact of draft bill on money remittance services

Increased KYC on walk-in clients may incentivise use of informal channels. Based on the current wording of the Bill, remitters in the formal sector will have to increase KYC requirements for walk-in remittances. Currently formal providers require walk-in remitters (both sending and receiving) to present an ID card or passport, an address (not verified), and in the case of large value transfers, a reason for the transfer (e.g. an invoice for university fees). This is less than is required by the draft AML bill. Under the Bill, clients will have to undergo a comprehensive KYC process (i.e. verifying identity, address[133] and source of funds). Although meeting these requirements is not *per se* impossible, it will raise the inconvenience and cost of transactions. Given low levels of formal employment, a large proportion of adults will have to go through the cumbersome process of having their income verified by a government official. Some clients are likely to shift to the informal sector where KYC requirements are less stringent. Enforcement on the formal sector will be made more difficult as people will simply move into the informal. We also expect to see an increase in costs for all formal remittance channels as a consequence of compliance expenses in relation to the keeping of records, monitoring of transactions and the reporting of suspicious transactions. Most commercial banks and Western Union and MoneyGram have these in place already but Postbank does not. It is likely that most of these costs will be passed back to the client in due course, or will result in selection policies that are biased against less profitable clients. The KYC requirements will also make the roll-out of innovative new remittance products, such as M-PESA, extremely difficult. The low cost and

[131] There is a difference of views on this point: the Postbank has indicated that it will not be covered by the Bill; the task force is clear that it will.

[132] There are 1.4m SACCO members without a bank account, potentially 0.5m deposit-taking MFI clients without a bank account and, most significantly, 1m active Postbank accountholders who are unlikely to have an account with a commercial bank. These institutions are their link to the formal banking system.

[133] Still only 5% of the population would be able to easily verify their residential address.

convenience of informal services means that formal services have a high elasticity to the introduction of more hassle.

Functional approach proposed in bill extends to informal providers. Money remitters, whether formal or informal, fall into the scope of the Bill because they are involved in “transferring of funds or value.” Any transaction with a money remitter, even small, once-off transactions, would oblige the remitter to KYC a client as described above. The remitter would also be obliged to maintain records of all transactions, to have internal AML procedures in place and to report suspicious transactions to the FRC.

The impact of the Bill’s measures to comply with FATF Special Recommendations VI and IX will be particularly dramatic for informal money remitters The FATF recommendations stipulate that governments should licence or register all informal transfer operators and ensure that they are AML/CFT compliant to the level of banks (SRVI), and should put measures in place to detect the physical cross border transportation of currency (SRIX). The informal sector exists in part because the right to transfer money formally is reserved for licence-holders (banks, partners of banks, Postbank or POSTA). For an informal provider to become “formalised”, it would be necessary to register as a bank or partner with a bank – both difficult options for current informal players.

Although there is no intention yet in Kenya to shut down informal remitters, this pressure is sure to come due to the terrorism threat, the presence of refugees and Kenya’s importance as the economic leader in East Africa. However, *no attempt has been made to formalise the informal remittance sector* or encourage the informal remitters to register and it is not clear whether the state has the resources at this point to undertake this process or whether they consider the effort worthwhile given the risks involved. On the assumption that the measures currently in the Bill will be enforced, it should be noted that the closing down of informal remitters without giving them appropriate time to formalise will have a significant impact on remittance flows into and out of Kenya. The informal remittance market is large and well used – mainly due to the dearth of affordable options available in the formal sector. Consequently, the results are likely to be:

- The closure of all informal mechanisms, including services provided by bus and courier services and hawala, except those who can register as a bank or partner with a bank, and a forced move of those currently using cheaper informal methods (at least 50% of remittance market) to more expensive formal mechanisms. Where the user is likely to be unable to meet the more expensive fees, transfers will have to be “saved up” for less frequent, larger transactions.
- With the closure of hawala, a drying-up of financing for intra-Africa trade in the Horn and East Africa regions, and deprivation of the needs of those in refugee camps.
- The incurrence of massive state spending on enforcement, including a closure or blockage of borders daily to enable the search of buses, courier services, taxi drivers and passengers for cash exceeding the threshold.
- A significant impact on remittance flows into and out of Kenya, as the informal remittance market is as least as large and popular as the formal sector.

APPENDIX D: MEXICO

SUMMARY AND KEY FINDINGS

- Mexico is characterised by a large informal economy, with a small number of tax payers. In 2000, only 4-5m tax payers out of 15m registered tax payers (10-12% of the economically active population) were paying income tax.
- Although the country does not have an official identity document, 95% of Mexicans that are eligible to vote have the Federal Electoral Card which is widely accepted as an official form of identification.
- A financial sector crisis during the 1990s had a direct impact on the ownership structure of the banking sector. More than 75% of bank sector assets are foreign owned.
- To date, the commercial banking sector has not actively focused on serving the poor. However, this segment presents lucrative business opportunities to a number of players, signified by retailers' and other popular finance institutions applications for bank licenses.
- The Mexican government is attempting to formalise the popular finance sector. The process is being led by BANSEFI, the government-owned savings bank and a number of federations serving as apex bodies for popular banks. This sector has been identified by the Mexican government as one way to serve low-income individuals. Banks are also recognising the potential of the popular finance sector and have started to buy shares in these organisations.
- We estimate that no more than between 10% and 25% of the Mexican adult population use a bank account. Between 50% and 64% of the Mexican adult population do not have access to transaction banking services on the basis of affordability.
- No evidence could be found that AML/CFT KYC requirements pose a serious barrier to access to transaction banking services.
- Due to a large diaspora residing in the U.S., Mexico is the largest remittance-receiving country in Central and Latin America and one of the top three remittance-receiving countries in the world. During 2005, remittances to Mexico totalled US$20 billion and were expected to grow to US$24 billion during 2006.
- A variety of organisations provide formal remittance services, thus facilitating the flow of funds through formal rather than informal means. No more than 10% of the total value of remittances is transferred through informal channels.
- The predominant usage of formal remittance channels is indicative of the affordability of remittance services. The cost of formal remittance services has decreased significantly since 2001 due to both greater competitiveness in the remittance service market and government.
- AML/CFT identification requirements do not appear to prohibit access to formal remittance services.
- Mexico became a member of the FATF in 2000.
- Money laundering was criminalised in 1996 under Article 400 BIS of the Federal Penal Code. International terrorism and the financing of terrorism were criminalised in June 2007.
- AML/CFT legislation impacts indirectly on individuals' access to financial services through its impact on institutions. The Mexican government initially drafted AML/CFT legislation that was not suited to local conditions and pitched the regulations at too high a level. This created a situation where at least two sets of institutions serving the low-income market will find it difficult to comply.
- Mexico has moved from a generic approach to legislation (that applies to all institutions) to a more risk-sensitive approach. While a generic approach was followed in the initial drafting of legislation, the regulations that apply to FSPs have since been tailored to reflect the differing realities that FSPs face, e.g. varying levels of resources, varying levels of money laundering risk due to the nature of their business.

GENERAL AND MARKET CONTEXT

Mexico is a middle-income country with high levels of poverty and inequality. The country has a total population of 103m (INEGI, 2005). While about 15% of the economically active population[134] is employed in the agricultural sector and 26% in the industrial sector, almost 59% are employed in the services sector (INEGI, 2005). During 2005, an average GDP per capita (constant 2000 US$) of US$6,172 was recorded, placing it in the league of upper-middle-income countries (World Bank, 2006). However, poverty levels are not low, with 4% of the population earning below US$1 a day and 21% earning below US$2 a day (World Bank, 2006). Approximately 36.5% of income accrues to the top decile of the population, while the bottom decile earns only 1.6% of income (INEGI, 2002).

The country has a large informal sector, with a small tax base. Approximately 28% of those employed could be classified as working in the informal sector (INEGI, 2005). However, this is likely to be an under-estimate as it is possible that individuals not classified as economically active are in fact earning an income from informal activities. The size of the informal economy has a direct impact on the number of tax payers. Although there are no recent formal estimates available for the number of tax payers, informal estimates place the number of tax payers around 20% of the economically active population. In 2000, it was found that only 4-5m tax payers out of 15m registered tax payers (or 10-12% of the current economically active population) were actually paying income tax (Dalsgaard, 2000).

Most of the country's adult population has access to the main identity document. The main form of identification used is the Federal Electoral Card, administered by the Federal Electoral Institute (IFE), an autonomous public organisation. In 2006 around 71m Mexican citizens (95% of those eligible to vote) were registered on the electoral roll and also had a valid voting ID-card (IFE, 2006). The card is provided free of charge and mobile units of the IFE service even very remote rural areas. The card has a number of security features that ensure the integrity of the system once cards are produced, though the process of obtaining the card could be susceptible to identity fraud[135]. Mexican banks are, however, unable to access the database backing the IFE card, making client re-identification processes very difficult. The act that governs the functioning of the Federal Electoral Institute prohibits any groups, except political parties, from accessing the database. While banks are allowed to query whether a specific IFE number does exist, they are unable to verify client information against information contained in the database.

Mexico faces significant money laundering risks. Mexican drug trafficking organisations and criminal groups control the majority of the American wholesale drug market, including smuggling, transportation and wholesale distribution (National Drug Intelligence Centre, 2006). A recent report estimates that "between US$8.3 billion and US$24.9 billion in drug proceeds [annually] is smuggled out of the United States by Mexican and Colombian DTOs [drug-trafficking organisations] across the U.S.-Mexico border, primarily in bulk through South Texas" (National Drug Intelligence Centre, 2006).

Dollarisation is taking place in the northern part of Mexico. The area just south of the US border is characterised by so-called "dollar boys" – teenage boys on roller skates moving from car to car to exchange dollars for pesos (or vice versa) for people entering or leaving Mexico (Servicio de Administración Tributaria, 2006). While cash flowing from the U.S. to Mexico

[134] The economically active population totals 41m individuals (INEGI, 2005).
[135] At least one of the four major banks has expressed reservations about the integrity of the IFE system.

facilitates a supply of U.S. dollars, the movement of Mexican migrants and so-called “transitory migrants” (immigrants moving from Latin America through Mexico to reach the U.S.) provide a strong demand for U.S. dollars.

Access to financial services will be a strong policy objective for the new administration[136]*.* Government policy on the financial sector is set by the Ministry of Finance (SHCP). Access to financial services for low-income households will form a particular focus area and that it will enjoy attention during the term of the new administration elected in 2006.

Banking sector development and structure

The financial sector crisis of the mid-1990s has shaped the current deposit-taking sector. A sequence of political events during 1994 triggered a sharp devaluation in the Mexican peso during December 1994 and culminated in a banking crisis in 1995. The crisis had a number of consequences for the nature of the Mexican banking sector:

- It resulted in a sharp contraction in the extension of domestic banking credit, to the extent that it declined at an annual rate of 6% in real terms between 1994 and 2004 (Schulz, 2006). In June 2005, domestic financing by the commercial bank sector totalled 10% of GDP (IMF, 2005).
- Systemic stability and risk avoidance now form key objectives for both banks and the bank sector regulator.
- It had a negative impact on (especially low-income) individuals’ trust in the formal banking sector.
- It affected the ownership structure of the banking sector. Today, foreign ownership of Mexican banks exceeds 75% of banking sector assets (prominent foreign-owned banks include HSBC, BBVA Bancomer, Banamex and Santander) (CVBV, 2006). This is a direct result of the Mexican government’s attempt to facilitate recapitalisation after the crisis.

Error! Reference source not found. defines the various entities comprising the Mexican financial sector and summarises their structure and supervision:

[136] Elections took place in 2006, following which a new government administration was instituted.

Institution	Legal structure and definition	Examples	Number of institutions	Governing law and article for AML/CFT Compliance	Supervisor	AML obligations Systems requirements	Client due diligence (CDD) for Mexican natural persons	Reporting requirements
Banks	In the first instance, under the relevant law, defined as a provider of credit. Also a deposit-taking institution.	Banamex, Banco Azteca	Total of 41 commercial banks.	Credit Institutions Act, Article 115 (1997)	CNBV	Required to have systems that are able to: • Maintain and update clients' CDD files; • Detect suspicious transactions based on criteria developed by the institution; • Detect and monitor transactions across accounts; • Create an audit trail; • Aggregate transactions to assess against thresholds; • Retain historical data; and • Be secure/tamper proof.	**Information required**: names, domicile, date of birth, nationality, occupation or profession, business activity, telephone numbers, e-mail. **Documentation required**: Personal identification with address, photo and signature (Federal Voting card, passport, professional certificate, national military service card, military identity card, drivers license, Consular ID, etc.); Proof of Population Register Code or Fiscal Identification Carnet (when available); Proof of residential address (e.g. uitlity bill) different from address on identity document.	Required to report all transactions exceeding US$10,000 to the CNBV.
Cajas de ahorro	Cajas are allowed to take deposits and extend credit. Two legal forms: Sociedades Financieras Populares (Sofipos or cajas populares) and Sociedaded de Cooperatives de Ahorro y Crédito Popula (caja solidarias). While the cajas populares are for-profit entities, cajas solidarias are cooperatives, owned by its members and allowed to only provide deposit-taking and credit services to members.	FinComún (caja populares)	There are roughly 300 cajas populares and 300 cajas solidarias. By early 2008, 48 of these entities had managed to formalise.	Savings and Popular Credit Act (LACP), Article 124	CNBV	Same as above	Same as above	Same as above

Institution	Legal structure and definition	Examples	Number of institutions	Governing law and article for AML/CFT Compliance	Supervisor	AML obligations Systems requirements	Client due diligence (CDD) for Mexican natural persons	Reporting requirements
Credit Unions (Uniones de Crédito)	Credit unions accept deposits from members, based on which it then extends credit to members. It is not allowed to extend credit to non-members.	Alpura		General Law of Organizations and Credit Auxiliary Activities, Article 5	CNBV	Same as above	Same as above	Same as above
Limited objective financial institutions (Sociedades financieras de objeto limitado or SOFOLES)	Credit institutions that are allowed to only extend credit for specific purposes, e.g. automobile loans, home loans.	Finsol	In March 2006, there were 60 institutions in operation (CNBV, 2006).	Credit Institutions Act	CNBV	Same as above	Same as above	Same as above

Table 4: Description of credit and deposit-taking institions

Source: CNBV, various interviews and articles, Mexican legislation

The banking sector is heavily concentrated. Approximately 80% of banking sector assets is owned by the 5 largest banks, while the two largest banks alone own almost 45% (CNBV, 2006). However, it is important to note that the high concentration levels are not a result of the financial sector crisis – the sector was already heavily concentrated before the crisis. The high concentration levels have not gone unnoticed - the Mexican media has recently started voicing concerns over the effect of high concentration levels on banking charges and fees.

Large commercial banks are not actively targeting the low-income market. A recent CGAP report, focused on assessing the availability of savings services, concluded that "the prospect of traditional commercial banks reaching down on a large scale to serve low-income clients is not likely in the near future. There is simply too much market in-between existing bank clients and low-income segments to expect traditional banks to invest in technologies for significant downreach" (Klaehn, Helms & Deshpande, 2006: 8). This was confirmed by conversations with various commercial banks that see the payroll market (formally employed individuals) as their primary interest.

Retailers and other entrants are acknowledging the profit opportunity in the low-income market by applying for banking licenses to "fill the gap" left by large commercial banks. An innovative low-income bank, Banco Azteca, evolved out of the Elektra appliance and furniture stores and forms part of the larger Elektra group. The bank was formed in 2002 and has since managed to amass the second largest number of accounts (namely 10m) in the market, held by 4m clients[137]. The rapid uptake confirms the necessity of banking services specifically targeted at the low-income market. The American retail giant, Wal-Mart, also recently applied for a banking license and, if granted, will soon start offering basic savings accounts and credit cards. The Mexican Ministry of Finance (SHCP) has granted banking licenses to six organisations during the last eight months of 2006. At least half of these licensees plan to target the low-income market. Some of the new banks include Banco Ahorro Famsa (owned by the appliance retailer, Grupo Famsa), Banco Autofin Mexico (a unit of the car and home financier group, Grupo Autofin) and Banco Compartamos (formerly Compartamos, the largest micro-credit organisation in Mexico) (Dickerson, 2006). During June 2006, Compartamos transformed from a SOFOL to a bank (see Table 4 for a description of the various regulatory forms of deposit- and credit institutions). The organisation that had started out as a small MFI with 26,716 clients in 1996, managed to grow to a bank with 543,100 clients by August 2006 (Compartamos, 2006). While it is currently only offering small loans and credit services, it will soon also start offering deposit-taking services. AML/CFT regulation has been noted as a reason for the delay in finalisation of deposit-taking services.

Technological innovation in the low-income market is still limited: cell phones are not actively used as distribution channel. While during recent years banks have evolved to provide ATM and Internet banking services, they have not yet started introducing cell phone technology as distribution channel. However, the Mexican Bankers Association (ABM) is completing a protocol on cell phone technology and it is likely to be introduced soon. A popular finance organisation, FinSol (a SOFOL extending micro-loans to micro-entrepreneurs), is currently finalising technology that will allow it to process electronic transactions through a special device relying on cell phone technology. The device will be placed in agencies, such as small convenience stores, in remote locations. At this stage, FinSol will not use the device to open

[137] At the end of June 2006, only BBVA Bancomer held more demand deposit accounts than Banco Azteca. BBVA Bancomer had a total of 10,663,300 accounts, while Banco Azteca had 10,009,084 accounts (CNBV, 2006). Banco Azteca offers consumer credit loans, basic savings accounts and even time deposits, specifically targeted at the needs of the low-income market.

bank accounts as it still has to resolve a number of difficulties related to remote account opening processes, of which the fulfilment of AML/CFT know-your-client requirements is one.

The popular finance sector

In the remaining gaps left by commercial banks, a vibrant popular finance sector has emerged. As indicated in Table 1, a number of finance institutions, in various legal forms and regulated under at least two different acts, i.e. credit unions, SOFOLES[138], caja de populares and caja de sociedades[139], are providing valuable savings and credit services to the low-income market.

The government is trying to regularise the popular finance sector. The *Ley de Ahorro y Crédito Popular (LACP)* was enacted in June 2001 with the intention of bringing popular finance institutions, specifically Sociedades Financieras Populares (SOFIPOS or cajas populares) and Sociedaded de Cooperatives de Ahorro y Crédito Popula (cajas solidarias), under the ambit of the law by specifying minimum capital requirements, requiring access to deposit insurance and various other regulatory measures (including compliance with AML/CFT measures) (Klaehn, Helms & Deshpande, 2005).

Box 1: The formalisation of the popular finance sector
Under the LACP, popular sector finance institutions will be supervised by federations representing groups of popular sector finance institutions. There are 16 popular finance sector federations that, after receiving authorisation from the CNBV to function under the LACP, will provide a variety of services to their member organisations, including delegated supervisory functions, technical assistance, representation functions and the development of deposit insurance (Klaehn, Helms & Desphande, 2006). It is not clear what precisely the role of these federations in the supervision process will entail. During 2005, there was estimated to be approximately 300 caja populares and more than 300 caja solidarias (Klaehn, Helms & Desphande, 2006). At the time, it was also estimated that 100 of the 300 caja populares would be unable to comply with the LACP and would remain outside the reach of regulations or would simply stop taking deposits, while only 170 caja solidarias would be able to comply with the LACP. According to BANSEFI, it had approximately 400 caja clients during September 2006, of which 300 are actively trying to formalise, 13 have already formalised and a further 20 will have formalised by the end of 2006, and 52 will simply be unable to comply[140]. BANSEFI is aware of approximately 140 “dissident” or “non-cooperating” cajas that are unwilling to establish any relationship with the bank. Although BANSEFI does not explicitly form a supervisory body of the popular finance sector, it does provide support to the formalisation process. It is intended that the federations to which the cajas belong will eventually buy BANSEFI and that it will become a cooperative bank.

The formalisation process of the popular savings and credit institutions is being led by BANSEFI, the government-owned savings bank, and a number of federations serving as apex bodies for cajas. In addition to establishing regulations for the popular finance sector, the LACP also transformed the former government postal savings bank, PAHNAL, into its current form, Banco del Ahorro Nacional y Servicios Financieros (BANSEFI). BANSEFI’s main function is to provide deposit-taking services to the low-income market, investing these funds in low-risk government financial instruments. As at September 2006, BANSEFI had approximately 3.5m clients (BANSEFI, 2006). In addition to deposit-taking services, it distributes government transfer payments (into BANSEFI deposit accounts) to 1.2m beneficiaries of the Opportunidades government grant programme (BANSEFI, 2006)[141].

[138] According to the IMF (2006a: 4), SOFOLES can be defined as “nondeposit-taking specialised credit institutions”.
[139] Popular savings and credit institutions
[140] This information was accurate at the time of writing. By early 2008, 48 of these institutions had managed to formalise (Banking, Securities and Savings Unit, 2008).
[141] In addition to providing direct deposit-taking services, BANSEFI also serves as meso-level institution for the cajas that are formalising under the LACP. It provides a number of services to the cajas, including liquidity investment instruments, a formal point of access to the payment system that allows popular finance institutions to pay out remittances and government transfer payments, training services and a standardised information technology platform (Klaehn, Helms & Desphande, 2006).

The deadline for full compliance with the LACP Act has been extended to 2007. Yet it seems likely that many cajas will not be able to comply, even with BANSEFI support. Furthermore, "it is unclear if the formalisation that has begun with the LACP will lead to the integration of one financial system or to the **continued development of a dual system**" (emphasis added) (Klaehn, Helms & Desphande, 2006: 17).

The potential of the popular finance market has not gone unrecognised by banks. Banks have started to buy shares in popular finance institutions. Thus, for example, Banorte owns a SOFOL, while HSBC recently purchased a 36% share in a large MFI (Ministsry of Finance, 2006). Furthermore, the large SOFOL, Credito Familiar, belongs to Banamex. Although banks are refraining from directly targeting the low-income market, they are ensuring a future share in the low-income market by utilising a bottom-up approach to market entry.

The popular finance sector will be the vehicle of choice for serving the poor. The Ministry of Finance (SHCP) and the National Banking and Securities Commission (CNBV), have taken the stance that the best way to facilitate the growth and availability of low-income financial services is to encourage the development of a range of FSPs (the underlying assumption is that sufficient diversity will foster competition in the market and, eventually, also suitable product offerings and lower fees). The facilitation of this sector has been an explicit attempt by the Mexican government to create the regulatory space for multiple entities to operate in the market.

Yet there are some concerns about the popular finance sector's ability to serve the poor. The sector is not without its problems, including solvency issues and limited ability to comply with AML/CFT legislation. Furthermore, it also does not always serve the poor. In 2002, the median users of cooperatives or cajas populares was found to be in the 6th income decile, while only individuals from the top 25% of the income distribution was found to use NGOs or cajas populares for credit purposes (World Bank, 2005).

Reach of the commercial banking and popular finance sectors

At most, a quarter of the Mexican adult population use bank accounts. According to recent estimates, approximately 20m Mexicans have accounts in commercial banks, 2.9m have accounts in popular finance institutions and 2.65m hold accounts with BANSEFI (Klaehm, Helms & Deshpande, 2006). Conversations with BANSEFI, however, revealed that since these estimates were made, the number of BASEFI accountholders has increased to 3.5m. It is expected that there may be some overlap between accountholders in the various types of institutions and the total number of accounts thus overestimates the total number of clients. A 2002 survey of a sample of Mexico City residents found that less than 25% of the city's adult population have access to *any formal financial institution* (World Bank, 2005). A similar survey amongst the residents of three large Mexican cities found that less than 15% of urban Mexicans use a bank account (World Bank, 2005). Usage of banks and other formal financial services in rural areas is much lower. A survey during 1999 of sampled households in the rural areas of Oaxaca and Huasteca found that that less than 6% of the households used any form of formal savings instrument (World Bank, 2001*). Given maximum usage of bank accounts in Mexico City by 25% of the adult population and low usage levels in rural areas, we estimate that **no more than between 10% and 25%** of the Mexican adult population use a bank account*.

The low take-up of bank accounts is not limited to the poor or unemployed. Although the unbanked group generally has lower incomes and tend to be employed in the informal sector, the 2002 Mexico City survey reveals that 56% of individuals in managerial positions do not have bank accounts, while 75% of formally employed, salaried workers are unbanked. The unbanked group also includes a large proportion of the middle class – individuals that earn incomes high enough to fall in the 6^{th} to 8^{th} deciles of the income distribution. *If these individuals, a seemingly easy target market for banks, do not have bank accounts, it is apparent that the situation is far worse for low-income individuals*.

Low usage levels reflect an inability to ***access*** *banking services – the most important component of which is unaffordability.* A few studies have highlighted affordability as one of the key factors in explaining low access to bank accounts in Mexico. Using the affordability rule that the total costs of a transaction bank account should not exceed 4% of personal income per month[142], we find that (using two income distribution data sets) respectively 50% of the *Mexico City adult population* and 64% of the *economically active Mexican population* would be unable to access a bank account[143]. It should be noted that these statistics *probably underestimate access to transaction bank accounts* as individuals in rural areas are likely to earn far lower incomes than in Mexico City and the second income distribution data set includes only the economically active population (i.e. the unemployed are excluded).

The distribution of financial service access points could exclude individuals in rural areas. A recent study on the availability of deposit-taking services in Mexico concludes that “financial branch penetration rates remain low and branches are not located in remote rural and poor urban areas” (Klaehn, Helms & Deshpande, 2006: 10). A calculation of the number of people per financial institution branch[144] by state found that branch penetration varies from 5,222 in Mexico City to 19,604 in Chiapas, with a country average of 9,799 inhabitants per branch (Klaehn, Helms & Desphande, 2006). The same calculation using only commercial bank branches led to estimates varying from 5,595 inhabitants per branch for Mexico City to 26,315 inhabitants for Chiapas. It can thus be concluded that proximity could form an obstacle to accessing financial services, especially for individuals residing in rural areas, and that it does have a cost impact on the affordability of transaction banking services. However, we were unable to find information that allows us to quantify this impact.

Banks’ eligibility requirements also exclude a large proportion of individuals from the financial sector. Furthermore, using the minimum deposit requirements and minimum balance requirements applied by the same banks as in the cost sample, one bank’s minimum deposit requirements and minimum balance requirements excludes the $25^{\%}$ of the Mexico City adult

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142 The measure of affordability applied by Genesis, in line with that used by Finmark Trust, is to say that a household will be able to spend 2% of their monthly income on a banking product. However, as we only had personal income data available, we assume that there are two earners per household and that an individual will therefore be able to spend 4% of personal income on a transaction bank account.

143 We calculated the affordability measure using cost data for 6 basic savings accounts (with debit cards and transaction capability) of 6 different Mexican banks. We selected the five large commercial banks (Banamex, Bancomer, Banorte, Scotiabank and HSBC) and one low-income bank (Banco Azteca). A basic transaction profile, derived from South African bank research, was used to then calculate a monthly average cost for each bank account. These individual costs were then weighted according to each of the banks’ proportion of bank accounts in the sample and an average cost was calculated across all the bank accounts. This cost amounts to $106.57 or US$9.79 per month, which implies an affordability threshold of $2,664.25 or US$244.68 personal income per month. (The Mexican $ values were converted to US$ using the average exchange rate for 2006, to date.) Two sets of income distribution data were used. The first derives from the World Bank Survey on access to financial services in Mexico City during 2002 and consists of thresholds for the 25^{th}, 50^{th}, 75^{th} and 100^{th} percentiles of the Mexico City adult population (see World Bank, 2005). The second derives from a survey by INEGI (the Mexican statistical service) during 2000 and categorises the economically active population in minimum wage categories (see Klaehn, Helms & Desphande, 2005).

144 For the calculation, financial institutions included all regulated by the CNBV (at the time) and those taking active steps to comply with the LACP, e.g. BANSEFI, Caja Popular Mexicana, Caja Libertad, Compartamos and FinComún.

population, while a second bank's minimum account balance requirements exclude 50% of the Mexico City adult population[145].

We conclude that the majority of the Mexican adult population will not have access to formal transaction banking services on the basis of affordability. Though higher, access levels are expected not to be far removed from the estimate of maximum usage of 25%.

The discrepancy between access and usage can most likely be explained by certain "softer" factors. It is important to note (see Section 2.3) that access refers to an individual's theoretical ability to access financial services, while usage is a measure of the actual take-up of those services. A number of "softer", less transparent factors can influence individuals' decision to use a specific financial service. A number of low-income FSPs mentioned that the low-income market has limited trust in large FSPs, most likely the result of the series of Mexican financial crises, and would therefore not want to provide AML-related personal information. Also, the formal financial sector environment can be perceived as an unfriendly place by those individuals that do not fit the typical bank client profile. The impact on usage of the "hassle factor", generally caused by formal documentation requirements, is likely to be exacerbated by the informal nature of a large proportion of the Mexican economy and the existence of a cash culture amongst low-income individuals.

Regulation does not seem to be a major barrier in accessing transaction banking services. AML/CFT regulation currently requires presentation of an identification document[146] with an address and signature, as well as proof of residential address (e.g. utility bill) if the address on the account application form is not the same as that on the identification document. In addition, clients are required to show the Population Register Code (issued by the Secretariat of the Interior) and/or the Fiscal Identification Carnet if the client has these documents. More than 90% of the population have an IFE or Federal Voting Card (the main form of identification used). We were also unable to find evidence that suggests that individuals may find it difficult to obtain proof of residential address.

The remittance landscape[147]

There is a large Mexican diaspora residing in the USA. Annual net migration from Mexico to the United States is estimated to have reached 400,000 individuals in 2004 (IMF, 2006b) and the number of Mexican born individuals living in the United States is currently estimated at 10m (CONAPO, as quoted in IMF, 2006b). Of this group, it is estimated that 6m are undocumented workers. A significant number of the undocumented Mexican workers are able to access formal financial services by means of the approximately 4m Matricula Consular cards in circulation in the U.S (see Box 2 below for a discussion on the Matricula card). In addition to the group of Mexican-born individuals residing in the USA, there are 19m second-generation Mexicans living in the U.S. There is thus a large Mexican community living and working in the USA and remitting money back to Mexico. This is one of the reasons why Mexico is a net remittance receiving country.

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145 We use the same assumptions as in World Bank (2005) that the initial minimum deposit requirements should not exceed a third of monthly income and that up to half of monthly income can be maintained as a minimum balance.

146 Possible identification documents include the Federal Voting Card, a passport, professional certificate, national military service card, military identity card, member card of the National Institute for Elderly People, cards issued by the Mexican Social Security Institute, drivers license, Consular ID and cards issued by federal and state entities.

147 The 2005 World Bank working paper titled the "U.S.-Mexico Remittance Corridor: Lessons on shifting from informal to formal systems" provides a detailed description of the Mexican remittance market.

The large Mexican diaspora has made Mexico the largest remittance-receiving country in Central and Latin-America and one of the top three remittance-receiving countries in the world[148]. During 2005, remittances to Mexico totalled US$20 billion (2.6% of GDP) – the result of 58m remittance transactions with an average value of US$341 each (Banco de México, 2006). It is estimated that the amount will increase to US$24 billion in 2006 (Williams, 2006). Remittance flows to Mexico have displayed high growth levels during recent years. However, a large component of this growth can simply be ascribed to better monitoring and reporting by the central bank, Banco de México.

The benefits of large remittance flows are widely recognised, also by the Mexican government. While remittance inflows as a percentage of gross domestic product (GDP) are still quite low (compared to other countries such as Lesotho), it assists in poverty alleviation through the provision of a social safety net, stimulates domestic demand and forms an important source of foreign exchange (IMF, 2006b). In light of the benefits of remittance flows for the Mexican economy and social welfare, the Institute of Mexicans Abroad (part of the Mexican Ministry of Foreign Affairs, Secretaría de Relaciones de Exteriores) has undertaken a number of initiatives to facilitate larger remittance flows through formal channels (Institute for Mexicans Abroad, 2006):

- It actively lobbied for the wide acceptance of the Matricula Consular card by American banks as proof of identity in the opening of bank accounts and sending of remittances[149].
- It publishes and disseminates information on the costs of remittances through the Mexican government's consumer watch agency, PROFECO.
- It launched a financial information programme reaching Mexican communities in the U.S. through identified community leaders.
- It established *Directo a México*, a programme that interconnects the U.S. domestic payment systems infrastructure (the federal automated clearing house system or FedACH) with Mexican payment infrastructure to send remittances between the U.S. and Mexico (Banco de México, 2006). This has led to a significant reduction in the costs of transfers and the active promotion of account-to-account transfers.
- Lastly, the formal "3x1" programme was launched by the state of Zacatecas and other Mexican states to channel funds back to the hometowns of Mexican migrants residing in the USA. For every dollar sent to so-called Hometown Associations for infrastructural and other improvements in the town, a dollar each is provided by the federal, state and local government. Each dollar sent through the programme thus generates three additional dollars for social and infrastructural investment.

Box 2: The Matricula Consular

The roots of the Matricula Consular, a card-based identity document issued by Mexican consular offices to Mexicans living abroad, dates back to 1871 (Institute for Mexicans Abroad, 2006). The initial purpose of the document was to provide Mexicans residing in other countries access to consular services, but with the large growth in Mexican immigrants (legal and illegal) residing in the United States, the Matricula (as commonly known) has started to be accepted by FSPs as proof of identity.

Wells Fargo became the first bank to accept the Matricula card in November 2001 and it is currently accepted by 175 banks as proof of identity (Orozco, 2006). However, the card only became a generally acceptable form of identification in the financial sector after concerted lobbying efforts by the Mexican government and, more specifically, by the Institute for Mexicans Abroad (that forms part of the Ministry of Foreign Affairs). Banks were offered the incentive of being able to open a small bank counter in Mexican consular offices in the U.S. if they accept the card as an identity document. Also, a special database was established in Mexico to eliminate duplications and allow banks to confirm the authentic nature of cards (see discussion below) (Institute for Mexicans Abroad, 2006).

[148] During 2004, only India and China received greater absolute remittance flows. However, from a relative perspective (i.e. remittance flows expressed as percentage of GDP), Mexico is not one of the largest remittance receiving countries.
[149] It offered banks the incentive of being able to open a bank stall in Mexican Consular offices in the USA if they accept the card as proof of identity. Also, the necessary security measures were implemented to safeguard the Matricula Consular from easy fraud.

The Mexican government also mobilised support for the card amongst the Mexican immigrant community in the U.S. During 2003, members of Congress indicated that they had some concerns on the wide use of the Matricula (Porter, 2003). The U.S. Treasury Department, consequently, created a period of public comment on the acceptability of the Matricula as official form of identification. Individuals were able to log their comments on the card on the website of the U.S. Treasury Department. Initially, the majority of comments opposed the use of the card. The Institute for Mexican Abroad reacted by sending e-mails to "hundreds" of leaders in the Mexican-American community in which they asked leaders to communicate their support for the card on the Treasury Department website. By the end of the public comment period, the vast majority of comments were in favour of the Matricula card and the Treasury Department announced that they would not oppose banks' acceptance of the card as identification documents (Porter, 2003).

Undocumented migrants should be able to satisfy the following requirements to obtain the card (Institute for Mexicans Abroad, 2006):

- *Proof of nationality*. A Mexican birth certificate, passport or certificate of Mexican naturalisation has to be presented.
- *Proof of identity*. Any official identity document issued by the Mexican or foreign authority has to be presented. This can include Mexican or U.S. passports, driver licenses, State ID cards, the U.S. Green Card, INS working permission, the Mexican Federal Electoral ID card, etc.
- *Proof of residential address*. Official documentation proving establishment in the foreign country, e.g. utility bill, has to be provided.
- *Fee*. A fee of US$29 is charged to issue the card.

The integrity of the card is protected by a number of features (Institute for Mexicans Abroad, 2006):

- A number of visible and hidden security provisions to avoid easy falsification, e.g. SRE ultraviolet logos, micro lines, high security lines design, ultraviolet text in security laminate. In total, there are 7 visual security features and 5 hidden features.
- The Matricula card is backed by a comprehensive centralised database/system to eliminate duplications and confirm the authenticity of required documents. This was established after U.S. banks voiced concerns about the integrity of the card.
- The card relies on the same procedures and requirements of the Mexican High Security Passport System. The card may, in fact, be used as a passport when entering Mexico.

A number of statistics have been generated on the need and use of such of the Matricula during recent years. A survey of migrant remitters between February and April 2006 revealed that 59% of the Mexican remitters surveyed did not have a bank account because of their legal status (Orozco, 2006), while a survey of Mexicans that were interviewed while applying for Matricula cards at Consulate offices found that 32% of respondents required the card to open a bank account in the U.S. (Pew Hispanic Centre, 2005). In a survey conducted at 30 FSPs in 12 U.S. states to assess the quality of remittance products currently being offered, it was found that 83% of the organisations accept the Matricula card as an official form of identification (Orozco, 2006).

Remittance service providers

Regulation creates four categories of remittance service providers. In Mexico, there are four categories of remittance services providers that are regulated and supervised. These entities are listed and described in Table 5 below.

Institution	Description and functions	Number	Example	Supervised by	Potential money transfer service functions fulfilled	Governing act for AML/CFT compliance	AML obligations		
							Systems requirements	**Client due diligence**	**Reporting requirements**
Banks	Full financial functionality, including wire transfers and foreign exchange transactions	Total of 41 commercial banks in Mexico, but not all necessarily involved in area of remittances.	Banamex, Scotiabank	CNBV (need to be licensed). Fully supervised.	*Capturing agent *MTO/money remitter *Disbursing agent *Foreign exchange dealer *Paying agent	Credit Institutions Act, Article 115	Required to have systems that are able to: • Maintain and update clients' CDD files • Detect suspicious transactions based on criteria developed by the institution • Detect and monitor transactions across accounts • Create an audit trail; • Aggregate transactions to assess against thresholds; • Retain historical data; and • Be secure/tamper proof	Information required to accompany wire transfers: Name, address, account number Verification required for walk-in/occasional clients if transfer exceed US$5,000: Copy of identification (IFE card, passport, etc.), proof of residential address	Required to report to the **National Banking and Securities Commission** (**CNBV)** all transactions exceeding **US$10,000**
Foreign exchange houses (Casas de cambio)	Can exchange foreign currency without limits. Capital requirements (US$3m) apply. Can perform cross-border wire transfers. Must be an incorporated entity.	23	Consultoria Internacional, Order Express	CNBV (need to be licensed). Fully supervised,.	*Capturing agent *MTO/money remitter *Disbursing agent *Foreign exchange dealer *Paying entity	General Law of Organizations and Credit Auxiliary Activities	Information not available	Same as above	Required to report to the **National Banking and Securities Commission** (**CNBV)** all transactions exceeding **US$10,000**
Money transmitters (Trasmisores de dinero)	Transfer money from one country to another. Capital requirements apply. Can also perform foreign exchange transactions.	200	MoneyGram, Western Union (through affiliates Orlandi Valuta and Vigo)	SAT, but only for AML/CFT purposes (need to be registered)	*MTO *Foreign exchange dealer	General Law of Organizations and Credit Auxiliary Activities, Article 81A	Information not available	Same as above	Required to report to the **Tax Administration Service (SAT)** all transactions exceeding **US$10,000**

Institution	Description and functions	Number	Example	Supervised by	Potential money transfer service functions fulfilled	Governing act for AML/CFT compliance	AML obligations		
							Systems requirements	Client due diligence	Reporting requirements
Money exchange centres (Centros cambiarios)	May buy or sell foreign exchange up to US$10,00 in cash. Cash includes bills, traveller's cheques and money orders. Not allowed to perform cross-broder wire transfers. Not allowed to sell documents. Can act as preliminary beneficiary for money remitters. Cannot accept money to remit. No capital requirements apply. Allowed to be either individual or legal person.	Estimates for centres range from 3,000-3,500. If branches are inlcuded, money exchange centres total around 6,000-7,000. By December 2007, SAT had managed to register 2,212 of these businesses.		SAT, but only for AML/CFT purposes (do not need to be licensed, merely register itself after starting operations).	*Foreign exchange dealer *Paying agent	General Law of Organizations and Credit Auxiliary Activities, Article 81A	Information not available	Information required to accompany wire transfers: Name, address, account number. Verification required for walk-in/occasional clients if transfer exceed US$3,000: Copy of identification (IFE card, passport, etc.), proof of residential address	Required to report to the Tax Administration Service (SAT) all transactions exceeding **US$3,000**

Table 5: Description, functions and legal obligations of regulatory categories of money transfer service provider

Source: Source: Tax Administration Service (SAT), Asociacion Mexicanan de Casas de Cambio, translated AML/CFT regulations

While the last two categories in the table are regulated for AML/CFT purposes only, the regulatory ambit for the first two categories extends wider than only AML/CFT. Banks and money exchange houses are fully supervised by the National Banking and Securities Commission (CNBV), while money exchange centres and MTOs are supervised by the Tax Administration Service (SAT).

Centros cambiarios: from regulated to supervised. In 1995, the CNBV made the regulatory distinction between casas de cambios and centros cambiarios. Before then, they were simply grouped together as foreign exchange businesses. Until 2004, centros cambiarios and money transmitters were effectively unsupervised, while banks and casas de cambios were fully supervised. The decision to regulate the money transmitters and centros cambiarios for AML/CFT compliance was made during 2004 and the necessary changes incorporated into law. It was decided that the CNBV simply did not have the capacity to effectively supervise these organisations because of the large number of centros cambiarios and their vast geographical spread. There are 6,000-7,000 centros cambiarios in Mexico operating in even remote areas. These small money changer businesses, often operated as a supplementary line of business of a small retailer, pay remittances in rural areas, but are not allowed to make cross-border transfers or accept funds for remittance purposes. Due to their geographically dispersed nature, the supervision responsibility for these entities was passed on to the tax authority, Servicio de Administración Tributaria (SAT), as (at the time) it was argued that it had more staff members available and that its 66 offices spread across the country would enable it to reach money exchange centres (centros cambiarios) in even remote locations (SAT, 2006). The SAT only actively started supervising the money exchange centres and foreign exchange houses in 2005. By December 2007, SAT had managed to register 2,212 centros cambiarios (SAT, December 2007).

Convenience stores: regulated, not supervised. Convenience stores (so-called “mom and pop” stores) that are used to *pay* remittances (but cannot accept money for remittance purposes or perform cross-border transactions) forms a fifth category of money transfer providers (not reflected on the table). This group is not directly supervised and is simply registered as agents or sub-agents of the money transfer company. The money transmitter thus forms the reporting and implementing agency for AML/CFT purposes.

Institutional categories created by regulation do not necessarily reflect the entities’ functional categorisation. The functional categorisation of an entity is often defined by its place in the remittance chain. It is possible to distinguish between at least five different functional entities:

- *Capturing agent:* The capturing agent interfaces with the client in the sending country and collects the money that has to be transferred, as well as information on the sender and recipient.
- *Money transfer operator (MTO):* The money transfer operator providers the basic information platform for the transfer to take place and forms the middle entity between the capturing agent and the paying agent. The SAT defines a MTO or money transmitter as the party “that in exchange for a commission, profit or benefit receives, by cable, fax or electronic transfer, resources in national or foreign currency, to be sent to another point of the national territory or abroad, to be delivered to the designated beneficiary” (SAT, 2006).
- *Disbursing agent:* Depending on the nature of the MTO’s relationship with its agents, a disbursing remitter may or may not form part of the remittance chain. The disbursing agent

receives the information and funds to pay a specific transfer to a specific individual and passes it on to the paying agent, with which it has a direct relationship.

- *Paying agent:* The paying agent interfaces with the recipient in the receiving country.
- *Foreign exchange dealer*: The foreign exchange dealer exchanges one currency for another to enable remittance recipients to receive their money transfer in their home country currency. Depending on the nature of the selected remittance service (formal vs. informal, account-to-account transfer through a bank, etc.), the place of the foreign exchange dealer in the remittance chain will vary. Thus, in the case of informal remittances, the foreign exchange dealer can be a centros cambiarios or a "dollar boy" that simply exchanges dollars for pesos and forms the final agent in the remittance chain. In the case of a formal remittance transfer through a bank, for example, the foreign exchange dealer could be the foreign exchange desk in a specific bank (in either the sending or receiving country) and the recipient of the remittance will never actually receive dollars – a peso amount will simply be paid out directly.

The information flows associated with each functional step in the remittance process is discussed in Box 3 at the end of this section.

More than one function possible for one institutional entity. Table 5 above also reflects the functional roles that can be fulfilled by each of the four regulatory categories. It is possible that an entity with a specific institutional classification, e.g. a bank, can play the role of more than one or even all of these functional entities. Thus, for example, a bank can act as capturing agent, can own and act as its own MTO (through being responsible for the cross-border wire transfer or generation of the message), can be a disbursing agent and, in the final instance, also form the paying agent or entity. Centros cambiarios however form an exception, as they are by law only authorised to act as a paying or disbursing agent and may not perform cross-border wire transfers or accept any money, i.e. act as capturing agent.

Account-based and walk-in transfers. A further important conceptual distinction relates to the sender's relationship with the capturing agent. While the sender can have an account with the capturing agent when it is a bank and thus not have to undergo a client identification process each time he or she wishes to send a remittance, the majority of remittances are walk-in transfers were the client does not necessarily have a long-term relationship with the capturing agent and has to be identified anew each time he or she transfers money.

Remittance channel usage

Although some informal remittances take place, formal channels seem to dominate. 89% of total value of remittances received during 2005 was transferred through electronic means (e.g. using the services of a MTO), 9% using money orders and approximately 1% through direct means such as friends or family members, i.e. informally (Banco de México, 2006). It is important to note that this data is collected through surveys and is therefore likely to under-estimate informal remittances. A recent survey by the Multilateral Investment Fund of the Inter-American Development Bank found that 8% of remittance recipients are receiving their funds through informal channels (Orozco, 2005). Conversations with industry players revealed that probably no more than 10% of the total value of remittances (even unrecorded remittances) are transferred using informal channels, mostly friends or family travelling to Mexico. The relatively low usage of informal channels (compared to other countries included in this larger study) can be viewed as the result, at least in part, of deliberate attempts by both the Mexican and U.S.

governments to lower the prices of formal remittance services in order to facilitate movement to formal channels.

The high usage of formal remittance channels is indicative of the relative affordability of formal remittance services. It is difficult to set a threshold for the affordability of remittance services. Affordability as access measure can best be determined by assessing the use of alternative (informal) services. It does not seem as if affordability forms a large barrier to accessing formal remittance services. The costs of formal transfers from the U.S. to Mexico have been well documented during recent years. However, no data was found on the cost of informal transfers. Table 6 demonstrates how the cost of transferring US$200 from the U.S. to Mexico has decreased, due to greater competitiveness and government pressures for lower costs, since 2001. Given the fact that the average remittance size today is greater than US$300, the average cost will have declined below 6% of the total remittance value.

Year	Cost expressed as percentage of total remittance*
2001	8.8
2002	9.3
2003	7.5
2004 (January)	7.5
2004 (November)	6.2
2005 (December)	6

Table 6: Cost to send US$200 from the United States to Mexico

Source: Orozco, 2006a.

Eligibility requirements and regulation do not represent barriers to formal channels. Walk-in or occasional clients of money transfer service providers are required to present an identification document and proof of residential address (e.g. utility bill), depending on the threshold imposed on the FSPs. The thresholds for centros cambiarios, casas de cambio and money remitters are set at US$3,000, while that for banks is at US$5,000[150] (see table Table 5). These thresholds do not present a major access barrier as the average remittance is less than US$400 and, in fact, help to limit the potential negative impact of AML/CFT on access. No other eligibility requirements or regulation were found that present major access obstacles.

Formal remittances: capturing agents in the U.S and paying agents in Mexico differ. Interviews with various industry players revealed that the majority of formal remittances in Mexico are being paid, on behalf of the money transfer/remitter companies, *by banks and their network of subagents*. This network can include retail stores (from large retailers to even small "mom and pop" stores), casas de cambios and even the branches of other banks. The table below contains data that was collected through a formal survey of MTOs during 2005 and illustrates the relative importance of various paying agents in Mexico. Interviews with various industry players, however, suggest that the volume of remittances paid out by banks and their networks may be higher than the estimate in the table. At least one major remittance player suggested that the percentage of remittances paid out by banks in Mexico was estimated to be as high as 75% of total formal remittance inflows (Banamex, 2006). It is important to note that while these

[150] It is important to note that the US$5,000 threshold has been lowered to US$3,000 in the new draft regulations for banks.

statistics give us a clear idea of banks' role as paying agent it does not provide a clear picture of their role in the actual transfer, i.e. whether they acted as MTO. Furthermore, according to the industry body representing 125 money exchange centres and remitter companies, Asociación Nacional de Centros de Cambiarios Transmisores de Dinero, the volume of remittances paid out by centros cambiarios could be as high as 30-40% of all formal remittance flows.

Type of payer	Percentage of total formal remittances paid out
Bank	55.3%
Cooperative, credit union, popular bank	2.1%
MFI	0.0%
Bureaus of Exchange[151]	2.3%
Retail store[152]	40.2%

Table 7: Distribution of paying entities in Mexico by type of business for various surveyed MTOs
Source: Orozco, M., 2006a.

The relative volumes of remittances being sent by various types of businesses in the U.S. differ significantly from the payout patterns in Mexico. For example, bank FSPs in the U.S. do not feature prominently as capturing agents. A recent study found that only 5% of money transfers are sent through a range of U.S. banks (Orozco, 2006b). However, this is already more than the 3% from which it increased in 2004 as banks are actively promoting their account-to-account and other remittance services through advertising and special deals. The bulk of money transfers is currently being sent by small agents or money service businesses in the U.S. that have an established relationship with a MTO.

[151] It is not clear what exactly the author meant by this term. It is likely to include either casas de cambios, centros cambiarios or both.
[152] The category "retail store" is likely to include both large retail stores and smaller convenience stores (so-called "mom and pop" stores) acting as paying agents.

Box 3. The information flows associated with a typical formal remittance sent from the USA to Mexico

In discussing remittance channels, it is important to distinguish between messaging (flow of information) and settlement (transfer of funds) processes[153]. Although it is possible to distinguish between different types of information chains, we here discuss the typical information chain when sending money from the U.S. to Mexico using a MTO. The discussion is intended to highlight certain **generic** issues that could also be made applicable to the information chain when sending money, for example, from one bank to another. At least three parties in the messaging chain have some responsibility for information capturing and control:

- *Capturing agent*: The capturing agent has to identify the sender, collect sufficient information to identify the recipient and also capture information on the value and destination of the remittance. Depending on the size of the transaction, this could mean collecting the name, identity number and address of the sender (and verifying this information), while also capturing information on the name and identity number of the recipient. Information on the size of the remittance should be objectively verifiable once the capturing agent has received the funds that are being sent (i.e. the agent should be able to match the amount received against the amount that has to be transmitted).

- *Money transfer operator/money remitter*: This information will then be entered into an information terminal by the capturing agent and stored in the information platform of the MTO (MTO), where it will be available to all agents and sub-agents of the MTO in the receiving country. The MTO is the owner of the information platform.

- *Paying agent*: The second party that has an obligation to collect information is the paying agent in the receiving country. The information that has to be gathered (and also verified) mainly relates to the identity of the recipient, e.g. a suitable identification document, possibly address information and the transaction code or other proof that the recipient truly is who he/she purports to be. The sender of the funds will also (independently from the MTO) communicate the transaction code to the recipient.

AML/CFT ENVIRONMENT

The government of Mexico became a FATF member in 2000 (U.S. Department of State, 2006). In addition, Mexico is a member of the Caribbean Financial Action Task Force and a member of the South American Financial Action Task Force[154]. It also holds membership in the Egmont Group and the OAS/CICAD Experts Group to Control Money Laundering. Mexico is party to a number of conventions, including the 1988 UN Drug Convention, the UN Convention against Transnational Organised Crime, the UN Convention against Corruption, the UN International Convention for the Suppression of the Financing of Terrorism and the Inter-American Convention Against Terrorism (U.S. Department of State, 2006).

AML regulator and supervisors: The Mexican government created a Financial Intelligence Unit under the Ministry of Finance (SHCP) in 1997 (U.S. Department of State, 2006). The Unit was previously known as the Dirección General Adjunta de Investigación de Operaciones (DGAIO), but was renamed to become the Unidad de Inteligencia Financiera (UIF) in 2004 when a consolidation of separate Ministry of Finance offices that were previously responsible for the

[153] This distinction is clearly made in Bank for International Settlements (BIS) & World Bank, 2006. *General principles for international remittance services*. March. Consultative report.

[154] Membership of the latter organisation changed from observer membership to full membership in September 2006.

investigation of financial crimes took place. The functions of the UIF include receiving, analysing and disseminating financial reports from a wide range of obligated entities. These entities, in the first instance, report to their respective supervisory units. The supervisors then forward the reports to the UIF.

The Ministry of Finance is the *regulator* for AML purposes, whilst the CNBV, SAT, the Comisión Nacional de Seguros Fianzas (CNSF, the insurance sector regulator) and the Comisión Nacional del Sistema de Ahorra para el Retiro (CONSAR, the pension funds supervisor) are the *supervisors* for the various types of FSPs.

Development of regime

The first AML legislation was introduced in the late 1990s. Money laundering was criminalised in 1996 under Article 400 BIS of the Federal Penal Code. Money laundering is defined generally in the Penal Code and predicate offences are not listed. A maximum penalty of fifteen years and a fine of up to 5,000 days' minimum wages can be imposed. In the case of a money laundering offence being committed by a government official, the penalty increases by 50%.International terrorism and the financing of terrorism was criminalised through changes to the Federal Penal Code, specifically Article 139, in June 2007.

Mexico follows a scheme of institutional regulation of the financial sector, i.e. different laws exist for various types of FSPs. AML-enabling sections were therefore inserted into the relevant financial acts, with each section referring to a set of general AML regulations to be promulgated. In 1997, one set of general regulations applicable to banks, casas de cambios, insurance companies, stock brokerages, bond institutions and limited objective FSPs (SOFOLES) was introduced. When the first FATF evaluation took place during 2000, the operations of money remitters and centros cambiarios were identified as areas of concerns, since these institutions had not yet been included in the regulatory net. In fact, their activities were not regulated at all. During 2000, an enhanced version of the original set of general regulations was issued, requiring additional due diligence (the identification of PEPs and financial beneficiaries, classification of clients based on levels of risk). In the same year, Mexico became a member of FATF.

Money remitters and centros cambiarios were brought into the AML regulatory net in 2004, although their activities remain unregulated for other purposes. In the same year, separate sets of general AML regulations were also released for mutual funds, financial leasing organisations, credit institutions and factoring financing organisations and explicit CDD requirements were added to these regulations (also as a result of the FATF evaluation). In the sets of regulations issued during 2004, institutions (specifically cajas) regulated under the LACP were also brought under the regulatory ambit for the first time. The same set of regulations that applied to banks was also made applicable to cajas. New sets of general regulations have already been completed for banks (or FSPs regulated under the Credit Institutions Act) and cajas (regulated under the Popular Finance and Savings Act), although these have not yet been promulgated.

At the same time the SHCP also created a special dispensation for banks with low-value accounts. Banks are required to only open a client identification file for old (bank accounts that existed before the issuing of AML/CFT regulations) and new bank accounts if it satisfies any of the following conditions[155]:

- If during any calendar month, the account has an average balance equal to or greater than $30,000 or about US$3,000.
- If, during the course of the same month, accumulated deposits are equal to or greater than the equivalent of US$10,000 in Mexican pesos.
- If a suspicious or relevant transaction takes place on the account.

A very interesting pattern in the evolution of the AML regime in Mexico can therefore be identified: the original AML controls promulgated were of general application to all the FSPs included in the net at that time and did not contain risk-sensitive exemptions. Since then, different sets of risk-sensitive regulations have been created for different FSPs depending on the transactions which they process and the clients which they serve. This has served to significantly limit the impact that the AML regime has had on access to financial services in Mexico.

Basic compliance requirements

Regulated FSPs are required to adopt and implement a CDD policy that includes:

The identification of clients; and
The reporting of "relevant transactions", "unusual transactions" and "concerning transactions".

- *Relevant transactions* are defined as those that exceed US$10,000 and have to be reported to the UIF via the relevant supervisory body.
- FSPs are required to decide whether a transaction can be classified as *unusual* based on the background and classification of the client, the usual transaction pattern of the client and a number of other factors. Transactions classified as unusual have to be reported to the UIF via the relevant supervisory bodies.
- *Concerning transactions* are those concluded by directors, officials, employees or legal representatives that are out of the ordinary and fulfil certain requirements established by the bank and set out in the regulations. FSPs also have an obligation to report concerning transactions.

Apart from the criteria used to classify unusual transactions, an unusual transaction threshold (related to a monetary value) will soon be applicable to institutions regulated under the Credit Institutions Act. This threshold appears in the draft regulations for institutions regulated under the Credit Institutions Act (see below). The new regulation will require these institutions to be able to aggregate all transactions that exceed US$3,000 (across accounts of the same client) and if the total value of transactions exceeds US$10,000 within a thirty day period, the institutions will be required to report these transactions as unusual transactions. This regulation will require FSPs to have sophisticated electronic monitoring systems for aggregation across accounts.

The FSPs are also required to establish internal structures for AML/CFT compliance and, more specifically, to have a Communication and Control Committee to exercise control over all AML

[155] These conditions on compliance with the General Provisions are detailed in official communications UBA/094/2005 and UBA/200/2005 issued by the SHCP.

policies developed and to oversee the implementation of these policies. The Committee also has to decide which unusual or concerning transactions have to be reported to the UIF. Furthermore, FSPs are required to develop training policies and have automated systems that are able to monitor and profile transactions. The requirements of these systems are set out in Table 4 .

A further obligation on FSPs is the storing of relevant documents. FSPs are required to keep copies or reports submitted to the UIF for no less than a period of ten years, and keep the files for clients or walk-in (“occasional”) clients for no less than ten years after the ending of the relationship with the client.

Know your client duties

Identification and re-identification. Banks and other FSPs are required to identify clients as part of their general CDD duties and the files of identified clients have to be updated on a regular basis. The basic CDD requirements for banks and other FSPs are described in Table 4. It is important to note that proof of residential address is only required when the address on the client’s identity document does not correspond with the provided address. Re-identification of existing clients to comply with CDD requirement is also required.

Enhanced due diligence for politically exposed persons. In addition to simply identifying all new clients and re-identifying existing clients, FSPs are required to identify clients that are classified as “politically exposed persons” or PEPs. These clients are considered to be high-risk clients and are therefore subject to more extensive CDD requirements. The value of implementing expensive systems to enforce this control for low-income clients is questioned by a number of FSPs operating in this market.

The identification of high risk clients has to be completed by May 2007. Mexican banks are currently busy with client re-identification processes. Banks will undergo a preliminary assessment by the banking sector regulator, the CNBV, in November 2006 to determine their progress. Depending on the individual progress of banks, they will be able to negotiate for an extended deadline with the regulator. At this stage, it seems as if a significant amount of accountholders still have not identified themselves and will not be doing so in the near future. A penalty of US$800 will be levied by the CNBV for each bank account not re-identified. This penalty, if imposed on all accounts not re-identified, could amount to more than the total capital of some banks (Santander-Serfin, 2006). Given the slow response to requests to existing clients to re-identify themselves, the Mexican Bankers Association has decided to launch a media campaign to raise awareness of the issue (Santander-Serfin, 2006). This was due to start during October 2006.

The Mexican AML/CFT regulations applicable to banks allow them to do non-face to face account origination for payroll accounts. Banks are actively targeting the payroll market for new account acquisition. The current and new AML/CFT regulations that apply to banks allow them to effectively delegate the CDD process, specifically the know-your-client component, to established companies acting on behalf of their employees. The file containing the bank client’s information and copies of his/her identification may thus be kept by his/her employer and only provided to the bank upon request. If the client with a payroll-originated bank account performs a transaction that exceeds the US$10,000 threshold for relevant transactions, the bank is required to request the information contained in the employer's file and integrate it with its own client information file.

Changes in AML/CFT regulations

Mexican authorities have embarked on a process to redraft the regulations that apply to different FSPs. This is an attempt to make the regulations more sensitive to the realities and risks that different FSPs face. Whereas the first sets of regulation followed a standards-driven approach, it appears as if regulation will be becoming increasingly pragmatic. The first two draft sets of regulations that apply to institutions regulated under the Credit Institutions Act and institutions regulated under the Savings and Popular Credit Act have been completed. These sets of AML/CFT regulations will only be enacted after the completion of a regulatory impact assessment, facilitated by the Federal Regulatory Improvement Commission (Comisión Federal de Mejora Regulatoria or COFEMER)[156]. COFEMER is an independent government body tasked with facilitating regulatory impact assessments for all new legislation. These assessments follow a participatory process where all individuals and institutions that will be affected are invited to make submissions. The final assessments are completed by its staff members[157]. After completion of the review by COFEMER, the deputy minister of the relevant ministry (in the case of AML/CFT legislation, the Ministry of Finance) is required to sign off on the regulation and it will be published. According to the Ministry of Finance, feedback provided through the COFEMER process was of particular importance in shaping the AML regulations that were enacted in 2004 and 2006.

New draft regulations distinguish between different tiers of cajas. The LACP creates four categories of cajas, based on the size of their asset bases[158]. The new draft AML/CFT regulations for institutions regulated under the Popular Finance and Savings Act distinguishes between these different tiers of organisations, with so-called "Type 1" entities in one group and "Type 2, 3 and 4" entities in another group[159]. Type 1 entities are subject to less onerous requirements than the second group due to their more limited asset base. Thus, for example, Type 1 entities are required to have less sophisticated monitoring systems (they need not necessarily be electronic) than the second group. The regulations have thus become more nuanced to reflect the differing realities of institutions.

[156] At the time of writing, the regulations had not yet been enacted. However, after completion of the regulatory impact assessment, they came into power in November 2006.

[157] COFEMER has 60 staff members that consist of mainly lawyers and economists. On occasion and when necessary, it receives specialist assistance from groups that will be affected by a particular piece of legislation, e.g. the compliance officers of banks. If a particular piece of draft legislation requires specialist input, it also contract help in from outside COFEMER (COFEMER, 2006).

[158] The entities asset bases are defined in terms of investment units (UDIS) rather than monetary values to isolate drafted legislation from the impact of changes in exchange and inflation rates.

[159] At the time when this information was collected, the regulations had not yet been published and Cajas de Ahorro were thus not yet under the obligation to implement the regulations.

KEY FINDINGS

Given the high cost barrier, AML/CFT does not directly impact on individuals' access to financial services, but may impact on usage

Individual access not impacted by AML/CFT. Access to financial services can be considered an implicit, if not explicit, policy priority of the Mexican government. However, current usage levels are low – survey data reveals that it is likely that no more than 25% of Mexicans use transaction banking services. Our access assessment finds that affordability forms the largest barrier to accessing transaction banking services. Using two income distribution data sets, we find that respectively 50% of the Mexico City adult population and 64% of the Mexican economically active population would be unable to access a bank account, should they wish to do so. Furthermore, banks and other FSPs are not imposing eligibility requirements (beyond the requirements of regulation) that are keeping individuals out of the formal banking sector and remittance sectors. AML/CFT regulation has little direct impact on access as any potential impact is exceeded by the affordability impact. Less explicit factors related to AML/CFT may, however, affect *usage* and these factors are likely to explain the discrepancy between usage and access. Banks' compliance with CDD requirements can be experienced as a drive to document the (often informal) economy and could be perceived as an increase in the hassle factor attributed to banks, even more so by low-income individuals. Although this is not easily perceivable or measurable, the impact of such factors on usage of financial services should not be underestimated.

AML/CFT impacts indirectly on individual's access to financial services through its impact on institutions

Indirect access impact via AML/CFT impact on institutions. We find that although there are no direct, major AML/CFT impacts on *individuals'* ability to access financial services, AML/CFT legislation is impacting on institutions' ability to *provide* financial services. This is manifesting in Mexico in a number of ways. As will be discussed, banks have started to close the bank accounts of centros cambiarios that provide essential services in urban and rural areas, thus impacting on the proximity (and, consequently, on the affordability) of remittance services. Furthermore, it seems as if many cajas will be unable to fully comply with the full set of AML/CFT regulations that apply to them and it is possible that these institutions will eventually stop providing their deposit and credit services to low-income individuals.

The Mexican government faces major challenges in extending access to financial services to the unserved population

Although the Mexican government has identified the promotion of access to financial services as a public policy objective, facilitating access will not be easy. The popular finance sector, the government's vehicle of choice in extending financial services, is not without its problems. These include uncertainty about the solvency of a number of cajas, as well as limited ability to comply (except for a few very large cajas) to comply with the LACP and formalisation process. The implementation of AML/CFT legislation will simply form an additional burden on already stretched small FSPs. The large commercial banks, mainly foreign-owned, do not have it as an explicit goal to actively expand access to the unbanked market.

The Mexican authorities initially set high AML/CFT standards

"Blanket" AML/CFT may undermine certain tiers of the financial sector. Mexico experienced significant international pressure to draft its first AML/CFT regulation and it was therefore initially not tailored to suit local conditions. Because of the pressure to draft the first set of regulations and the high speed at which this proceeded, other government objectives were not necessarily taken into account. A situation has now arisen where it seems as if the burden of AML/CFT legislation may conflict with the Mexican government's objectives of a tiered approach to the development of the financial markets. At least two sets of institutions will find it difficult to comply with AML/CFT standards:

- *Popular finance institutions*. The LACP that regulates popular finance institutions and is intended to promote the formalisation of the popular finance sector (more specifically cajas) requires these organisations to comply with AML/CFT regulations, albeit soon in a graduated manner[160]. However, there are a number of cajas that will simply be unable to comply with the full set of regulations. It is likely that cajas that are unable to fully comply will choose to do so in a nominal sense, i.e. only selectively comply with those regulations that are not too onerous from their perspective.
- *Centros cambiarios*. It also seems as if many centros cambiarios will not be able to comply with the AML/CFT regulations. These remittance service providers form the last mile of the remittance process and provide valuable pay-out services in even remote rural villages. The association representing centros cambiarios and money transmitters estimates that a significant proportion will be unable to comply with the full set of AML/CFT regulations to which they are currently subject.

The creation of regulation ms that are simply too difficult for small financial services organisations to comply with will eventually either lead to the disappearance of the valuable financial services they provide, or simply facilitate the enlargement of the underground unregulated sector, where, if money laundering or the financing of terrorism activities do occur, it will be difficult to detect and trace transactions.

Ad hoc adjustments, without generalising adjustments to all relevant FSPs, increases compliance costs. The Mexican AML/CFT regulations have been subject to "ad hoc" adjustments where the regulator passes standard sets of laws and regulations expecting smaller institutions to advise it on how the regulations should be tailored to suit their needs. Once these changes are made, they are not generalised to the rest of the market. In practice, the *ad hoc* regulation approach has turned out to be problematic as smaller institutions do not always have the necessary skills and resources to lobby for changes. When over-regulation (in the first instance) occurs, institutions either tend to establish systems and procedures to comply with the overly strict regulations (thus incurring unnecessary systems costs) or incur lobbying costs in order to change the regulations.

Conservative compliance with AML/CFT regulation by banks leads to severance of ties with smaller, less regulated institutions. In a situation of limited resources, governments often choose to actively regulate the cluster of financial service providers that are smallest in number and have the largest asset base, thus posing the highest level of risk for the financial system, i.e. banks. In addition to the regulated layer of financial service providers, there are often other

[160] The soon to be promulgated AML/CFT regulations of the LACP distinguish between 4 different categories of cajas according to deposit base and certain other indicators. The extent and severity of AML/CFT regulations vary for each of these 4 levels.

layers of financial service providers that are greater in number and smaller in asset base and therefore more costly to effectively regulate and supervise. The supervision of these lower levels of financial service providers then often become the responsibility of the supervised financial services layers. Under these circumstances, the thoroughly supervised institutions will tend to take the most conservative approach in ensuring compliance with government regulation. This can lead to the exclusion of the less supervised FSPs.

Centros cambiarios are perceived to pose high levels of risk from a money laundering perspective. These organisations have only recently been included under the ambit of AML/CFT regulation and are not regulated for any other business purposes or functions. A number of large commercial banks have started closing the bank accounts of registered and unregistered centros cambiarios or have established a policy of simply not opening any new accounts for these organisations, in order to minimise the risk of money laundering through the banking system.

This can be viewed as the result of, firstly, discretion provided to banks by the regulator to ensure that their clients are complying with AML/CFT legislation. In Mexico, banks carry the final responsibility for the CDD applied by centros cambiarios to their clients and this legal liability contributes to the implementation of an overly conservative approach. Mexican authorities have expressed concerns that centros cambiarios may hold risk of money laundering. As discussed, the supervision responsibility of these institutions was passed to the SAT due to its greater geographic spread and staff capacity than the CNBV. Centros cambiarios do not have to apply for a license before they start operating, but only have to register themselves once the have started operating. It is at this stage that the SAT has to take responsibility for the supervision of centros cambiarios. The effective supervision of the centros cambiarios is difficult. The biggest problem is obtaining a warrant to investigate those centros that seem not to be complying. The warrants have to be specified in such detail that it is time consuming and leaves much room for the centros use legal technicalities to escape or stall supervisory inspections. SAT is in the process of adressing this issue.

The costs of AML/CFT legislation may delay entry into deposit-taking services. Once financial service providers are established in the area of credit services, there appears to be a certain hesitance to move into the area of deposit-taking services. In adding deposit-taking services to a financial service provider’s already existing suite of credit services, a significant delay is often experienced as it requires time and effort (and thus entails high costs) to change monitoring systems and internal policy to comply with the more strenuous AML/CFT requirements for deposit-taking services (than for credit services).

Maintenance of multiple legal forms. One large SOFOL mentioned that it has obtained licenses to potentially operate as two other institutional forms, but that it is hesitant to give up its current SOFOL license. This approach is the result of the potentially higher AML/CFT compliance burdens for the other two legal forms and uncertainty on the direction that AML/CFT legislation will move into for the other two legal forms. The different regulatory requirements applied to different legal forms could thus be leading to regulatory arbitrage.

Mexico has moved from a generic approach to legislation (that applies to all institutions) to a more risk-sensitive approach

While a generic approach was followed in the initial drafting of regulation, the regulations that apply to FSPs have since been tailored to become more risk-sensitive and nuanced to reflect the differing realities that FSPs face, e.g. varying levels of resources, varying levels of money laundering risk due to the nature of their business. This gradual evolution is especially prominent in the regulations for banks and cajas that came into force in November 2006.. Before these general provisions were enacted, the same AML/CFT regulations applied to commercial banks and loan and savings entities (cajas). With the new regulations, a more adequate and less burdensome system has been created for the popular savings sector. Requirements regarding client identification and automatic alert systems were customized to the activities of different FSPs[161].

The regulations for cajas distinguish between two groups of cajas – a first group so-called "Type 1 entities" and a second group consisting of "Type 2, 3 and 4" entities. These entities differ in terms of their asset and deposit base: the Type 1 entities are much smaller (in terms of assets and deposit base) than the second group. Risk-sensitivity has also been a key driver of the use of thresholds beyond which more strict compliance is required.

However, it is important to note that the more risk-sensitive approach has been characterised by an institutional definition of risk. An institutional rather than functional approach was followed in the drafting of the regulations. This can create an unlevel playing field when different institutions start to play in the same markets with the same risks levels, but are subject to different levels of regulations.

The use of thresholds in the crafting of regulations has allowed the authorities to limit the negative impact on access.

When assessing the affordability of financial services, affordability for the service provider also has to be considered, i.e. a supply-side perspective has to be included. Financial service providers realise that in order to offer an appropriate service (e.g. a basic bank account) to a specific market (e.g. the low-income market) it is necessary to do so at a cost that is affordable to the market. Under certain circumstances, the only way to provide appropriate services to the low-income market is to create certain thresholds (commensurate with risk levels) that allow for regulatory costs to be decreased in critical areas.

A number of thresholds have been used in the Mexican AML regulations:

- *KYC threshold*. A critical threshold is for the implementation of full know-your-client requirements for cross-border wire transfers by occasional or walk-in clients. The sender of the funds is only required to provide proof of identification and residential address if, depending on the entity, the amount exceeds US$3,000[162]. Above this amount, the financial institution will be required to open a physical file, with copies of the verified identity document and proof of residential address, for the sender.

[161] General Provisions on Article 124 of the LACP, Official Gazette, published on November 28th, 2006

[162] It is important to note that this threshold has been decreased from US$5,000 to US$3,000 for banks in the new regulations that apply to institutions regulated under the Credit Institutions Act.

- *Relevant transaction reporting threshold*. A second threshold is the US$10,000 threshold for the reporting of relevant transactions – FSPs do not have to report transactions below this threshold (unless they have reason to be suspicious of the nature of transaction or client).
- *Physical file opening threshold*. If these thresholds did not apply, at least one low-income bank would have had to increase its minimum balance requirements on its savings accounts significantly and a large proportion of its current clients would not have been able to open an account. About 95% of their clients have an account balance below US$10,000.

Foreign ownership of the Mexican banking sector can negate the positive impacts of the risk-sensitive and threshold approaches to regulation.

The AML/CFT regime in Mexico is characterised by appropriate exemptions and flexibility to facilitate access to financial services. The positive impact of such a regime, however, is likely to be negated by AML/CFT policy set by the headquarters of the foreign-owned banks in Mexico.

The flexible regulation of remittance service providers has facilitated the evolution of multiple players in a vibrant remittance market

The continued evolution of the remittance market is likely to depend on the continued development of non-bank remittance channels. Until 2004, the Mexican government applied a very light touch to the regulation of the remittance market. A number of players in the remittance industry were allowed to operate without any licensing requirements or regulation. This has helped to facilitate the use of formal channels in sending remittances from the U.S. to Mexico. Areas of central importance for access to remittance services (on the receiving side) are the paying agents (often retailers with whom remittance receivers tend to feel comfortable) that have been allowed to operate in an unregulated and unsupervised manner. These institutions are now being faced with the challenge of compliance, with system burdens, and with the risk of being cut off from the formal financial sector by banks.

However, it is important to note that the development of a large number of unregulated remittance providers also has a negative side to it. The perception seems to exist of an unlevel playing field for casas de cambios relative to centros cambiarios. While casas de cambios are strictly regulated and supervised, with large minimum capital requirements applying, centros are essentially unregulated and unsupervised. Their image tarnishes the image of casas de cambios, thus affecting the ability of casas de cambios to transact internationally. The challenge, in this regard, will be to regulate and supervise centros cambiarios in such a manner as to limit the risk of illegal activities and money laundering, but to also allow their continued development.

APPENDIX E: PAKISTAN

SUMMARY AND KEY FINDINGS

- Pakistan is a low-income country with a large informal economy. It possesses a comprehensive, high integrity national identity system and roll-out of national identity cards to the adult population is progressing steadily.
- Extending access to financial services is a key objective of the State Bank of Pakistan (SBP). Initiatives include the launch of a national savings scheme offered by government, and a basic bank account that all banks are compelled to offer. Take-up has however been limited and commercial banks' incentives to extend services to the poor remain limited.
- We estimate that 65% of Pakistani adults have access to a national savings scheme account, whereas only 5% actually have/use such a product. We estimate at most 10% of Pakistani adults to have access to a basic bank account (BBA), based on the relatively high required opening balance. An estimated 15% of the adult population has access to a non-BBA. Usage is estimated at between 8% and 11% of the adult population.
- Pakistan is a remittance-receiving country. The SBP has made a considerable effort to increase the flow of remittances through formal channels. Nevertheless, it is estimated that at least 50% of the value of remittances still flow through informal channels. This phenomenon appears to be the result of deliberate choice, rather than clear access barriers.
- An AML law has been in the making for a number of years and a bill is currently being considered by parliament. Until the Bill is passed, the AML legal framework consists largely of prudential regulations issued under the Banking Ordinance. Financing of terrorism is a predicate offence for money laundering in terms of the Anti-terrorism Act.
- KYC requirements include verification of identity, monitoring of accounts and transactions, and re-identification of existing clients.
- In the absence of a comprehensive AML/CFT law, AML/CFT implementation has been weak and the impact thereof muted.
- Should the potential impact of AML/CFT (under a scenario of full implementation) be considered, we find that the presence of a strong national ID system should limit the impact of KYC measures on access. Resistance to bank account usage (due to tax evasion and other considerations) may however be strengthened by AML/CFT legislation.
- It will be virtually impossible to formalise or close down the informal remittance market.
- An unequal AML regulatory burden will affect competition and access. Institutions competing in the same market (most notably the providers of the national savings scheme vis-à-vis the commercial banks) are not subject to the same regulations.

GENERAL AND MARKET CONTEXT

Pakistan at a glance

Pakistan is a low-income country where 74% of the population live on less than $2 (PPP) a day (Rs1061/month[163]) and 17% of the population live on less than $1 (PPP) a day

[163] The $/day figure takes account of Purchasing Power Parity, therefore a person earning Rs1061 per month would be able to buy goods and services equivalent to $2/day ($60.8/month), even though it only amounts to $17.6 per month (i.e. Rs1061/60.13) should no PPP adjustment be made. Rupees are converted to dollar values by using the Rs./$ exchange rate of 60.13. This is the average exchange rate for 2006 up until 2 November 2006 (taken from http://www.oanda.com/convert/fxhistory).

(Rs530/month[164]) (World Bank, 2006[165]). There are 80m (Pakistan Economic Survey, 2007) adult Pakistanis out of a total population of 156m and 66% of the population reside in rural areas (World Bank, 2006[166]).

Large informal, undocumented and cash 'comfortable' economy. It is estimated that 50% of GDP is derived from the informal market[167] and that 65% of non-agriculture workers are employed in the informal sector (Government of Pakistan, 2006). Until recently, most transactions could be conducted in cash (i.e. even property and share purchases). Although government has implemented steps to move away from cash (e.g. limits on cash purchases for property and share transactions and instituting a withholding tax on cash withdrawals), cash is still widely used. The ratio of cash (M0 to M2) has steadily been decreasing, but still remains high relative to other developing countries (see Figure 4 and Table 8).

Total revenue from tax is low in Pakistan. The average ratio of tax revenue (direct and indirect) to GDP of 9.5% (Khan, 2006) in Pakistan is low in comparison to a comparable sample of developing countries (18%) and very low in comparison to members of the OECD (38%) (Tanzi and Zee, 2001). On the one hand, this is as a result of the high numbers of people involved in the informal economy and, on the other hand, the high levels of tax evasion in Pakistan. There are only 1.5m income tax payers[168] out of an adult population of 80m (Pakistan Economic Survey, 2007). The high incidence of tax evasion is conditioned by a number of factors, including deficiencies in the delivery of public services.

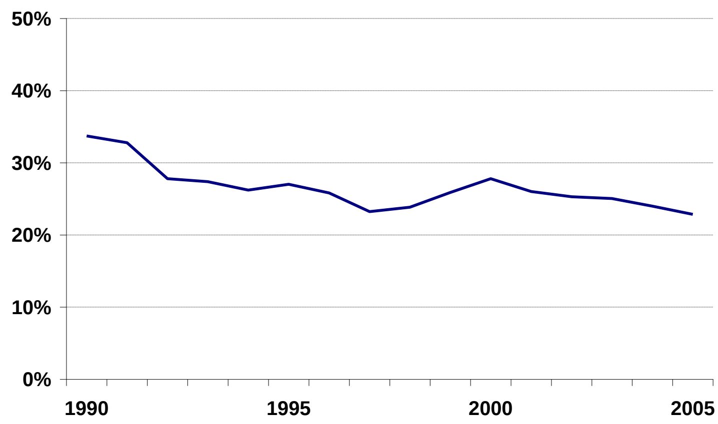

Figure 4: Cash in circulation as percentage of M2 (Pakistan)
Source: State Bank of Pakistan, 2006

Country	Cash to M2 ratio (M0/M2)
Ukraine	33.7%
Russia	29.0%
Argentina	24.6%
Pakistan	**24.0%**
Nigeria	20.3%
Columbia	18.2%
India	16.6%
Mexico	13.9%
Egypt	12.9%
Kenya	12.6%
Brazil	11.0%
Indonesia	10.6%
Nicaragua	10.2%
South Africa	7.8%
Turkey	6.4%
Malaysia	6.1%
UK	3.1%

Table 8: Country comparison – cash to M2 ratio
Source: International Financial Statistics, 2004

[164] As per the previous footnote, the $/day figure takes account of Purchasing Power Parity. Therefore a person earning Rs530 per month would be able to buy goods and services equivalent to $1/day ($30.4/month), even though it only amounts to $8.8 per month should no PPP adjustment be made.
[165] Reflecting 2002 data.
[166] Reflecting 2004 data.
[167] Information from a meeting with Ahsan Javed Chishty (BMA Capital), 23 June 2006.
[168] Information from a meeting with Shahid Ghaffer (HBL Asset Management), 22 June 2006.

Comprehensive national identity system[169]. Pakistan has a comprehensive national identity system run by the National Database and Registration Authority (NADRA). Currently, 52m adults (65% of the adult population) have been issued with Computerised National Identification Cards (CNICs) since the system became operational in October 2001. On average, there are 25,000 new cards being issued per day and NADRA expects to provide CNICs to the remaining Pakistanis over the next five years.

NADRA is a self-financing parastatal and, as a result, must maintain itself from user fees and other services sold. For example, NADRA charges a fee to verify identity and provide the details of someone captured on their database. As a result, banks and other FSPs can access the NADRA database to verify the identity of a client. This can happen in two ways:

- *Batch verification*. Banks can send a number of old national identity card numbers as a batch to NADRA for verification that new CNICs have been issued for the old numbers. NADRA can also provide the bank with an unattested copy of the CNIC. However, in order to maintain a client's account, the bank would still need an attested copy of the CNIC. This costs between Rs20 ($0.33) and Rs40 ($0.67) per ID verified.
- *An online system*. Using an online system, banks can connect to the NADRA system and verify people as they come into the branch. This method is more expensive than the batch verification.

The NADRA system has a high level of integrity and uses an acquisition process (e.g. a combination of fixed office locations and mobile units moving around the country using technology to collect information rather than a paper process) that is suitable to the profile of the population which is largely rural-based and illiterate.

Banking sector structure and development

Transactions and savings accounts can be accessed through commercial banks. In addition, savings accounts are provided through the National Savings Scheme which can be accessed through banks, the post office and the Central Directorate of National Savings (CDNS) outlets.

The following table summarises the various financial sector institutions in Pakistan as well as their regulatory scheme. This table will form the basis for the discussion of the banking sector and the overview of the AML/CFT regime to follow:

[169] Information for this section was obtained during a meeting with NADRA officials on 28 June 2006.

	Category	Functional definition	Example	# of accounts	Regulated/ supervised by	General regulation/ applicable law	Applicable AML/CFT legislation	Applicable KYC requirements
Commercial banks	First tier banks	The "big five" banks holding 54% of all banking assets	MCB, Allied, United, Habib and NBP	26.4m (of which 17m is personal)	SBP	Banking Companies Ordinance (LVII of 1962) and Banking Companies Rules (1963), made under the Ordinance (as amended 31 May 1997)	Prudential guidelines XI and XII issued by the SBP (under the Banking Ordinance - covering banks and money exchange companies). However not sufficient power for SBP to do so under the Ordinance. Has approach parliament for amendment to Ordinance.	Verification of identity (attested copy of ID card or passport, drivers license; attested copy of service card for salaried person); introduction letter for new accountholder; systems to monitor accounts and transactions; maintenance and updating of client records and transactions for 5 years; suspicious transaction reporting; client profiling; training of staff; Re-identification of existing clients
	Second Tier banks	Mid-sized, locally owned banks (19 in total)	Bank Al Falah, Union Bank, etc	Unknown	SBP	Banking Companies Ordinance (LVII of 1962) and Banking Companies Rules (1963), made under the Ordinance (as amended 31 May 1997)		
	Foreign banks	Foreign owned banks (11 in total). High end retail focus.	Standard Chartered and Citibank (largest)	Unknown	SBP	Banking Companies Ordinance (LVII of 1962) and Banking Companies Rules (1963), made under the Ordinance (as amended 31 May 1997)		
Other	Microfinance banks	3rd tier banks, emerged after 2001, fast-growing.	Kushali Bank (largest), Tameer Bank, etc	0.5m accountholders (but significant overlap of accounts with commercial banking sector)	SBP	Micro-finance Bank Ordinance (XXXII of 2000)	SBP guidelines for MF Banks	Fewer and more flexible requirements than for commercial banks. Main requirement: determine "true identity" of client, no clear instructions as to which documents/methods needed for verification.
	Post office: Post Bank	n/a	n/a	4m National Savings Scheme accounts	Ministry of Finance	Unknown	Not subject to prudential guidelines therefore currently no specific KYC requirements.	
	Central Directorate of National Savings (CDNS) branches	n/a	n/a		Ministry of Finance	Unknown		
	Money exchange companies	Category A foreign exchange companies: those allowed to remit money cross-border and trade in foreign exchange (min. capital requirement of USD1.7m) (Category B not allowed to remit cross-border).	447 money exchange companies with Category A licenses have been registered as of 2006.	Walk-in clients; small vis-à-vis banks: 70% of value of formal inward remittances flow through banks, rather than money exchange companies.	SBP	Through an amendment to the Foreign Exchange Regulation Act (1947) in June 2004, informal money changers were required to convert and register as foreign exchange companies by August 30, 2004.	Prudential regulations issued by the SBP (under the Banking Ordinance - covering banks and money exchange companies). However not sufficient power for SBP to do so under the Ordinance. Has approached parliament for amendment to Ordinance.	For transactions exceeding $10,000, establish identify of money remitters/receivers through the ID card/passport. Obtain (though not verify) address of remitter/receiver. Additional reporting requirements not excessive, applied in step by step process.
	Non-banking Finance Companies	leasing companies, Investment Banks, Discount Houses, Housing Finance Companies, Venture Capital Companies, Mutual Funds, stock exchange and insurance companies.	n/a	n/a	Securities and Exchange Commission and the Controller of Insurance	Unknown	Unknown	Unknown

Table 9. Overview of the Pakistani financial sector structure.

Source: Genesis Analytics compilation, based on information from SBP and other sources.

Privatisation is central to banking sector development[170]. In 1974 there was a large-scale nationalisation of companies and assets (including banks and insurers). In contrast, the focus of the last 15 years has been on privatising and commercialising the economy. In 1990 the banking sector was 90% government-owned. This large government share was as a result of the government-owned banks at the time, which included MCB, Allied, United, Habib Bank and NBP. Policy reforms in 1990, aimed at promoting competition amongst banks, led to an increase in the number of commercial and investment banks. In 2006, after a number of privatisations (MCB and Allied in 1991, United in 2001 and Habib Bank in 2004), the banking sector is 20% government-owned. The privatisation of both United and Habib Bank is quite recent and, therefore, the necessity to implement new systems is dominating the agenda of these banks. NBP is still government-owned, although part of the shareholding was sold in 2001. NBP has, however, always been a government-owned bank and was not part of the nationalisation process in 1974.

The period of government ownership of the large banks coincided with an explicit directive to open branches in rural areas and provide services to the broader population. This was, however, largely unsuccessful and take-up remained low. Rather than putting explicit pressure on commercial banks to serve the broader population, the policy directive changed to one of *improving competition* in order to encourage banks to look for new markets. Since the privatisation process began, there seems to have been a reduction in the number of bank branches with, for example, the number of Habib Bank branches having declined by about 25% since 1996 (Habib Bank, 2005).

Relaxation of monetary policy has led to credit expansion. During the financial sector restructuring process, interest rate and capital controls were dropped and prudential controls developed. Relaxation of monetary policy in 2001 and the improvement of the contractual environment for credit (e.g. passing of Financial Institutions (Recovery of Finance) Act) have resulted in rapid credit expansion. Overall, the advances to deposit ratio has increased from 55% (2002) to 70% (2005) (State Bank of Pakistan, 2005).

Today there are 35 commercial banks[171] in Pakistan, *but the banking sector is dominated by the big five banks* (MCB, Allied, United, Habib and NBP), holding 54% of banking assets (NBP, 2006). The following categories of commercial banks can be identified:

- *Big 5*. Of the big five banks, only NBP is still government-owned and derives a large part of its income from acting as a government agent for pension and salary payments.
- *2nd tier*. There is also a second tier of mid-sized, locally owned banks, including Bank Al Falah and Union Bank.
- *Foreign banks*. There are 11 foreign banks operating in Pakistan, the largest in terms of assets and deposits being Standard Chartered and Citibank (NBP, 2006). Where operating in the retail market, the focus of these foreign banks is on the high end of the retail market.
- *Microfinance banks*. Recently a 3rd tier of MF banks emerged (e.g. Tameer Bank). This was the result of the Microfinance Institutions (MFI) Ordinance, which was promulgated in 2001 and provides a separate regulatory framework for microfinance institutions (Government of Pakistan, 2006). These banks may not extend loans in excess of Rs100,000 ($1,607). The MF bank category is growing fast (i.e. already 0.5m new accountholders), but there still seems to be a significant overlap with the currently banked

[170] Information drawn from meeting with Mudassir H. Khan (Habib Bank), 29 June 2006

population. For example, Kushali Bank (0.25m), the largest MFI bank, only provides credit and all clients also have accounts with other commercial banks[172].

Modernisation and improvement in financial sector infrastructure. Years of government ownership has undermined the development of an efficient banking system. Clearing took place manually, which created risks and prevented the introduction of efficient transaction products. One of the results is that the Pakistan economy is dominated by the use of cheques and electronic payments are only available at high cost (e.g. Rs50 to Rs150 ($0.8 to $2.5)) per transaction vs. Rs3 ($0.05) for a cheque)[173]. Key government initiatives have been launched to address the deficiencies. These initiatives that will help improve competitiveness, compliance and transparency include:

- *Large-scale IT investment to improve management capacity and move to international best practice*. This has included bringing banks online and, thereby, improving their regulatory reporting. In addition, large-scale IT investments have been made to cope with the introduction of AML/CFT regulation and Basel II (of which the first phase commenced in June 2006).
- *Establishment of credit rating agencies*. Credit rating agencies have been established and banks are compelled to obtain credit ratings from agencies approved by the SBP[174]. The aim is to improve the risk rating process in support of the current rapid credit expansion.
- *Introduction of a new electronic payment system*. Government has drafted a Payment Systems and Electronic Funds Transfer Act (2005)[175] to encourage the move to electronic transactions.This will facilitate the introduction of more efficient transaction products and reduce the risk of manual clearing, and will increase the intermediated and, thus, documented flows.
- *Pressure on banks to extend the ATM infrastructure as a means to extend coverage of the banking sector*. Banks were ‘pressured’[176] to share the same ATM infrastructure (ABN Amro or MCB) and, as a result, ATMs have increased from 206 in 2002 to more than 1,200 in 2005 (State Bank of Pakistan, 2005).

National savings scheme[177]

The National Savings Scheme (NSS) was set up by the Pakistan Ministry of Finance (MoF) to encourage savings and to also serve as a source of funding for the government. The scheme is administered by the Central Directorate for National Savings (CDNS) under the guidance of the MoF. A number of CDNS products are offered including: savings accounts (with no transaction functionality), savings certificates and bearer instruments (prize bonds[178]). All of these compete with and offer higher returns than commercial bank accounts. These CDNS products are sold through commercial banks (compelled by government to sell), CDNS outlets and the post office:

- CDNS products are sold through 379 CDNS outlets.
- There are approximately 12,000 post office outlets (including main branches and franchised branches) in Pakistan. The Post Bank operates from 7,500 of these outlets and

[172] Information from meeting with Ghalib Nishtar (Khushali Bank), 27 June 2006.
[173] Information gathered during bank branch visits in Islamabad, 28 June 2006.
[174] SBP circular No. 15 dated June 06, 2000.
[175] Since approved as the Finance Act (2007).
[176] In a circular issued on August 2002, the SBP ‘asked’ banks to join one of these ATM switch networks or come to an agreement on their use (Maimbo, Adams, Aggarwal & Passas, 2005).
[177] Information compiled from meetings with Fazli Sattar Khan (Post Office), 28 June 2006 and Ahsan Javed Chishty (BMA Capital), 23 June 2006.
[178] Prize bonds have been introduced as an explicit means to ‘whiten money’. No interest or profit is paid on the bonds, but the names of the bond holders are put into a lottery. There is then a prize for the anonymous winner of the lottery. If people do no win, they get their money back.

sells the CDNS products. The Post Bank transfers all funds collected to the MoF and receives a 1.5% commission for the total value of deposits collected.

Access environment

Extending access to financial services is a key objective of the SBP. Although there is limited information on usage and access to financial services, extending access to financial services and to transaction/savings products, in particular, is a key objective of the SBP. Evidence of this includes:

- Although not reflected more broadly in government policy, extending access to financial services is articulated explicitly as one of the four SBP objectives. This has also been echoed more recently in speeches made by the Governor of the State Bank (State Bank of Pakistan, 2006b).
- The introduction in November 2005 of a basic bank account (BBA) by the SBP that all banks are compelled to offer. The BBA allows a limited number of free transactions and a limited number of free deposits. According to the SBP, data does not yet show significant take-up. This may be as a result of a very limited push by banks to market the product and other factors (such as a lack of disposable income) which keep the poor out of bank branches. The take-up at this stage may also be existing clients changing to a lower-cost account rather than new accountholders.
- Legislation to create a separate regulatory framework for MF banks and, thereby, create a tier of banks to serve the lower-income market (Microfinance Institutions Ordinance, 2001). This legislation forms part of the explicit government objective to create a multi-tiered banking sector, where different bank tiers serve different niches in the market.
- SBP policy initiatives aimed at catalysing further consolidation amongst banks, in order to improve stability and efficiency in the banking sector, may have indirect benefits for access. There are still around twenty banks that in total hold less than 10% of total banking assets. These banks are gradually losing ground on operational efficiency (as measured by the cost of intermediation). Capital adequacy requirements are gradually being increased (to Rs6bn ($100m) in 2009) and prudential norms are also being tightened. These initiatives are expected to catalyse further consolidation in the market. With consolidation there will likely be fewer banks, but stronger competition in the banking market, which may drive banks to seek new markets and develop suitable products which will all be positive steps for increasing access.

Limited incentive for commercial banks to extend services to the poor. The major banks are occupied with the privatisation process and other government initiatives (e.g. improving risk management processes as a result of Basel II and AML/CFT). There is also no pressure on banks from government to go beyond the BBA and their focus seems to be on consumer credit. In addition, given the limited penetration, there is still much scope for market expansion and cross-selling in the high-income market. A limited deposit base may, however, force banks to extend accounts to facilitate funding for credit. Extending accounts to a broader population will bring banks into conflict with the NSS.

Limited number of informal FSPs serving the low-income market. There are a limited number of informal financial groups that offer savings/transaction products to the low-income market. This is probably as a result of the cash-based nature of the Pakistan economy and also of a general culture whereby people store their savings in assets such as property and jewellery. Evidencersuggests that there are limited numbers of these groups and that they do not accumulate funds, i.e. immediately pay out all funds collected to one of the members. There is thus no apparent link between such groups and formal financial providers. (Please note that the situation is different for money transfer services.)

Reach of the banking sector

We estimate that 65% of Pakistani adults have access to a CDNS savings product/account. Although the CDNS products/accounts offer an attractive yield and are available for free, the requirement of having to show a CNIC[179], will prevent those currently without a CNIC (35% of adults) from obtaining a CDNS product/account. Given that there is a wide network where the CDNS products/accounts are sold and that proximity to such an outlet is unlikely to be a problem, we estimate that about 65% of adults have access to a savings product/account in Pakistan.

There is a significant difference between access to and usage of CDNS savings products/accounts. It is estimated that there are 4m CDNS account/product-holders (5% of the adult population) in Pakistan holding an estimated[180] Rs.1,000bn ($16.6bn) in deposits, compared to Rs.1,107bn ($18.4bn) personal deposits in the banking sector[181]. (It is important to note that the CDNS offers higher interest rates than commercial banks.) As a result, the estimate of 65% of Pakistanis who have access to a savings product/account, far outstrips the 5% that seem to make use of the savings products/accounts on offer. It is difficult to explain this large difference between access and usage. The reasons could be economic in that a large number of Pakistanis may not have the disposable income to save. Alternatively, the very low usage of savings products/accounts could be related to a mistrust of government (the CDNS is a government institution) or to general tax evasion. People may be wary of saving money through products administered by a government institution, given the potential risk of traceability/documentation as a result. This is explored further in the sections below.

The BBA is still not an access-friendly account. The transaction functionality offered by the BBA[182], which, within limits, is free of charge, seems to be more than sufficient for someone wanting a transaction-type account in Pakistan. However, applying the access drivers we find that the eligibility requirement of the opening balance (Rs1000 ($16.6)) is restrictive[183] for the majority of Pakistanis and excluded 90% of the population. As a result, although the BBA was developed as a low-cost alternative to the other more costly accounts available through commercial banks, the fact that the opening balance is as high as Rs1000 ($16.6), presents a significant barrier for the majority of Pakistanis.

15% of Pakistani adults have access to a non-BBA bank account. Of all the access drivers, the affordability of bank accounts in Pakistan seems to be the most restrictive:

- *Even a simple account is unaffordable to most*. In order to afford an account with limited transaction functionality[184], a person would need a monthly income of at least Rs1,204[185]($17). Given that 74% of the population lives on less than Rs1,061/month ($17.6/month), it would be safe to say that, at most, 15% of Pakistanis could afford a bank account.

[179] This is not a requirement of AML legislation, but of the general instructions that have been developed by the CDNS.
[180] From a confidential presentation made by one of the big five banks.
[181] From State Bank of Pakistan, 2006
[182] For example: no monthly service fee, unlimited ATM withdrawals, and two free deposit and cheque withdrawals per month.
[183] Monthly income to afford this opening balance (using the rule that a third of monthly income can be used for the opening balance) would be anything above and including Rs3000 ($49.9). Given that 74% of the population lives on less than Rs1061/month ($17.6/month), it would be safe to say that, at most, 10% of Pakistanis could afford this opening balance.
[184] This would be limited to deposits, withdrawals and statements.
[185] This is calculated by estimating the total monthly cost of a basic savings account at the following banks: Union Bank, Allied Bank, Bank Alfalah, United Bank, Standard Chartered, National Bank, Muslim Commercial Bank and Habib Bank. Each banks cost is then weighted by the number of branches of that bank and these figures combined to calculate an overall total monthly cost of Rs48/month.

- *Eligibility requirements are not restrictive*. The eligibility requirements with regard to opening[186] balances and minimum[187] balances do not seem to be overly restrictive.
- *Regulatory requirements pose certain restrictions to currently opening a bank account*. At this stage, the regulatory impact is dominated by the proof of ID requirement (as laid out in the Prudential Regulations – see the discussion of the AML/CFT framework below) and 65% of adults have the required CNIC. Thus, 35% of adults will not be able to produce a CNIC when opening an account currently. New CNICs are being issued quite fast and given that they are relatively easy to obtain, the roll-out of CNICs should progress much faster than the roll-out of bank accounts.

Usage of bank accounts remains low. For the purpose of this study, we estimate that there are probably about **6m-9m individual bank accountholders** (8% to 11% of the adult population) in Pakistan. These are likely to be higher-income and urban individuals, but even these groups are underserved given that about 33m adults live in urban areas.

There is very limited information on current usage (and access) levels of bank accounts in Pakistan. According to the SBP Statistical Bulletin (State Bank of Pakistan, 2006) there are 27m accountholders with commercial banks and 17m of these are personal accountholders. Through our meetings and interactions with banks and government, it was clear that there is a prevalence of dormant and multiple accounts that could range up to 3 accounts per person. This phenomenon is, in part, due to the lack of trust in banks following the 1998 foreign exchange crisis, but, more importantly, to avoid tax by splitting flows across multiple accounts (in the current system there is no way to aggregate accounts across banks – something that will change with the introduction of a credit database and AML/CFT identification requirements). Assuming:

- 2 accounts/person this would mean that there are 8.5m accountholders in Pakistan; and
- 3 accounts/person this would mean that there are 5.7m accountholders in Pakistan.

Number of "softer" factors influencing usage. 15% of adults have access to a bank account, whereas only a maximum of 11% of adults make use of a bank account. Why the difference? Personal choice seems to be a significant factor in determining usage, even where people have access. Discouragement to use bank accounts is provided by a number of factors, including:

- Mistrust of the banking system;
- Reluctance to be documented and, thereby, continuing to avoid being caught in the tax net; and
- Limited need for a transaction account:
    - Pakistan is a cash comfortable economy;
    - The payment system currently has limited functionality and accounts offer limited transactions at a high cost;
    - The cost to write a cheque is far lower than the cost of a standing/debit order; and
    - Loans/insurance do not require a debit order (even credit cards are paid by cheque).

[186] Opening balance requirements of some of the larger banks with large branch infrastructure (Allied Bank, National Bank and Habib Bank) were between Rs100 ($1.7) to Rs500 ($8.3). These would still be difficult for poorer people to afford, but are not an absolute exclusion in that once the account is opened, the opening balance can be withdrawn.

[187] Most banks in Pakistan allow flexibility regarding the minimum balance requirement. Generally, if the minimum balance falls below a certain amount then a monthly fee is charged to the account. This fee has been accounted for in the affordability analysis of bank accounts, as it is assumed that poorer clientele will generally have balances below the minimum.

In addition to the above, even if low-income people had access to bank accounts (i.e. accounts were more affordable), there are other factors to consider that may also prevent take-up of accounts at traditional commercial banks. This is evidenced by the significant take-up of newly launched MF Bank accounts in urban areas. These factors include:

- Bad treatment of lower-income individuals (MF Banks are finding that previously unbanked individuals are opening accounts with them as they do not feel welcome at commercial banks);
- Lack of marketing to low-income individuals, as they are not a priority for banks;
- Hassle factors – having to fill out forms, produce certain documents etc. (51% of the population is illiterate (World Bank, 2006[188])).

Money transfer services

Pakistan is primarily a *remittance receiving* country from a wide range of countries including Gulf States, the US, UK and other parts of Europe. The bulk of value comes from the US (estimated at about 30% of the total), UK and Europe, with the largest number of remittances deriving from the Gulf States. Although there is exists little information on the extent and nature of *remittance outflows*, it is clear that remittance inflows far outstrip outflows. The bulk of outflows are likely to come from about 2.6m Afghanistan refugees in Pakistan and 2m immigrants of mixed nationality in Karachi.

Given that Pakistan is primarily a *remittance receiving* country, the discussion in this section will focus on the market for remittance inflows.

Political turmoil and the balance of payment crisis in 1998 led to a decline in remittance inflows through formal channels. Nuclear tests by the Pakistani government in 1998 resulted in the West imposing sanctions on Pakistan and the IMF cutting off its assistance, which led to a balance of payments crisis. To stem mass withdrawals, foreign currency accounts were frozen by the Pakistani government, resulting in a loss of faith in the formal sector and further capital flight. Workers remittances fell to as low as $0.9bn per annum (from previous levels of $1.5bn) through formal remittance channels.

The SBP has made a considerable effort to increase the flow of money through formal channels[189]. Since the 1998 crisis, the SBP has made attempts to increase the flow of inward remittances through formal channels. This has mainly been driven by the Pakistani government's attempt to capture increased amounts of foreign exchange coming into the country. Efforts to increase flows through formal channels, by the SBP, include:

- *Reducing transfer costs*. A subsidy equivalent to SAR25[190] ($6.7) for every remittance transaction sent through bank channels where the transaction is converted to rupees and where there is no charge to the sender or recipient.
- *Increasing competition*. The creation of a regulatory framework to facilitate formalisation of money transfer exchange companies by registering such companies and to improve competition in the money exchange market (discussed below).
- *More attractive exchange rate*. Reducing the differential between the official exchange rate and the kerb rate.

[188] Reflecting 2004 data.
[189] Information from a meeting with the State Bank of Pakistan, Exchange Policy Department, 21 June 2006
[190] Saudi Arabia Riyal

- *Support for Pakistanis abroad*. The establishment of a loyalty programme (through the Overseas Pakistanis Foundation (OPF)) for Pakistanis working abroad to support, amongst other things, the sending of money through formal channels.
- *Improving efficiency of the formal channels*. The drafting of codes of conduct for formal channels, which, for example, include a maximum delivery time through formal channels (e.g. 48 hours instead of 2 to 3 weeks).

September 11 and, to a lesser extent, the 2005 earthquake in the North West Frontier Province (NWFP) have been the main drivers of the formalisation of remittance flows. Following September 11, total remittance inflows have increased through both informal and formal channels. Firstly, many Pakistanis who previously invested their funds in other countries, decided to repatriate funds back to their home country, preferring that investment to investments abroad. This and the earthquake in NWFP, which forced people to use formal channels in an emergency situation, have been the main drivers in increasing flows through formal channels, although the various efforts by the government to formalise the informal MTOs and to increase the attractiveness of the formal channels, have also contributed. Formal channels have shown significant increases and inflows have risen consistently to the current estimate of **$4.2bn** for 2006.

Through an amendment to the Foreign Exchange Regulation Act, 1947 in June 2004, informal money changers were required to convert and register as foreign exchange companies by August 30, 2004. These companies are then allowed to exist separately from banks. Two categories of foreign exchange companies were created: (i) category A operators who are allowed to both remit money cross-border and trade in foreign exchange (the minimum capital requirement for category A is Rs100m ($1.7m)), and (ii) category B operators who cannot remit funds cross-border, but can buy foreign exchange and sell rupees (the minimum capital requirement for category B is Rs20m ($0.3m)). The SBP has also encouraged the consolidation of smaller players into larger entities and the exit of smaller, badly run exchange companies. To date, 447 money transfer companies with category A licenses have been registered.

70% of inward remittances through formal channels flow through banks. Only banks and category A money transfer companies are registered to receive inward remittances. As a result, money transfer agencies such as Western Union or MoneyGram must partner with either banks or money transfer companies. It is estimated that 70% of formal inward remittances in value flow through banking channels. Banks are not geared for smaller amounts, which will tend to flow through MTOs.

There is a strong and thriving informal remittance sector in Pakistan. The informal remittance sector includes the Hawala/Hundi network and the carrying of cash. The Hawala/Hundi network[191] is an informal, unregistered channel through which to remit money. It has been estimated that 50% of the total *value* of inward remittances to Pakistan flow through informal channels[192].

Although there has been pressure to use formal channels to remit money into Pakistan, a far greater number of households still receive remittances through informal channels. The cost and efficiency differential between formal and informal channels has been narrowed considerably, given the SBP efforts and increased competitiveness amongst formal providers.

[191] See http://www.interpol.int/Public/FinancialCrime/MoneyLaundering/Hawala/default.asp for a good description of the Hawala system.
[192] Interview with registered money transfer companies at the SBP on 23 June 2006

Even so, about 1m households are estimated to receive remittances through formal channels, whilst 4.5m households receive remittances through informal channels[193].

There do not seem to be explicit barriers to receivers using formal channels. For money remittance products, <u>access</u> to formal channels seems to be much greater than <u>usage</u> of formal channels. *Affordability* does not appear to be an exclusionary barrier if remittances are sent/received through banking channels. There are no specific *eligibility* requirements that make formal channels restrictive for receivers. From a *regulatory* point of view, all that is required from the receiver is proof of identity, through a passport, driver's license or CNIC. The family of a migrant is more likely to have a CNIC card, given that such a card is required for the migrant to get a passport and that OPF provides support to migrant families and would assist in this regard if there was a problem. *Proximity* to a point of collection may be an issue, but when combining the likely reach of banks, the post office and money transfer companies, most areas could potentially be reached. As a result, the relatively low usage of formal remittance channels can only be explained as being the result of deliberate choice on the side of remittance senders and receivers.

"Soft" factors condition the use of informal remittance channels. As there do not seem to be barriers to using formal remittance channels, it would seem that the use of informal remittance channels is probably driven by issues like *familiarity, habit, culture, convenience and possibly relative cost*. In addition, and similar to banking, low-income individuals are likely to resist using formal channels as they mistrust these channels, are not treated favourably by formal channels and do no want to face the hassle factors of producing documents and filling out forms. (This does, however, not take into consideration the barriers to using formal remittance channels that may exist on the sending side.)

AML/CFT ENVIRONMENT

An AML law has been in the making for a number of years. In 1997, terrorist financing and some aspects of money laundering were criminalised through the Anti-Terrorism Act and reporting of suspicious transactions to the Anti-Narcotics Force (ANF) was required as a result of the Control of Narcotic Substances Act. In 1999, the National Accountability Ordinance provided for the setting up of a National Accountability Bureau (NAB). The purpose of NAB is to eradicate corruption and hold accountable all those persons accused of corruption. In this regard, NAB requires FSPs to report suspicious transactions. At this stage, NAB is operating as a Financial Intelligence Unit, given its legal and operational framework. These laws all include provisions to allow investigators to access financial records and conduct financial investigations. In 2002 a working group coordinated by the Ministry of Finance and comprising key stakeholders such as law enforcement agencies, other ministries, the SBP and SECP was formed to draft the AML law. The purpose of this law is to strengthen the existing legal framework, to establish a Financial Monitoring Unit, to include further offences deemed to be money laundering[194], to provide for the investigation and prosecution of money laundering offences, and to bring Pakistan's AML regime in line with international best practice. In 2005

[193] In order to come to this conclusion, a number of pieces of information were put together. (i) Total population in Pakistan is 156m with an average household size of 7 (Federal Bureau of Statistics, 2003). As a result, there are about 22m households in Pakistan. (ii) About **25% (5.5m)** households in Pakistan receive remittances from abroad - this is based on information provided in meetings with money exchange companies and the Overseas Pakistanis Foundation (26 June 2006). (iii) Given that $4.2bn flows in through formal channels/year and the average size of each remittance through formal channels is $665 (from meeting with United Bank, 22 June 2006), there are about 6.3m incoming remittance transactions/year through formal channels. (iv) And assuming that a household receives a remittance once every 2 months, thus six times a year, then there are about **1m households receiving through formal channels** (if a household received every month, 12 times a year, then there would only be about 0.5m households receiving through formal channels). (v) As a result, the rest of households, **4.5m, must receive their remittances through informal channels**.

[194] The provisions of the AML bill are in addition to the Control of Narcotics Substances Act, the Anti-terrorism Act and the National Accountability Ordinance

the draft AML bill was approved by Cabinet and was forwarded to the standing committee of the National Assembly in Parliament. According to discussions with a number of players in Pakistan, the approval of the draft bill now appears to be stalled in Parliament. Pakistan is an active member of the Asia/Pacific Group on Money Laundering (APG) and in 2005 the APG conducted a review of the Pakistan situation regarding AML/CFT laws, rules and procedures. As a result of this review, a number of deficiencies were noted and the importance of a comprehensive and finalised AML law was highlighted (US Department of State, 2006). At the moment, the SBP and SECP have independently established AML units. As far as financing of terrorism is concerned, it is still a predicate offence for money laundering in terms of the Anti-terrorism Act.

Until the Bill is passed the current AML legal framework consists largely of prudential regulations. The SBP has issued prudential guidelines (under the Banking Ordinance and covering banks and money exchange companies) to be consistent with the FATF recommendations. These guidelines cover the areas of KYC policies, record-keeping, due diligence of correspondent banks and reporting of suspicious transactions. Separate guidelines have been issued for MF Banks that are slightly less onerous. The SECP has issued KYC regulations under the Insurance Ordinance, which cover insurers, stock brokers and dealers, trusts, leasing companies, charities, NGOs and other non-financial institutions. Importantly, no AML requirements have been passed pertaining to the activities of institutions like the Post Bank and CDNS outlets that sell CDNS product/accounts. There are, however, general instructions developed by the CDNS under guidance from the MoF, which seeks to establish a framework to 'encourage' institutions to know their clients better before they deal with them. These instructions are not related to the AML regime. When selling a CDNS product or opening an account, what is required is an introduction and verification of identity by the CNIC.

The *AML policies* in the prudential guidelines issued under the banking ordinance require commercial banks to:

- Undertake reasonable efforts to determine the true identity of every prospective client. This would include obtaining the minimum set of documents:
  - An attested photocopy of the CNIC[195] or passport.
  - In the case that the CNIC does not contain a photograph (this occurs most regularly where strictly observant Muslim women refuse their photos to be taken), any other document (e.g. drivers license), in addition to the CNIC, that contains a photograph. If the individual does not have a suitable document with a photograph, then a copy of a duly attested photograph and a written statement "to the effect that the individual has no other document bearing (a) photograph".
  - In the case of a salaried person, an attested copy of their service card or any other evidence of service.
  - In the case of an illiterate person, a passport-size photograph of the new accountholder together with their right and left thumb impression.
- Obtain an introduction for the new accountholder. This introduction can come from a current accountholder of the same bank or different bank or from an employee of the bank.
- Put in place systems to monitor accounts and transactions.
- Maintain and update client records and transactions for a minimum period of 5 years. Interestingly, there do not seem to be any thresholds for this record keeping which could place quite an onus on banks of having to keep records of all transactions.

[195] In cases where the prospective client has not yet obtained a CNIC, banks may obtain attested copies of the old National Identity Card and a receipt from NADRA of evidence that the client has applied for a CNIC, along with an undertaking in writing that a copy of the CNIC will be submitted when it is received.

- Train staff to be able to comply with the prudential guidelines.
- Lay out profiles of clients in order to support monitoring of suspicious transactions.
- Report suspicious, complex or unusually large transactions to SBP.

In addition, banks are required to re-identify existing clients following the procedures applicable to new clients. The deadline for re-identification was 30 June 2006, but according to discussions with government officials during our country visit (just prior to the deadline) this deadline was to be extended as banks were struggling with the re-identification process. One of the largest banks, with significant rural distribution, has only been able to re-identify 30% of their clients and expects difficulties in re-identifying the remaining clients (particularly rural clients). Once again, it should be noted that the Post Bank and CDNS are not required to re-identify existing CDNS product- or accountholders.

In comparison to the guidelines for commercial banks which are extensive and quite prescriptive, the *guidelines for MF Banks are fewer and also more flexible*. In this regard, MF Banks are only required to determine the true identity of clients and, although it is suggested that MF Banks try obtain the CNIC of clients, this requirement is not rigid. It is accepted that clients of MF Banks in far-flung regions, particularly women, may not be able to produce a CNIC and then it is left to the MF Bank to establish clients' identities through other appropriate means.

Foreign exchange companies are now subject to prudential regulations and stricter monitoring. These regulations lay out certain AML requirements around establishing the identity of money remitters/receivers through obtaining the CNIC or passport. Exchange companies must also record the address of the person sending and receiving remittances, although they are not required to verify it. In addition, reporting for exchange companies is not excessive (more lenient on category B exchange companies) and is being applied in a step-by-step process. According to the SBP, online reporting for exchange companies may be introduced towards the end of the year, which will enhance the capability of the SBP to monitor and check compliance on a real-time basis. This is primarily for the monitoring of foreign exchange flows, but will also help in the supervision of AML compliance.

KEY FINDINGS

Impact of AML/CFT on usage to date

In the absence of a comprehensive AML/CFT law the impact of AML/CFT implementation on usage has been muted. At this stage, the prudential guidelines are not entirely clear as to the sanctions that can be imposed to enforce AML/CFT compliance. Commercial banks find themselves in a difficult position on two counts regarding their AML responsibilities:

- Firstly, banks have no way of forcing existing clients to produce the documents for re-identification, as the prudential regulations under the Banking Ordinance do not provide for account closures by the banks where clients fail to comply with the controls as laid down in the regulations. Where banks freeze accounts in an attempt to pressurise clients to re-identify themselves, they face the threat of legal action.
- Secondly, although banks are required to report suspicious transactions, they find it difficult to file a report without breaching client confidentiality. The AML bill will provide protection to FSPs for lawful disclosure of information, but for now it is difficult to persuade banks to report suspicious transactions.

The result is that implementation has been weak and impact on usage muted.

Potential impact of AML/CFT on access

Presence of strong national ID system should limit impact of KYC measures on access. Given the high level of integrity of the NADRA identification system, KYC for both new and existing clients will rely strongly on the CNIC. For re-identifying existing clients, it should be sufficient that their details are captured on the NADRA database. The obligation to acquire an attested copy of the CNIC should fall away. The number of adults in possession of CNICs is at least six times the size of the current banked market. In addition, the pace of roll-out of CNICs seems to be quicker than the roll-out of bank accounts. The potential market for bank accounts is likely to have CNICs before they have the opportunity to open an account. This suggests that if CNIC is sufficient for identification purposes, KYC requirements alone are unlikely to impact on access. However, the requirement of an introduction will remain a potential barrier for persons who are unbanked or from an area where few people are banked. Given the strong integrity of the NADRA system, there would seem to be space for relaxing the other verification requirements.

Potential impact of AML/CFT on usage

Usage of bank accounts likely to be impacted by AML/CFT legislation: Pakistan is a country with high levels of tax evasion. Providing all manner of documentation to banks for KYC purposes will be resisted because clients do not want their money to be traced too closely. As a result, the implementation of AML regulation will be conditioned by the wider attempt to document the economy. Although current and potential clients may in general not be resistant to the AML process, they will be resistant to the potential use of the information they have to provide, through the AML process, to the government. From a *usage* point of view, this may have the following consequences:

- A reduction in the usage of accounts by existing clients.
- Prospective clients may choose not to take-up/use accounts. They will prefer to keep their money in cash, property and institutions with lower levels of compliance. This is quite feasible, given the informal nature of the economy and the high levels of cash usage.
- Low-income clients are also going to be resistant. This is borne out by our findings regarding the significant gap between access to and usage of the CDNS products. We hypothesise that this gap is driven by, at least in part, a reluctance of people to save money through products administered by a government institution – indicating their distrust of government and their caution in having their money traced too closely.

Thus, in a largely cash-based economy like Pakistan, trying to achieve AML compliance and tax enforcement at the same time is likely to result in neither being achieved. A cash-based and informal society affords people other means to transact, which are well away from both documentation for tax and AML purposes and also more convenient.

It will be virtually impossible to formalise or close down the informal remittance market. Despite dedicated and far-reaching attempts by the government to formalise the money transfer market, a large informal market remains (estimated to be at least 50% of the total remittance market). Reasons for the continued pervasiveness include cost, convenience, familiarity and cultural preference. In addition, there are no formal banking ties between Pakistan and India – the transfer of funds linked to trade, commerce and remittances therefore has to be facilitated via the informal sector or through third countries which do have formal banking ties with India. The increased remittance flows through formal channels since 2001 has been largely triggered by non-government and non-AML reforms. In fact, remittances through both informal and formal channels into Pakistan have increased as a result of external factors such as the post-9/11 impacts. Additional attempts by government to close down informal money transfer companies will be costly and will probably force remittance flows further underground into a world where they are not monitored, where no records are kept and where tracing the proceeds of crime or the funding of terrorism will be increasingly difficult.

Unequal AML regulatory burden will affect competition and access: In comparison to the AML requirements for commercial banks, the requirements for MF Banks are fewer and more flexible. On the one hand, this is a positive for access, in that these banks will find it easier and more affordable to serve poorer clients. On the other hand, there is the risk that higher-income and higher-risk individuals could use MF banks as a means to launder money and, thus, undermine Pakistan’s AML regime. The fact that commercial banks do not have to comply with the same lower levels of controls for low-income clients will also make commercial banks less prepared to serve that market if MF banks can serve the same clients at lower regulatory costs.

Institutions competing in the same market are not subject to the same regulations. The CDNS-administered National Savings Scheme (sold mainly through the Post Bank and CDNS outlets) accounts for 4m product/account-holders, compared to the estimated 6m to 9m commercial bank accountholders. These institutions, therefore, compete directly with the banks for deposits. Yet, they are not subject to prudential regulations in the same way. For example, currently the Post Bank and CDNS outlets have no regulatory AML/CFT KYC requirements and are not required to re-identify clients. This undermines the AML regime in that it allows more risky individuals a place to deposit their money without having to be identified. In addition, this may skew the market into depositing funds with a government scheme (supporting government spending) rather than into private institutions like banks. Not having these deposits will curtail the ability of banks to on-lend funds to borrowers (e.g. small businesses), which will be to the detriment of private sector investment and enterprise.

APPENDIX F: SOUTH AFRICA

SUMMARY AND KEY FINDINGS

- The South African economy is characterised by a large informal sector and high unemployment levels. Depending on the unemployment definition used, unemployment levels could be as high as 40% of economically active population.
- South Africa has a well-developed formal financial sector, characterised by high concentration levels in the banking sector. At the end of 2005, the assets of the four largest banks constituted nearly 90% of total bank assets.
- After the 1994 democratic transition, the South African government focused on the expansion of banking services to the adult population. This led to the creation and introduction of the Mzansi account, a basic bank account, by the four major banks and Postbank.
- During 2005, 47% of the South African adult population used bank accounts. Given an affordability measure, 67% of the adult population has access to bank accounts.
- Although South African has a comprehensive national identification system, it is susceptible to fraud. Recent estimates placed the number of fraudulent identification documents as high as 25%.
- The use of formal remittance channels is low, mainly due to foreign exchange rules that limit remittance services to FSPs with bank licenses and high prices.
- Money laundering was first criminalised in the early 1990s. The current AML compliance regime was constructed in 2001, with CFT legislation enacted in 2004.
- South Africa became a member of the FATF during 2003 and held the presidency during 2005/06.
- The overall negative impact of AML/CFT legislation on access to bank accounts was to have been mitigated by Exemption 17. Exemption 17 eliminates the need to obtain and verify the residential address details in respect of low-value, low-risk accounts. However, the conditions imposed by this exemption proved too strict to be of real assistance to the poor. The exemption was amended in 2004 on the strength of research into financial exclusion and the financial reality of the poor. The amended Exemption 17 has proved crucial to the success of the Mzansi account.
- No impact of AML/CFT legislation on the affordability of low-income bank accounts has yet been perceived. The political imperatives on banks to retain these accounts will prevent any costs generated by AML/CFT legislation from being passed on to low-income accountholders.
- Regulatory identification barriers, due to foreign exchange rules, AML/CFT legislation and control requirements under the Immigration Act, exclude some South Africans and all undocumented migrants from formal remittance services.

GENERAL AND MARKET CONTEXT

Country at a glance

Although experiencing generally buoyant economic circumstances, unemployment is high and the informal sector large. South Africa is a middle-income country with a population of 47.4m (Statistics South Africa, 2006). It found its way back into the international fold with the ending of apartheid and election of a democratic government in 1994. Owing to its discriminatory history, the country is characterised by the presence of two unevenly developed economies, one sophisticated and developed, the other serving the poorly educated, low-income majority. The economy as a whole has grown on a consistent basis since 1993, with growth in GDP (constant 2000 prices) between 2000 and 2005 averaging almost 4% (South African Reserve Bank, 2006). GDP per capita for 2005 totalled US$12,161 (IMF, 2006). However, levels of unemployment remain high at 25.6%[196]. In 2002/03, the informal economy comprised 29.5% of the economy (Schneider, 2005) and about 24% of the economically active population were employed in the informal sector in 2006 (Statistics South Africa, 2006).

Urbanisation continues apace: 60% of the population now live in urban areas (Centre for Development and Enterprise, 2005). The 2001 Census found that there are 9.1m households in South Africa and about a third of these live in informal or traditional dwellings (Statistics South Africa, 2001).

The banking sector structure and evolution[197]

Table 10 below captures some salient features of the South African banking sector:

Bank sector indicators	2000	2005
Bank assets to GDP	81%	140%
M2 to GDP	51%	87%
Number of registered banks	45	36
Total liabilities to GDP	67%	128%
Share of assets of top 4 banks	75%	85%
ROA (after tax) of banking sector	1.1%	1.1%
Interest margin of banking sector	2.9%	3.1%
Efficiency ratio (all banks)	62.5%	66.3%
No. of ATM's	Not available	12,488
No. of online POS devices	Not available	114,286

Table 10: Various bank sector indicators for 2000 and 2005

Source: South African Reserve Bank, PWC Banking Survey 2005

Sophisticated, though concentrated banking sector. The retail market is dominated by four banks - First Rand, Standard Bank, ABSA and Nedbank – known as the "Big Four". At the end of 2005, the assets of the Big Four plus Investec Bank (the fifth largest bank) constituted nearly 90% of total bank sector assets. All commercial banks are privately owned and three of the Big Four are locally owned, the exception being ABSA in which Barclays Bank plc UK purchased a controlling stake in 2005. The Big Four have 19.8m retail clients – the projected number for 2008 is 22.8m clients (PricewaterhouseCoopers, 2005).

In addition to the Big Four, a second tier of smaller niche banks exists. Three of these focus on the low-income market viz African Bank, Capitec and Teba Bank. The government-owned Post Office Savings Bank (PostBank), a division of the South African Post Office, also offers basic savings and transaction accounts (though no lending).

Mixed revenue model with high bank charges. Banks derive a large proportion of income from transaction-based fees. A 2006 study found that 38% of the banking industry's joint income for 2004 derived from transaction-based fees (Feasibility, 2006). Bank charges and the structure of the banking sector, more generally, is currently the subject of an enquiry by the competition (anti-trust) authorities.

Comprehensive branch infrastructure. In 2005, there were about 3,000 bank branches[198] offering commercial banking products, as well as 2,000 post office outlets carrying Postbank products (South African Post Office, 2006). Given a population of 30m adults, this translates to

[196] The expanded definition of unemployment (i.e. including discouraged work seekers) brings the number closer to 40% (SAPRN, 2005).
[197] This section draws heavily on Porteous, 2004.
[198] According to PricewaterhouseCoopers (2005), the "Big Four" had 2,500 bank branches during 2005. If allowance is made for growth in branches since 2005 and a rough estimate of the branches of other banks added, this approximates to 3,000 branches.

about 17 branches per 100,000 adults or almost 11 branches per 100,000 individuals (adults and children).

The informal financial sector is active. Lower-income financial needs are often met by informal bodies like burial societies and stokvels (rotating savings clubs). It is estimated that there are between 80,000 and 100,000 burial societies to which 6.2m members belonged in 2003 (Genesis Analytics, 2003), while contributions to stokvels totalled around R6.2bn ($936m[199]) in 2004 (FinScope 2004). Burial societies or stokvels are not licensed or regulated.

The history of access

Historically, poor people in SA had low levels of access. The exclusionary effect of apartheid locked many poor South Africans out of the formal financial system and FSPs have traditionally not been geared to servicing the poor. In the past, they focused on corporate and middle- and upper-income retail markets. Lower-income financial needs were largely met by informal bodies like burial societies and stokvels.

A change in attitude around 1994. This attitude changed in the early 1990s and the first foray into the lower-income market was made in 1994 by Standard Bank with the launch of its E-Plan account. Two other large banks, ABSA with its Flexi-Banking transaction products, and FNB with its Smartsave product, followed suit. The state banking institution, PostBank, also facilitated the roll-out of bank accounts to the mass market in the late 1990's.

The Financial Sector Charter (FSC). Since the democratic government came to power in 1994 and as part of a broader movement to empower black South Africans, it has sought to make the financial sector more accessible. From the late 1990s, government started to request banks to do more to offer services to neglected clients. Negotiations within the financial sector resulted in 2003 in the Financial Sector Charter (the Charter) in which the banking industry committed itself to the provision of access to basic banking services to 80% of lower-income consumers by 2008.

The Financial Sector Charter facilitated the Mzansi initiative. From this commitment to access was born the Mzansi bank account, a savings account with basic transaction capability, launched in collaboration by the Big Four and PostBank in October 2005. The Mzansi banking project has been startlingly successful – according to the Banking Association, by June 2006, around 3.29m accounts had been opened (Banking Association, 2006)[200]. This was followed by the Mzansi money transfer product, a cheap means of transferring money domestically (but only domestically). This has enjoyed less success in take-up than the Mzansi bank account.

New players emerge to serve the low-income market. From 2001 onwards, new banks emerged with a specific focus on the low-income market. These include Teba Bank which evolved out of the mass provision of financial services to miners, and Capitec Bank, the result of the financial consolidation of a number of micro-lenders.

The recent period has seen the introduction of new banking technology, d*evelopment of virtual banks and cellular banking services.* Given that 30.7m people have access to cell phones[201], they potentially provide banks with a large network to reach prospective clients. The launch of Wizzit Bank in 2004 and MTN Banking, a virtual banking partnership between Standard Bank and cellular network operator MTN, in 2005 signal the first steps in the cell-phone banking market.

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[199] All dollar conversions are based on average year to date exchange rates as obtained from www.oanda.com.

[200] It is important to note that this is a slightly controversial statistic as there are some issues around double counting and already banked individuals opening Mzansi accounts to benefit from lower costs.

[201] This figure was arrived at by adding the market sizes of the three largest cell phone network providers (MTN, Vodacom and Cell C) during July 2006. The information was collected from their most recent annual reports and financial statements.

Partnerships with retailers. Banks have also started to form distribution partnerships with retailers. In 2006, Capitec Bank launched a money transfer product with Shoprite, a low-to-middle-income food retailer with extensive geographic reach. Although retailers wanting to offer banking services currently have to do so in partnership with a bank, the Dedicated Banks Bill (a new regulatory framework for second-tier banking) will, if enacted, allow retailers and other non-core banking institutions to become deposit-taking institutions in their own right, increasing competition in the banking sector.

Cross-border money transfer market

The formal sector cross-border money transfer market is not well developed. Although the need for remittances is significant, the money transfer market in South Africa is not competitive or well diversified. The reason for this is foreign exchange rules which limit full dealing in foreign exchange (necessary for a cross-border transfer beyond the Common Monetary Area (CMA)[202]) to those holding a dealers' licence – at present such a licence is reserved for banks. A non-bank money transfer operator (MTO), short of registering as a bank, must thus partner with a bank. The minimum capital requirement for a banking licence is R250m (+/-$35m). These high barriers to entry limit competition in the international money transfer market and push up the price of formal remittance mechanisms.

Formal sector mechanisms few and expensive. Commercial banks offer account-to-account transfers through the SWIFT system, but this presupposes the holding of an account. For non-accountholders, options are limited. Western Union entered South Africa in 1995 but struggled to comply with foreign exchange controls, and exited in 2001. MoneyGram provides it services in South Africa through Bidvest Bank (previously known as Rennies Bank) and Standard Bank, though clientele of MoneyGram are mainly higher-income individuals and legal economic migrants who remit money home. The average transaction value of a MoneyGram transfer is R2,000 (just more than $300), while the average size of remittances to the SADC[203] group of countries is lower at around R500 ($75.50) (Genesis Analytics, 2005b). This reflects the less skilled labour migration from SADC. However, an international transfer of a small amount, say R500, using MoneyGram, will cost up to R185, i.e. more than 30% the total amount sent (i.e. it costs up to $28, or 37%, to send an amount equal to about $76). This arguably remains beyond the affordability of the mass market.

The Mzansi Money Transfer product was launched in 2005 by the Big Four banks and Postbank. This service offers a person-to-person, cash-to-cash product based on the Western Union/MoneyGram transfer model, but at a lower cost of only up to R35 for a R500 transfer (i.e. $5.28 for a $75.50 transfer, amounting to roughly 7%). However, Mzansi transfers are restricted to domestic transfers only – this is one of the reasons the product has not seen great take-up.

South Africa a net sender by volume of transactions; a net receiver by value. In terms of total remittance flows, accurate data are largely absent. However, conversations with formal industry players lead us to conclude that 50-75% of total remittances measured by value are inflows, while 25-50% are outflows.[204] It is likely that the *value* entering the country exceeds the value exiting the country, but that numbers of transactions is higher going out than coming in. This apparent anomaly is explained by the fact that formal remittance inflows come are mostly originated by higher-income South Africa diaspora, especially those living in the United Kingdom, United States and the Antipodes, and from families who are supporting foreign

[202] South Africa, Lesotho, Swaziland, and Namibia are members of a common monetary area.

[203] Southern African Development Community consisting of Angola, Botswana, Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Zambia, Zimbabwe and Tanzania.

[204] These figures are based on conversations with MoneyGram and banks acting as agents for MoneyGram, namely Standard Bank and Rennies Bank.

students studying at South African colleges. In contrast, formal remittance outflows are mainly originated by SADC economic migrants engaged in lower-income work in mining and farming. It has been estimated that there are 2.1m legal migrants from SADC alone working in South Africa, accounting for R6.1bn (US$921m) in cross-border remittances from South African into SADC (Genesis Analytics, 2005b). In other words, remittance outflows are characterised by lower-value, high transaction volumes, and inflows by higher-value and lower transaction volumes.

Informal networks are widely used: The most common informal mechanism is the transfer of money in person or via a driver on the extensive taxi and bus network. This is cheaper than formal systems: sending R500 ($75.50) to a neighbouring state with a taxi driver will cost about R50 ($7.55, amounting to 10% of the sent amount). There is no evidence of a ubiquitous hawala system in South Africa, although certain ethnic groups certainly use these covertly, particularly communities of Somalis, Pakistanis and Indians. Genesis Analytics (2005b) estimates that 48% of all domestic remittances flow through informal channels, while 42% of all inter-SADC remittances are sent informally.

Regulatory overview of the financial markets

The Ministry with overall responsibility for financial markets is the National Treasury. The basic regulatory and supervisory structure is as follows:

- Banks are supervised by the South African Reserve Bank (SARB), specifically the Office of the Registrar of Banks.
- Non-banking FSPs including insurance, retirement funding and collective investment schemes are supervised by the Financial Services Board (FSB).
- The provision of any form of credit is supervised by the National Credit Regulator.
- Informal sector financial service providers, like stokvels and burial societies, are not regulated, unless their size and/or activities bring them within the regulatory net. Even where they do strictly fall within the regulatory net, the limited resources of the regulator would mean that they are effectively unsupervised.
- Issues relating to AML/CFT are handled by the Financial Intelligence Centre (FIC) which is housed in the National Treasury. Supervisory powers were not given to the FIC but to existing financial services supervisory bodies. Thus, the Reserve Bank, as supervisor of banks, supervises compliance by banks; the FSB supervises compliance by non-banking FSPs and advisors; the Law Society by attorneys, and so on.
- South Africa also has exchange controls which restrict the movement of funds in and out of the country. They are contained in the Exchange Control Regulations issued in terms of the Currency and Exchanges Act, 1933, and are administered by the Exchange Control Department of the SARB. Only authorised dealers may exchange currency. Currently, the SARB licences only banks to act as full authorised dealers. A few bureaux de change are licensed as limited dealers. To send money out of the Common Monetary Area (CMA) from an authorised dealer, the remitter will be required to show that he or she is a citizen, legal resident, or temporary resident with a valid work permit. Every foreign exchange transaction, irrespective of its size, must to be individually reported to the SARB utilising a reporting system as specified by the SARB[205].

For a diagrammatic overview of the broader financial sector regulation see

Figure 5 overleaf.

[205] As foreign exchange controls was not the focus of this study, no quantitative information on the costs of reporting requirements were collected.

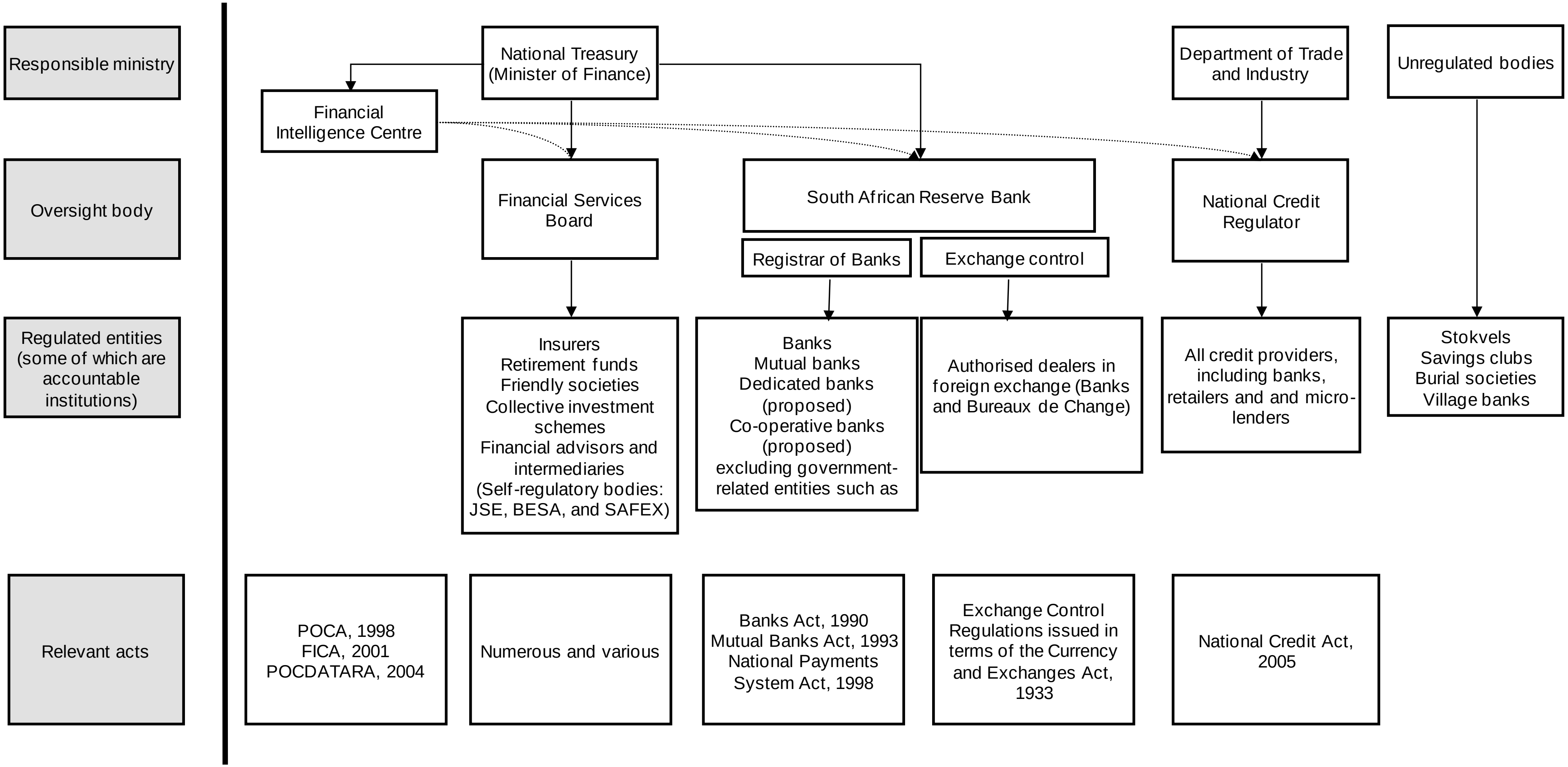

Figure 5: Overview of SA AML/CFT and other financial regulation applicable to financial institutions

National identification system

Comprehensive national identity system. The national identification system is administered by the Department of Home Affairs. Bar-coded Identity documents are issued to citizens and permanent residents 16 years or older. Identity documents are required to vote in national and local elections. Approximately 1.75m eligible South Africans do not have an identity document, but could obtain one free of charge at any Home Affairs office (Department of Home Affairs, 2006a), although the process may be quite lengthy for some applicants. According to recent press reports, however, the integrity of the system is in question and many cases of identity fraud or corruption have been reported.

South Africa is a regional economic hub and attracts economic migrants, particularly from the other SADC countries. It has been estimated that there are 2.1m legal migrants from SADC alone in South Africa (Genesis, 2005b). Legal migrants are issued with work permits by the Department of Home Affairs.

There are high levels of illegal migrants in the country. Due to their furtive nature, numbers of undocumented migrants are difficult to measure. A 1996 study estimated that between 2.5 and 4.1m persons reside in the country illegally[206], the majority of whom arrive from Mozambique, Zimbabwe, Lesotho and Asia (Department of Home Affairs, 2006b)[207]. Other sources put the estimates for illegal migrants at even higher levels.

Residential address infrastructure

The majority of the population do not have residential addresses. About 44% of the population has a residential address (i.e. does not live in an informal settlement or in rural areas on communal or farm land where it is difficult to attach "an address" to the dwelling). This amounts to just more than 4m addresses out of 9.1m households (Genesis Analytics, 2004a) The 2001 Census found that approximately a third (31.2%) of South African households resides in informal or traditional dwellings.

Internal migration is high. There is significant internal migration among South Africans. A 2003 study on internal migration showed that between 1992 and 1996, 38% of South Africans moved house at least once (Kok et. al., 2003)***.*** There is also a general migratory movement to metropolitan areas (Collison, Kok & Ganene, 2006)*.* The high mobility means that formal address details, to the extent they exist, date relatively quickly.

Current levels of access and usage: bank accounts

Less than half of adult South African population use a bank account. As a result of the number of initiatives explicitly targeted at promoting access to banking services in South Africa, access levels have improved in the last decade. However, they remain low compared to the developed world, with only about 46% of the adult population (14m people) being currently banked (FinScope, 2005).[208] Approximately 12% of adults are previously banked (but currently unbanked), while about 41% (13m) have never been banked (FinScope, 2005).

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[206] The study by the HSRC was commission by the Department of Home Affairs in 1996 and although initially posted on the Department of Home Affairs website, it was later withdrawn due to methodological issues and flaws.

[207] According to a study released at the end of 2006, the number of undocumented migrants in South Africa could be as high as 10m. However, as the fundamental assumptions on which this estimate is based are questionable, we do not use it here.

[208] FinScope is a national household survey, underwritten and coordinated by the FinMark Trust. It is focused on measuring financial services needs and usage across the South African population. The FinMark Trust was created in March 2002 with funding received from the United Kingdom Department for International Development (DFID). Its mission is "making financial markets work for the poor".

	Number of individuals	Percentage
Currently banked	14.3m	46.6
Previously banked	3.8m	12.3
Unbanked	12.6m	41.1
Total	30.7m	100

Table 11: Banked status in South Africa

Source: FinScope 2005

Given the average monthly costs of a basic transaction bank account, just two thirds of adult South Africans have access *to banking services.* We find affordability to be the largestp barrier to accessing basic transaction banking services. If we assume that the total costs of a transaction bank account should not exceed 2% of household income per month[209], we find that (using income distribution data from FinScope 2005)[210] 33% of adult South Africans would be unable to afford transaction banking services. We include the average cost of travelling to the bank in our calculation to control for the influence of proximity on affordability.

Eligibility requirements are limited. Although most banks have a small initial deposit and minimum balance requirement, these cannot be considered exclusionary. Banks do not generally impose eligibility requirements in excess f what is required by regulation. One bank interviewed does require proof of income to open its most basic account (other than Mzansi). Given the size of this bank's branch network, the total access impact of eligibility requirements is negligible.

Regulatory ID barriers pose a significant barrier to access to undocumented migrants. A citizen or legal resident must, as a general rule, produce an official identity document to open an account or to transfer money (a foreigner must produce a passport). This requirement excludes (but not absolutely) the 1.75m eligible South African citizens or 6% of the adult population who do not have identity documents until such time as they obtain them. It also excludes any person who is in the country illegally (conservatively estimated as 2.5m people). In terms of the Immigration Act, financial institutions are required to endeavour to ascertain the status or citizenship of persons with whom they enter into commercial transactions. They must then report to the Director-General of the Department of Home Affairs any illegal foreigner, or any person whose status or citizenship could not be ascertained.

Current levels of access and usage: remittances

Formal remittance services cannot be considered affordable to low-income individuals. As described above, formal remittance products are, on the whole, unaffordable for the low-income market. Foreign exchange rules severely limit competition in the remittance market – as a result, prices remain (for now) beyond the reach of most low-income consumers. However, remittances are not ad hoc voluntary transfers but a financial necessity. The remitter is left with little choice whether to remit or not, given the financial circumstances of his/her

[209] The measure of affordability applied by Genesis, in line with that used by Finmark Trust, is to say that a household will be able to spend 2% of their monthly household income on a banking product.

[210] We calculated the affordability measure using cost data for 8 basic transaction accounts at 8 South African banks. We selected the four largest commercial banks (ABSA, Nedbank, First National Bank and Standard Bank) and three low-income bank (Capitec, Teba and Post Bank), as well as one retailer bank (Pick 'n Pay Go Banking). A basic transaction profile, derived from South African bank research, was used to then calculate a monthly average cost for each bank account. These individual costs were then weighted according to each of the banks' proportion of bank accounts in the sample and an average cost was calculated across all the bank accounts. This cost amounts to R23.61 ($3.56) per month to which travel cost (assuming two round trips to the bank) of R25.76 ($3.89) was added, which implies a total monthly cost of R49.37 ($7.45) per month and an affordability threshold of R1288 ($194.46) household income per month. Income distribution data was derived from FinScope 2005. Using this data we calculated that 33% of adult South Africans would be unable to access transaction banking services or, alternatively, that 67% of South African adults have access to transaction banking services, given the affordability threshold. All dollar conversions were made based on average year to date exchange rates obtained from www.oanda.com.

family in his/her country of origin. The choice is, thus, not whether to remit but how much money and through which channel (formal or informal). This choice is likely to be significantly influenced by the affordability of the product.

The prevalent usage of informal remittance services in South Africa could be considered indicative of the low affordability of formal remittance services.

Eligibility requirements seem negligible. Currently, the only eligibility requirement imposed by banks is a minimum remittance amount of about R100 or $15 (even lower for Mzansi transfer product) which is set low enough that all prospective remitters are able to meet it. Eligibility factors do not, therefore, impact on access to remittance services.

Proximity may pose a barrier. Currently, formal remittance services can only be provided by FSPs with a bank license. This includes the Big Four and other smaller banks (e.g. Rennies Bank), as well as the Post Bank. Although traditional commercial banks have limited reach in rural areas, the Post Office has a wide distribution network, also extending into rural areas. Even though the Post Office's distribution network provides it with wide reach, its clients can only transfer money to a limited number of countries in Africa and the rest of the world[211].

Regulatory ID barriers exclude some South Africans and all undocumented migrants from formal remittance services. Some individuals (those without proof of residential address and proper identification) that need to remit money across South African borders and especially undocumented migrants (those that cannot prove legality of stay as required by the Foreign Exchange Control Regulations[212]) will be excluded from the formal money transfer system. As with transaction banking services, there are 1.5m eligible South Africans (or 5% of the adult population) without identity documents, while about 2.5m undocumented migrants will also be excluded from these services.

THE AML/CFT ENVIRONMENT

Highly committed to the FATF recommendations. South Africa is strongly committed in both the private and public spheres to implementing the FATF recommendations. South Africa is one of the few developing country FATF members. It became a FATF member in 2003 and held the presidency in 2005/2006.

History and AML/CFT evolution

Money laundering criminalised in the early 1990s. South Africa was quick off the mark to criminalise money laundering, and drug-related laundering was criminalised as long ago as 1992. In 1996, the Proceeds of Crime Act broadened this to the proceeds of any type of offence irrespective of the amount involved. Money laundering is currently criminalised by the Prevention of Organised Crime Act of 1998 (POCA). This Act provides draconian penalties for money laundering offences, including offences of negligence, ranging from fines of up to US$13 million and 30 years imprisonment to US$130 million and life imprisonment where proceeds of racketeering are laundered. POCA did not, however, create standard AML control duties for FSPs. To this end, the South African Law Commission, as it was then known, was asked to prepare a money laundering control bill.[213]

Cognisance taken of potential impact but no quantified impact assessment. In 1998, the Minister of Finance appointed a task team to advise him on the appropriateness of the money

[211] The countries to which electronic transfers can be made are Lesotho, Swaziland, Namibia, Botswana, Kenya, St. Helena and Zambia. Postal money orders can be sent to the United Kingdom, Jersey, Botswana, Kenya, St. Helena, Zambia, Brazil, Canada, Italy, Malaysia, Mauritius, Singapore, Switzerland and Sri Lanka.

[212] Section 3.2.2 of the Exchange Control Manaul issued by the SARB.

[213] For the development of the framework, see De Koker *South African Money laundering and terror financing law* (Service Issue 7, 2007) Chapter 2.

control laundering bill. The task team consulted widely but owing to the fact that there was a lack of hard statistics and research available, could not accurately assess how the Bill would impact on FSPs. Some assumptions were made about the ability of banks to comply which later proved incorrect.

FICA forms the framework for the current AML compliance regime. The draft bill eventually served as the basis for the Financial Intelligence Centre Act (FICA), 2001 which is the key piece of AML legislation. A more detailed description of the main obligations imposed by FICA is set out below in Table 12.

FICA regulations require identity and address verification. The regulations to FICA (now known as the Money Laundering and Terrorist Financing Control Regulations) were drafted during the course of 2002 in consultation with relevant stakeholders. Amongst others, the regulations set out the identification and verification requirements for various types of clients. The standard requirement in respect of natural persons is that banks must verify the identity of a client by means of an identity document and by comparing the person's residential address details with information that is reasonably practical to obtain and can reasonably be expected to achieve such verification.

Producing an identity document not an insurmountable barrier to most clients. The identity document was an obvious choice for identification because South Africa has a national identity system and most citizens and residents have access to an identity document.

Address verification as additional check on identity proved difficult. However, law enforcement agencies wanted the regulations under FICA to insist that clients produce more than an identity document in order to make it more difficult for launderers and terrorists to commit identity fraud. The address verification requirement appears to have been chosen to act as such a safeguard. The drafters did in fact identify address verification as a potential obstacle for the poor. As a result, the regulations were drafted to include a specific exemption (Exemption 17) which relieved institutions of the obligation to obtain and verify residential addresses if the financial product in question met certain stringent criteria. This exemption was later modified because, while the initial exemption was in itself a prescient achievement, the relief offered was subject to conditions that proved impractical for both poor clients and banks.

Implementation schedule was not based on research about the financial sector's capacity or on workable timelines. When the regulations to FICA were released on 20 December 2002, banks were faced with a huge compliance challenge. Although the core duties were set out in FICA itself, the banks were not able to design and implement any compliance processes before the detail was made available in the regulation. So when the regulations to the FICA were released, the banks effectively had six months to redesign their internal systems before all new clients had to be properly identified and verified (30 June 2003) and only 18 months to simultaneously complete the identification and verification requirements in respect of all *existing* clients (30 June 2004).

New procedures and systems had to be developed and implemented, which included the drafting of training materials and training of between 120,000 to 140,000 staff members across the industry. Although the banks largely succeeded in reaching their target date for the identification and verification of new clients, it placed great strain on their internal compliance resources. According to National Treasury, these timelines were based on information provided by the banks *themselves*.

Potential for pro-access outcomes of bank consultation in drafting process undermined by compliance focus. Little research was available at the time on the financial services needs and transaction patterns of the unbanked. The regulations were formulated in consultation with banks but the key input was provided by staff who lacked sufficient knowledge about the unbanked market and their needs, to provide practical guidance to the drafters. It is natural for a banker to be familiar with the banked market, but far fewer bank employees are in a position to give meaningful views about the needs of the *unbanked* market. For limited impact on access is to be limited, such a view is vital.

Discretion granted to banks not successful, as banks chose most conservative route. Certain unforeseeable bank practices made the account opening processes even more difficult than the drafters envisaged. Although the regulations had been crafted to include leeway for banks to accept alternate documents if the client was unable to produce an official identity document for an "acceptable reason", some banks declined to exercise this leeway. Compliance officers were reluctant to leave the judgment as to what constitutes an acceptable reason in the hands of junior employees and tellers. Many compliance officers, whose job it is to mitigate risk, applied their discretion conservatively and drafted standard and rigid procedures that did not leave space for employee discretion. In addition, when it came to accepting certain documents for purposes of address verification, banks tended to be stricter in their approach than the regulator had envisaged. The high penalties for money laundering offences under South African law appear to be one of the main driving forces behind the conservative compliance approach.

Guidance issued for clarification. The FIC attempted to address the uncertainty around acceptable documentation and a number of other issues by means of guidance notes issued in terms of FICA. These notes, the first of which was released on 30 April 2004, proved helpful where they provided institutions with an official interpretation of their statutory obligations, but were issued after institutions had formulated and implemented their initial procedures.

Re-identification of existing clients even more challenging than new client identification. While identifying new clients brought its own challenges, it was the *re*-identification process of *existing* clients that proved most difficult. The industry had to apply the identification requirements to a national client base comprising millions of accounts - and they had to rely on voluntary cooperation by their clients. It is not clear why parliament decided that the process could and should be completed within one year after the FICA identification requirements for new clients came into effect. The statutory deadline may have been based on information obtained from the industry and assumptions made about the existing systems of banks and the quality of existing client records and interactions, which in fact were not as sophisticated, comprehensive and regular as assumed.

Deadline extended and risk-based implementation introduced to prevent catastrophic impact on banking sector. By early 2004 it was clear that none of the larger banks would meet the deadline. Banks increased their expenditure on the process by engaging temporary staff and by keeping certain branches open after hours to assist clients who wished to present their verification documents. They found some clients were loath to attend at a branch to provide identity documentation, especially when they had been banking with the institution for many years. Some co-operated, understanding the reasons behind the requirement, but others simply ignored repeated requests to present the required document to their banks. Calls thus went out from the industry for an extension of the deadline, in the absence of which banks estimated they would have to freeze 80% of their accounts, a step posing great systemic risk to the banking system. In the month before the deadline, the Minister of Finance was convinced by the regulators and industry to step in. Thus a temporary and conditional exemption was issued that provided some relief to the institutions. This exemption reflected a risk-based approach in that it required banks to categorise their clients in terms of risk, and then re-identify high-risk clients within a few months, medium-risk over a longer period and low-risk clients over an even longer period. The banks were given discretion to categorise their clients as they saw fit. The re-identification deadline expired in September 2006.

Re-identification at considerable cost to banks. The exemption provided welcome respite to the industry, and indications are that banks succeeded in re-identifying the majority of accountholders. Even so, the re-identification project has been a massive and costly undertaking. Estimates of costs to the industry have been put by an independent consultant at least R600m ($85m) and other estimates range between R750m ($105m) and R1,5 billion ($210m). It is clearly difficult to estimate this accurately. One of the Big Four banks reports that it had to employ 700 new staff in call centres and in branches to collect and copy documentation. These costs are in addition to the general expenditure in relation to money laundering control duties. Larger banks have purchased state-of-the-art management information and monitoring systems which can cost up to R30m ($4m) a piece – these will also enhance the banks' ability to understand their clients and manage risk more effectively. All banks have incurred costs in respect of increased training (though some training expenditure was shared because banks worked together to produce a standard set of training materials with government funding). The training material requires employees to spend at least a half day in training and also to undergo several assessments. Banks found that they had to invest thousands of person days on AML/CFT training to meet their new requirements.

Finding appropriate exemptions for the poor. In the same period that banks were struggling to meet their re-identification obligations, the Big Four banks were developing the Mzansi account to meet their Charter obligations. By 2004 it was clear that the original Exemption 17 was not going to provide a suitable framework for this product because it did not take into account the product needs of the poor. Research conducted in the FinScope survey gave a much clearer picture of these needs. It enabled the drafting of a new Exemption 17. This did away with the address verification requirements on accounts where the balance does not exceed R25,000 ($3,300) and in which individual transactions do not exceed R5,000 ($660). This exemption also covers certain single transactions that meet the criteria of the exemption. The new Exemption 17 allowed the launch of the Mzansi account. As mentioned, this account has been opened by more than 3m people in the past two years.

The state of AML/CFT presently

AML law as its stands in SA is mainly set out in FICA. FICA imposes on so-called "accountable institutions", which range from banks to lawyers to casinos, the duty to obtain and verify the identity of their clients, to keep records and to put in place the internal procedures necessary to combat money laundering. These institutions, together with all other businesses in South Africa, also have the duty to report suspicious transactions to the Financial Intelligence Centre (FIC) that was set up by FICA.

CFT introduced in 2004. The current AML/CFT framework was completed when South Africa criminalised terrorist financing as part of the Protection of Constitutional Democracy against Terrorist and Related Activities (POCDATARA) Act of 2004. This act ensures that South African law complies with the core FATF recommendations on terrorist financing.

A brief analysis of how the elements of FATF recommendations have been implemented in South African law under FICA and POCDATARA is provided in Table 12.

Dealing with cell phone banking

Regulation adapted to accommodate technological banking innovation. As markets shift and new products and technologies emerge, so the need arises for policymakers to revisit the AML/CFT regime. One new development in South Africa has been the introduction of cell-phone banking. By its very nature cell-phone banking relies on paperless and convenient non-face-to-face client origination. How then to originate new clients while complying with KYC requirements? A solution was approved by the regulator for products that fell within the ambit of Exemption 17[214] which allows non-face-to-face registration of clients by obtaining from the client his or her identity without having to verify address. However, because the regulator is of the view that this model introduces higher AML risk, the product is required, amongst others, to meet the conditions of Exemption 17 and to limit debits from such accounts to R1,000 ($130) a day. The bank must also obtain a national identity number from the client and then cross-reference this against third-party databases including those of the Department of Home Affairs. It is not yet clear whether the use of credit bureau databases and the voters' role would also be acceptable.

Undermining of flexibility by other regulatory developments underlines importance of holistic policy framework. Cell phone banking is also subject to other regulatory developments relating to the cell phone industry. A bill was introduced to parliament in 2006 to amend the Regulation of Interception of Communications and Provision of Communication-related Information Act, 2002. The bill provides for registration of cellular phones and SIM cards. At their own cost, telecommunication service providers will be required to provide a system of information storage, giving full names, identity numbers, and addresses of all subscribers. They would have to verify the full names and identity number of the owner with reference to his or her identification document and require the client to submit documentation in which his or her residential and business addressed are identified to the satisfaction of the service provider. The cell phone banking industry took cognisance of the impact of the bill at a very late stage. In essence, the bill, if passed into law, would neutralise in respect of the mass market the space that was created by Exemption 17.

Other regulations may also pose unforeseen issues for AM/CFT regulation to deal with. Despite the earlier compliance challenges, the South African money laundering and terrorist financing control laws appear now to be embedded within the legal and regulatory structure. The money laundering control laws have developed into important tools to combat crime. In certain cases, however, the government has had to view the laws in their broader law enforcement context and therefore treat AML/CFT regulation with some flexibility to not undermine policy goals as encapsulated in other legislation.

For instance: compliance exemptions had to be created to support specific amnesty schemes. South Africa had strict exchange controls in the past and, despite some relaxation, this system remains. In the 1970s and 1980s exchange controls were often evaded by persons who wished to shield assets from political risks. Tax morality was also low. The new government invested in building the capacity of the revenue authority and in changing the national mindset about tax morality. After tax revenues increased dramatically, the government declared an exchange control and tax amnesty that allowed persons to legitimise property that they held in violation of exchange controls. Many applicants had to utilise the services of a financial advisor in this regard. Under FICA, however, a financial adviser had an obligation to report such a client to the FIC. Government therefore created a temporary and limited exemption from such reporting duties to promote the success of the scheme. More than 42 672 amnesty applications involving nearly R68,6 bn ($9bn) was received. This amnesty was followed by a tax amnesty

[214] See South African Reserve Bank, Banks Circular 6/2006 in respect of cell phone banking issued on 13 July 2006.

for small businesses in 2006, and a similar exemption was created in October 2006 for the same reason.

FATF	Essence of recommendation	Given effect in SA law by:	What is required of accountable institutions to comply with the AML law?	
R5	Perform client due diligence	S21 FICA, read with regulations and guidance notes	For an ordinary bank account	For SA citizens and legal residents: 1) Obtain client's name, date of birth (DoB), identity number, and verify these against official Identity document, or if client has no official ID for an acceptable reason, other suitable photographic ID. 2) Obtain residential address details and verify against recommended proof of address document
				For foreign nationals: 1) Obtain client's identity details, and verify them against official passport. 2) Obtain address details - no need for address verification
				For legal persons: Obtain name, address, registration number, legal form of legal person, and registered address (verify against founding document) , and names, DoB and identity of CEO, and representative (verify against ID document), and address of representative (no need to verify) as well as particulars of major shareholders (verified as required for natural and legal persons)
			For Exemption 17 account	For SA citizens and legal residents: Obtain client's name, DoB, and identity number, and verify them against official identity document, or if client has no official ID document for an acceptable reason, other suitable photographic ID. No address requirements
				For foreign nationals: cannot open Exemption 17 account ("citizen and residents" only - meaning of resident likely to be taken as permanent residents only)
			For person to person cross border remittance	Same as ordinary bank account above. This applies to both originators sending money, and beneficiaries in SA receiving money. Note: cross border cash transfers are also subject to the foreign exchange control rules which require identity to be verified against ID document, and for address, contact details, and reason for foreign exchange transaction to be obtained
			For Exemption 17 remittance	Exemption 17 can only be used to make *domestic* remittances, not cross-border
R10	Firms must maintain all records for five years	S22, 23 FICA read with regulations and guidance notes	For ordinary bank account	A record must be kept of documents used to verify identity and address particulars as well as transaction details; records must be kept for five years after business relationship ended
			For Exemption 17 account	A record must be kept of documents used to verify identity and address particulars as well as transaction details; records must be kept for five years after business relationship ended
			For cross border remittance	A record must be kept of documents used to verify identity and address particulars as well as transaction details; records must be kept for five years after transaction
			For Exemption 17 remittance	A record must be kept of documents used to verify identity and address particulars as well as transaction details; records must be kept for five years after transaction
R13	Firms must report suspicious transactions to the FIU	S29 FICA	n/a	A firm must have systems in place to monitor and identify suspicious transactions. These must be reported electronically to the FIC using their website
SRIV	Firms must report suspicious transactions related to TF	S 29 FICA and s 12 of POCDATARA	n/a	All businesses must file reports with the FIC and the South African Police Service regarding suspected terrorist financing, including persons of the UN SC list. (In terms of S28A of FICA accountable institutions must report to the FIC if they possess or control property linked to terrorist activity.)
		S 28A of FICA	n/a	A firm must report to the FIC if it possesses or controls property linked to terrorist activity, including persons on the UN SC list

FATF	Essence of recommendation	Given effect in SA law by:	What is required of accountable institutions to comply with the AML law?	
R15	Policies and training for firms	S49 FICA	n/a	Firms must formulate and implement policy document and AML/CFT internal rules; employees must be trained; compliance officer must be appointed
R11	Firms must pay special attention to complex, unusual, large transactions	S29, 52 FICA	n/a	All businesses and employees (irrespective of size or type) must be vigilant and must file reports, if suspicious.
R21	Firms must give special attention to transactions linked to NCCT	No statutory obligation	n/a	No statutory obligation, but firms comply anyway because of reputational risk. They perform CDD duties on correspondents. Relationships have been terminated.
R7	Ensure integrity of cross-border correspondent relationships	No statutory obligation. Guidance note 3 from FIC urges compliance but this has no force of law.	n/a	No statutory obligation. Firms comply anyway because of reputational risk. They perform CDD duties on correspondents. Relationships have been terminated.
R8	Firms must pay special attention to threats that may arise from new technologies	No statutory obligation. Guidance note 3 from FIC urges compliance but this has no force of law.	n/a	No statutory obligation. Firms comply anyway because of reputational risk. Common sense measures are taken.
R22	Branches and subsidiaries must apply recommendation to the extent permitted	No statutory obligation.	n/a	No statutory obligation, but firms comply anyway because of reputational risk. Foreign branches are expected to comply to SA standard or their own AML/CFT laws, whichever is higher. Common sense allowance is made for local conditions.
R19	Govt-run threshold transaction reporting regime	Not in force	n/a	Not in force
SPVII	Accurate and meaningful originator information to accompany wire transfers	S21 FICA	n/a	The same ID and verification procedures apply as listed for cross-border remittances above (R5).
SRIX	Regulate and police physical cross-border transportation of currency	1) Exchange control regulations. 2) Customs law.	n/a	1) Exchange control regulations control the transfer of currency out the country 2) In addition; travelers are required to provide information, including the amount of cash as well as the denomination of notes, as part of customs declaration when they enter the country.

Table 12: FATF recommendations in South Africa law

Source: Genesis; laws of South Africa

KEY FINDINGS

Policy priority on access and willingness to compromise minimises access barriers

Compromises reached to meet both AML and access goals. South Africa is strongly committed to complying with the FATF recommendations and increasing levels of access and has adopted some pragmatic compromises to accommodate both.

Initial impact of legislation on access was underestimated

Role of access research. At the time of the initial drafting of AML/CFT legislation, little research was available on the financial needs and transaction patterns of the unbanked. Although the legislation was formulated in consultation with banks, the key input was provided by staff that lacked sufficient knowledge about the unbanked market and its needs. Certain assumptions were made about the ability of banks to comply which later proved incorrect. Moreover, the first Exemption 17 offered relief that proved inappropriate to meet the financial needs of the poor. Research conducted through the FinScope survey gave a much clearer picture of these needs, which enabled the re-drafting of a more appropriate Exemption 17. This, in turn, facilitated the launch of the popular Mzansi account.

Where FSPs were given discretion, they tended to the more conservative option. The regulations to FICA were crafted to include leeway for banks to accept alternate KYC documents. However, banks in general declined to utilise this space because they were reluctant to place discretion in the hands of junior employees. Compliance officers applied their discretion conservatively and drafted standard and rigid procedures that did not leave space for employee discretion, even though it was available in the law. The conservative compliance approach seems to be driven in part by the draconian penalties for money laundering offences, including offences of negligence.

The impact of FATF recommendations on bank accounts

Exemption 17 (as amended) helped to minimise impact on access. While the requirement to verify residential address with documentary evidence initially posed a major barrier, its impact has been greatly softened by the introduction of the pragmatically amended Exemption 17 which does away with the requirements for low-value, low-risk accounts. KYC requirements now create limited barriers for access to basic bank accounts.

AML/CFT legislation unlikely to impact on the affordability of low-income bank accounts. There are no indications that FICA and other AML/CFT legislation is impacting directly on the affordability of basic accounts. This is not to say that significant compliance costs have not being incurred by FSPs. Some banks interviewed indicated that costs of this magnitude will eventually feed back to clients but it is unlikely, in our view, to impact on the affordability of low-income accounts because of the political imperatives on banks to retain these accounts. It is more likely that costs will filter back to middle- and upper-end bank users, with no loss of access to low-income users. The counterbalancing access policy objective has thus protected low-end users from an increase in charges.

Regulatory ID barriers do pose a barrier for undocumented migrants. A citizen or legal resident must, as a general rule, produce an official identity document to open an account or to transfer money (a foreigner must produce a passport). This excludes any person who is present in the country without documentation (conservatively estimated at 2.5m people).

The impact of FATF recommendations on remittance services

Foreign exchange rules limit competition in the formal sector. Cross-border money transfers can only be undertaken by a bank or entity acting in partnership with a bank. The sector is thus not competitive or well diversified.

Verification remains a barrier for walk-in remittances. In terms of FICA, a walk-in client must produce an identity document as well as proof of address. These are the same requirements as when opening a (non-Exemption 17) account. Though an exemption was created to do away with the address requirements on the opening of low-value bank accounts (Exemption 17), the equivalent exemption was not carried through to cross-border money transfers. Full identification and verification are required for transfers, as well as full observance by the institution of the other AML/CFT requirements (i.e. record-keeping and reporting of suspicious transactions). Proving residential address remains problematic for those without a formal address or without the ability to prove their address.

Confusion around keeping copies raises costs for some institutions with knock-on effects on access: The compliance duties on FSPs can push up costs, making small remittance transfers unattractive or even unviable. We have seen some evidence of this. Many South African institutions adopted the practice of photocopying identity documents presented as verification. FICA, by contract, only requires *a record to be kept* of the documents that were used to verify a client's identity. Some institutions regard this as a best practice procedure while others are under the impression that it is actually required by FICA. An interview with one of the Big Four banks revealed that 80% of walk-in remittance business constitutes small transfers of less than R500 ($70). The bank in question found that considering the diminutive profit made on such transfers, it was not viable to take a copy of the identity document and address verification document. Instead, the bank resorts to only capturing identity details (not keeping any copies). Although this practice was compliant with their statutory obligations, the bank was under the impression that its practice breached the law. In cases like this, open communication channels between the regulator/supervisor and FSPs could assist in eliminating the use of overly conservative practices.

Regulatory ID barriers exclude undocumented migrants from formal remittance services. Undocumented migrants will be excluded from the formal money transfer system on the basis of the documentation requirements, since they are unlikely to be able to provide documentary proof of their residential address (note that they also face the non-FATF barrier of proving the legality of their stay in the country to be able to purchase foreign exchange – a requirement of the Exchange Control regulations). This group consists of about 2.5m individuals that will have no access to formal remittance services, yet have a very strong need for such services.

Compliance with FATF requirements to monitor informal remittance sector virtually impossible. FATF recommends that governments regulate the informal remittance sector and detect if funds are being carried across the border illicitly. Considering the levels of money being carried in and out of South Africa and how unstructured the informal cash courier sector is, this would be difficult. Effective compliance will be costly as it will rely on individual searches of every person and vehicle crossing every border point. It would also be necessary in terms of the special recommendations to register or licence the hawalas that are presently operating under the radar. If the present regulatory regime for remittances is retained, a hawala would have to register as a corporate entity and then either register as a bank, or partner with a bank. The high capital requirements and the risk inherent in such a joint venture make both options unattractive. Effectively, these informal operators will be left with no space to operate legally and would be forced to close down (if current regulation could be effectively enforced), with a concomitant loss of access to the services by their current users.

APPENDIX G: CASE STUDIES

In this part of the analysis, we consider three case studies illustrating respectively:

- adjustments to the AML/CFT regime in the United Kingdom to facilitate access;
- the potential for unintended access-consequences of AML/CFT, as witnessed in the United States; and
- the interplay between AML/CFT technological innovation in the Philippines, with emphasis on how cell phone banking was implemented in an AML/CFT compliant way.

Though there is no single theme cutting across the case studies, each represents an interesting aspect of AML/CFT from which potential lessons for other jurisdictions facing similar circumstances can be drawn[215].

ACCESS-FRIENDLY ADJUSTMENTS TO CDD IN THE UK

This case study explores the recent changes in the UK CDD regime aimed at facilitating greater access to financial services.

The case study illustrates that:

- Access and unintended regulatory barriers to access are universal issues and not restricted to developing countries.
- Even developed economies require on-going adjustments to ensure efficient regulation.
- The UK regulator recently refined its AML/CFT systems to minimize unintended impacts on access
- Initial discretionary approaches were not effective in a regulatory environment that engendered the conservative treatment of risks.
- A risk-sensitive approach complemented by industry guidance was used to create more flexible system.
- Account restrictions and monitoring could be used to compensate for imperfect identification systems.

Access is a universal issue. Lack of access to formal financial services by vulnerable groups in society is by no means exclusively a developing country phenomenon. Similarly, the unintended impact of regulation access is an issue faced by developing and developed countries alike. This dynamic is illustrated by recent developments in the UK AML/CFT regulatory framework.

AML/CFT constrains efforts of UK government to extend access. At the turn of the century the UK's Financial Services Authority ("FSA"), the regulator of financial services, found that around 1.5 million households (or 7% of the households) in Britain lacked any financial products at all and a further 4.4 million (or 20% of households) were on the margins of financial services and usually had little more than a bank account. In response, the UK government required banks to develop the Basic Bank Account to address exclusion from banking services. These accounts

[215] The three cases were selected from a number of options that arose out of the consultations for the project and were approved by the Steering Committee members.

are normally current accounts that exclude cheque or credit facilities but are linked to a cash card that allows withdrawals from ATMs. The government also required the large banks to allow the operation of their basic bank accounts through local post offices. By October 2000 these accounts were available at all UK banks. Despite their general availability, the Basic Bank Accounts were not being taken up at the expected rate. Apart from a lack of information/consumer education, the stringency of AML/CFT client identification and verification (CIV) requirements were flagged as a stumbling block.

The former identification and verification requirements

In the absence of a national identification card, reliance is placed on alternative documents to verify identity. The UK lacks a national identification system. The Identity Cards Act was only enacted in March 2006 and the first identity cards are expected to be issued in 2008/2009. As a consequence CIV requirements that were document-based were set by the government and supported by guidance formulated by key representatives of the financial services sector. The government requirements were set out in the Money Laundering Regulations and the FSA Handbook, while industry guidance was contained in the previous set of Guidance Notes issued by the Joint Money Laundering Steering Group. In essence, this system required a prospective client to produce at least one document (e.g. a passport or driving licence) to verify his name and another document (e.g. a utility or council tax bill) to verify his residential address. The standard identification system therefore relied on two documents of which one verified a person’s identity and the other his residential address.

References accepted by exception for those without required documentation. It was realised that this system may create an access barrier for those who lacked the standard identification requirements. The FSA Handbook therefore allowed a firm to accept a single, alternative document if it had reasonable grounds to conclude that an individual client was not able to produce the standard evidence of his identity and could not reasonably be expected to do so. In such a case the firm was allowed to accept as verification evidence a letter or statement from a person in a position of responsibility who knew the client, that tended to show that the client was who he said he was and that confirmed his permanent address if he had one. Examples of persons in a position of responsibility included solicitors, doctors, ministers of religion, teachers, hostel managers and social workers. A firm that wished to employ this measure had to keep a record of its reasons for doing so.

“Fear factor” undermines discretionary space created in support of access. Despite the availability of this simplified CIV procedure, the CIV requirements still had an adverse effect on access to financial services. It seemed as if banks opted for a conservative approach to client due diligence (Financial Services Consumer Panel, 2002). Firms indicated that the FSA’s supervisory approach and enforcement actions caused them to take a very conservative approach to CIV procedures to reduce the likelihood of regulatory sanctions (FSA, 2005). The FSA refer to this phenomenon as the “fear factor”.

Move to risk-sensitive approach. In 2004 the FSA began to reconsider the CIV requirements. Apart from exacerbating financial exclusion the two document verification system appeared to be unnecessarily onerous and expensive, while not necessarily adding proportional value. The FSA formed an ID working group and they indicated, for instance, that the second document may add limited additional corroborative value as many of these documents, such as utility bills, can be easily forged (FSA, 2004). In addition, the FSA began to consider a new approach to compliance and supervision. In terms of its regulatory model the FSA determined rules and procedures based on its general analysis of risk. The premise was that a company would mitigate its risks if it complied with the rules. However, in many cases such a rule-based system would not mitigate a particular company's unique risks. In other cases the rules would be unnecessarily onerous, given the company's low risk profile. The FSA therefore decided to adopt a risk-sensitive system that recognises the responsibility of the management of a regulated financial services provider to manage the AML/CFT risks of their business.

The risk-sensitive approach

Rules replaced by principles. In 2006 the new regulatory approach as well as new approach to CIV was introduced. In terms of the new regulatory approach regulated firms are expected to assess their AML/CFT risks and to adopt proportionate and appropriate measures to mitigate those risks. The FSA simplified and streamlined much of its detailed money laundering guidance. In essence, it replaced it with high-level principles that regulated providers must uphold. The key industry role-players, grouped together in the Joint Money Laundering Steering Group, issued a new set of Guidance Notes to assist firms to design, implement and monitor their AML/CFT risk controls. Firms are not compelled to implement the guidance, but it has been accepted by the UK Treasury and firms are at least expected to take cognisance of the contents of the guidance notes.

Firms expected to implement reasonable measures to manage their risks. In terms of the new approach a firm is required by the FSA principles to consider and mitigate its AML/CFT risks. Every firm must adopt control measures that comply with the law (e.g legal duties such as client identification, verification, monitoring and record-keeping) and the principles set by the FSA. When designing and implementing its controls, the firm should consider industry guidance and practices. This would imply that a firm would recognise that some clients may pose a higher risk than others and that more controls need to be applied to the higher-risk clients and their transactions. A firm may, however, decide to design unique controls if it believes that such controls are required to manage its unique risks effectively. The FSA addressed the "fear factor" by stating on record that a risk-sensitive approach means that things may sometimes go wrong. It accepted that zero failure is impossible to achieve and that a zero failure objective may make for bad regulation. If the firm therefore misjudges risk, enforcement action would be unlikely as long as it acted reasonably and its decisions were informed by industry guidance and other relevant facts.

The new identification and verification requirements

Range of CIV options allowed. The new system allows firms a range of options in relation to CIV requirements. The JMLSG Guidance Notes:

- increased the number of circumstances where firms may rely on a single document for purposes of verification, rather than the standard two documents;
- recognised the use of electronic ID verification methods, where appropriate;
- provided a range for clients who do not have standard identity documents such as passports; and
- puts less reliance on ID checks and more on wider KYC procedures and monitoring.

Range of acceptable documents expanded and made more explicit. According to the Guidance Notes, a firm should obtain a personal client's full name, residential address and date of birth. The information should be verified by means of a documentation produced by the client or should be verified electronically by the firm or by a combination of the two methods. If identity is verified electronically, the firm could perform the procedures directly or through a service provider. One match on an individual's full names and current address and a second match on an individual's full name and either his current address or his date of birth would normally provide reasonable assurance in this regard. If reliance is placed on a document produced by the client, a valid passport or photocard driving licence should enable most individuals to meet the new verification requirements in face-to-face situations. The Guidance Notes provide a list of alternative documents for persons who may struggle to meet the standard requirements. The Notes indicate specifically that these documents will generally be appropriate for opening a Basic Banking Account. Examples of categories of clients and acceptable documentation include the following:

- In respect of those in care homes/sheltered accommodation/refuge - a letter from care home manager/warden of sheltered accommodation or refuge;
- In respect of homeless persons who cannot provide standard identification documentation - a letter from the warden of a homeless shelter, or from an employer if the client is in work; and
- In respect of travelers who are not able to produce standard identification evidence - a check with the local authority, which has to register travellers' sites, may sometimes be helpful to verify a person's address.

Any such documents must be current and letters must be of recent date. All documents must be originals. In case of need, consideration should be given to verifying the authenticity of the document with its issuer. As with all retail clients, firms should take reasonable care to check that documents offered are genuine (not obviously forged), and where these incorporate photographs, that these correspond to the presenter.

Account restrictions and monitoring to facilitate access where limited identification is possible. The new scheme again makes specific provision for those who are financially excluded. The Guidance Notes advise firms that staff should be discouraged from citing the Money Laundering Regulations as an excuse for not opening an account when a prospective client produces non-standard documents. Employees should rather be guided to give proper consideration to the available evidence and refer the matter to management for advice, if necessary. If a firm concludes that an individual client cannot reasonably meet the standard identification requirement or furnish any of the standard or listed alternative documents it may accept as identification evidence a letter or statement from an appropriate person who knows the individual, that indicates that the person is who he says he is. On the other hand, the Guidance Notes also recognise that the "financially excluded" are not a homogenous category of uniform risk. Some financially excluded persons may represent a higher AML/CFT risk regardless of whether they provide standard or non-standard documents to verify their identity. In this regard firms may wish to consider whether additional KYC information or monitoring of the size and expected volume of transactions would be useful control measures in respect of some financially excluded categories. In other cases, where the available evidence of identity is limited and the firm judges that the individual cannot reasonably be expected to provide more, it should consider instituting enhanced monitoring arrangements over the client's transactions and activity. In addition, the firm should consider whether restrictions should be placed on the client's ability to migrate to other, higher risk products or services.

Conclusion

The initial approach of the UK regulator resulted in unintended and unnecessary barriers to access. Firms indicated that their reluctance to apply their discretion to extend services to clients that lacked the standard identification documents was caused by their fear of the FSA's supervisory approach and enforcement action.

In response, the UK introduced a more flexible system of identification and verification. One of the objectives with the new system is to facilitate access to financial services. The FSA argues that this system will prove more effective to counter money laundering and terrorist financing than a rule-based system. It focuses on risk and requires the firms, which are in the best position to judge their risks, to assess and manage those risks. The system is new and its effectiveness could only be assessed at a future date. However, the UK financial sector reacted very positively to the new regime and there are encouraging signs that the FSA identified key elements of a proportional and effective AML/CFT system.

MONEY SERVICES BUSINESSES IN THE UNITED STATES

This case study explores the impact that AML/CFT regulation has had on the relationship between Money Service Businesses (MSBs) and banks in the United States.

This case study illustrates that:

- The impact of AML/CFT on access is not exclusively a developing country concern
- Regulation may indirectly impact on access by severing the link between banks and the financial service providers serving lower-income groups and migrants. This has been the case with MSBs in the United States.
- The US financial sector regulators are aware of the problem and it has prompted them to issue guidance allowing banks the scope to apply a risk-sensitive categorisation of MSB clients
- However, even with clear guidance, a risk-sensitive approach may incentivise an overly conservative approach by banks
- This illustrates that utilising banks as enforcers of regulation subjects implementation to narrow commercial objectives

Access to financial services is often facilitated through a variety of intermediary organisations. One such category of intermediaries is MSBs, who utilise the banking sector to provide remittance services to (often low-income) immigrant populations. This case study considers the impact that anti-money laundering regulation has had on the relationship between banks and MSBs and, thereby, on the ability of MSBs to operate.

Over the past few years, anti-money laundering regulation has resulted in many US banks closing down MSB accounts due to the perceived risk of such accounts. Only a few still offer banking services to MSBs making it difficult and costly for MSBs to operate. This is the unintended result of regulatory attempts to manage money laundering risk and illustrates the dangers of following a risk-sensitive approach. It furthermore emphasises the possible unintended consequences, should regulation create uncertainty that leads to fear of regulatory sanction or reputational risk.

The following discussion introduces MSBs and the chain of events leading to the current situation. We place particular emphasis on how the federal banking agencies[216] tried to rectify the impact on access by issuing guidance on following a risk-sensitive approach and, importantly, why the guidance did not have the desired effect.

What are MSBs? A money services business is defined by the Financial Crimes Enforcement Network (FinCEN) as any financial service provider: (i) dealing in or exchanging currency; (ii) cashing cheques; (iii) issuing, (iv) selling or redeeming traveller’s cheques, money orders or stored value; or (v) transmitting money. Apart from money transmitters (to which no minimum threshold applies), such providers will only be regarded as MSBs, should they engage in transactions exceeding $1,000 per client per day in any number of transactions (FinCEN, 2005a).

[216] Consisting of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Financial Crimes Enforcement Network, the National Credit Union Administration, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

Money transmitters are an important MSB category: there are in excess of 23,000 licensed and regulated remitters, as well as a further estimated 20,000 informal remittance businesses in the USA operating from convenience stores, restaurants and small shops (Forbes.com, 2005). It is estimated that the 40 MSBs who are members of the National Money Transmitter's Association (NMTA) alone were responsible for $14bn in cross-border remittances in 2004.

MSBs serve predominantly immigrant and lower-income communities. FinCEN notes that MSBs "provide valuable financial services, especially to individuals who may not have ready access to the formal banking sector" (FinCEN, 2005b).

Regulatory set-up. MSBs in the USA are licensed at state level, but are required to register with the Department of the Treasury (represented by FinCEN) at the federal level[217]. MSBs, like other FSPs, are subject to the Bank Secrecy Act (BSA)[218] of 1970 (as amended) and the USA Patriot[219] Act of 2001. Under the BSA, MSBs are required to have an AML programme and, for transactions above certain thresholds, to record and verify clients' identity and address, file CTRs and STRs and keep records (FinCEN, 2006b)[220].

Banks are required to apply due diligence to MSB accounts. MSBs manage the cross-border payment instructions relating to the transaction and receive or pay out cash, but require a bank account to settle transactions and store money. Under banks' BSA requirements, they must apply the following minimum due diligence when opening and maintaining accounts for MSBs (Federal Banking Agencies, 2005b):

- apply the banking organisation's Client Identification Programme;
- confirm FinCEN registration, if required;
- confirm compliance with state or local licensing requirements, if applicable;
- confirm agent status, if applicable and
- conduct a basic Bank Secrecy Act/Anti-Money Laundering risk assessment to determine the level of risk associated with the account and whether further due diligence is necessary.

Banks are uncertain on how to respond to their MSB-related obligations under the BSA and USA Patriot Act as it relates to their relationship with MSBs. This uncertainty is the result of the strict requirements for bank examination purposes (which would tend to classify banks with MSB accounts as "high BSA risk"[221], even though banks may argue that they have applied the basic due diligence as required in the legislation) and, importantly, the illustration of risk when first JP Morgan Chase (in late 2004) and later the Bank of America were prosecuted or threatened with prosecution for holding an account for MSBs suspected to be involved in money laundering. Bank of America subsequently closed all MSB accounts in early 2006, including those of Western Union and MoneyGram. These instances have increased the regulatory pressure on banks.

[217] As Passas (2006) notes, there is no standard regulation of MSBs across states and licensing procedures differ from state to state.
[218] Supervised by the Internal Revenue Service (FinCEN, 2006a).
[219] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act.
[220]Identity should be verified by means of an acceptable identification document for transactions amounting to more than $10,000 (refer to 31 CFR103:22 and 103:28); CTRs are to be filed for cash transaction amounts exceeding $10,000 per client per day (from $3,000 per client per day in the case of traveller's cheques or money order cashing); STRs should be filed for suspicious transactions of more than $2,000 in value; and records are to be kept of money transfers of more than $3,000 per client in any one day, or currency exchanges in excess of $1,000 per client per day.
[221] One of the criteria stipulated in the BSA AML manual for bank examiners in whether a bank should be regarded as posing high BSA/AML risk, is "… a large number of high-risk clients and businesses. These may include check cashers, convenience stores, money transmitters, casas de cambio, import or export companies, offshore corporations, PEPs, NRAs, and foreign individuals. Conducting a significant amount of businesses with "high-risk" geographic locations, is also deemed a high-risk indicator. Remittances, even for legitimate purposes, are often sent to such countries (NMTA, 2006).

To avoid the risk, many banks proceeded to close all MSB accounts. In the words of the Federal Banking Agencies: “money services businesses are losing access to banking services as a result of concern about regulatory scrutiny, the risks presented by money services business accounts, and the costs and burdens associated with maintaining such accounts” (Federal Banking Agencies, 2005a). MSBs have objected to this trend arguing that legitimate businesses are cut off from banking services, thereby denying access to financial services to clients that are not served by the banking sector. These clients are likely to resort to other informal means should they no longer be able to use MSBs (American Banker, 2005; NMTA, 2005a).

A recent World Bank survey of MSBs in the United States (Andreassen, 2006) ranks getting access to, maintaining or opening accounts with banks as the main obstacle experienced by MSBs in their business environment. AML requirements rank fourth: 40% of firms noted AML as one of their main expenses, while 50% reported that it is necessary to hire outside expertise to meet AML standards (Andreassen, 2006).

Federal banking agencies issued guidance to curb the trend. In March 2005 the federal banking agencies convened a fact-finding meeting[222] during which banking institutions made submissions regarding the cost and difficulty of identifying and monitoring MSBs, as well as the increased regulatory and reputational risk that they associate with this duty (FinCEN, 2006a). Following the meeting, the federal banking agencies issued a joint statement (on 30 March 2005) to reiterate the importance of granting access to banking services to law-abiding MSBs. According to the statement, the closing of MSB accounts is due to “a misperception of the requirements of the Bank Secrecy Act and the erroneous view that money services businesses present a uniform and unacceptably high risk of money laundering and other illicit activities”. In April 2005, the federal banking agencies also issued a guidance note with the purpose of addressing the fears that banks were required to act as *de facto* regulators of MSBs and to create clarity as to what is expected of banks in terms of their MSB clients. The guidance note states that “it is essential that banking organisations neither define nor treat all money services businesses as posing the same level of risk”.

Guidance advocates a risk-sensitive approach. According to the guidance, banks must know the business of their MSB clients. This includes:

- the types of products and services offered by MSBs;
- the location(s) and market(s) served by MSBs;
- anticipated account activity; and
- the purpose of the account.

Using this information, banks need to classify their MSB clients as either low or high risk. The guidance also provides examples of risk indicators. Where an MSB is classified as high-risk, enhanced due diligence is required. This may include a review of the MSB’s AML programme, on-site visits, a review of the list of agents and their locations serviced by the MSB account, a review of the written procedures for the operation of the MSB, a review of written employee screening practices for the MSB, etc. These steps are explained in the guidance note to the requirements of the Bank Secrecy Act as the *minimum steps* that banking organisations should take when providing banking services to MSBs.

[222] Jointly hosted by the Non-Bank Financial Institutions and the Examination subcommittees of the Bank Secrecy Act Advisor Group of the Federal Banking Agencies.

Banks not required to close MSB accounts. It is stated that "FinCEN and the Federal Banking Agencies do not expect banking organisations to act as the *de facto* regulators of the money services business industry" (Federal Banking Agencies, 2005b). Furthermore, banks are not required to close the accounts of MSBs that are subject to suspicious transaction reports or of high-risk MSB clients, even if it is found that they are not properly licensed. "The decision to maintain or close an account should be made by a banking organisation's management under standards and guidelines approved by its board of directors" (Federal Banking Agencies, 2005b).

Guidance note did not stem the closing of MSB accounts. In spite of the guidance, there have since been numerous cases of MSB bank accounts being closed. Between mid-2005 (when the guidance was issued) and mid-2006, at least three national banks as well as a number of state banks have ceased to offer banking services to MSBs (House Committee on Financial Services, 2006). The NMTA estimates that 90% of banks do not to accept MSBs as clients any more[223].

Why has the guidance not achieved its goals? The three main reasons quoted are:

i. *Uncertainty created by the risk-sensitive approach.* MSBs have more often than not been classified under a blanket *high-risk* classification, as the guidance has not managed to remove banks' fear of regulatory action or reputational risk. The NMTA ascribes the lack of success of the guidance note to the fact that no clear limits were defined as to the level of due diligence required as "reasonable", or the penalties banks will face. It is argued that the guidance is not specific enough and that words such as "reasonable" or "appropriate" is insufficient to create the right incentives for banks in the absence of clear minimum *and maximum* actions required of banks. Banks are given no sense of security (no guarantee against regulatory action, should they classify some MSBs as lower risk, e.g. based on the fact that they are licensed). Therefore banks still find it less risky to rather close such accounts.
ii. *Cost of enhanced due diligence for high-risk accounts.* Once MSB accounts are classified as high risk, many banks have found the cost of monitoring and managing their relationship with them too high to continue keeping such accounts. Some banks, e.g. the Bank of Florida (as quoted in American Banker, 2005), have informed its MSB clients that it will charge them $975/month to monitor their accounts, in an effort to shift the cost of the requirements onto the MSB clients. Should they be unwilling or unable to afford such monthly fees, the account would need to be closed[224].
iii. *Lack of uniform regulation applied to MSBs at the federal level.* The regulatory scheme governing MSBs is claimed to be problematic. According to the NMTA: "despite its assertion that banks were not [the] *de facto* regulator, the Joint Guidance could not say who was [the] regulator because, at the federal level, [MSBs] have no functional regulator. Despite the assertion that 'zero tolerance' was not being practiced, there was no onus lifted off the banks' shoulders" (NMTA, 2005b). The NMTA therefore advocates MSBs to be regulated at the federal level[225] to provide a federal stamp of approval of the level of AML/CFT compliance, which banks can then accept for opening or maintaining an MSB

[223] The result has been that MSBs need to bulk up more and more cash before depositing it and then need to make use of armoured vehicle services to transit cash, often to another state, where it can be banked. The cost and liquidity implications for the industry have been severe (Landsman, 2006).
[224] Note that this was according to letters sent out by the Bank of Florida to clients in August 2005, to take effect from 1 October 2005 – we have not been able to confirm whether this has, in fact, happened.
[225] By means of voluntary, AML-centric federal certification of MSBs, non-pre-emptive of state licensure, which will be AML-centric (Landsman, 2006).

bank account. This would remove the burden on banks to classify MSBs into a certain risk category and to monitor accounts accordingly (which can be costly).

As a result of continued concerns, there have been further public hearings (e.g. that by the Bachus Subcommittee of the House Committee on Financial Services to Review Effect of BSA on MSBs, on 21 June 2006) to ascertain the extent of the problem and devise strategies to address this. The verdict is however still out on the future of MSBs in the United States.

Conclusion

The impact of AML/CFT on access is not exclusively a developing country concern. The MSB situation in the United States illustrates that not only developing countries grapple with issues surrounding access to financial services. Even highly developed countries with sophisticated legislation drafting processes and well-equipped regulators may introduce regulations with unintended consequences for access.

Even with clear guidance, a risk-sensitive approach may incentivise an overly conservative approach by banks. The case study has shown that, even though banks are allowed to classify MSB clients as high or low risk, their exposure to risk may guide them to opt for the most conservative option. Furthermore, determining risk categories and monitoring high-risk accounts is costly. Where MSBs are classified as high risk, the increased regulatory cost could undermine the profitability to the extent that it is no longer viable for the bank to maintain the relationship. A rule-based system where the state determines the risks and lays down the control measures in terms of clear rules and exemptions (e.g. transaction limits) or clear maximum measures to be taken by banks (e.g. verifying the licence) may prevent this problem. If an approach is followed where banks must determine the risk, rule-based exemptions for clearly-defined categories of low-value, low risk clients and transactions must be made, if this problem is to be avoided.

Utilising banks as enforcers of regulation subjects implementation to narrow commercial objectives. Banks hold different and more narrowly defined (commercial) objectives compared to that of government policy. Where the state utilises banks to implement AML/CFT regulation, this results in a more conservative implementation of regulation, which lacks the temperance of impact achieved by counter-balancing government objectives such as social or market development.

BOX 4. COMPARISON OF APPROACHES: UK AND USA

The above description of the chain of events relating to MSBs in the United States, in light of the discussion of the implementation of a risk-sensitive approach to client due diligence in the UK, begs the question: how do the approaches followed by regulators in the UK and the USA compare and why the different experiences?

In both of these case studies the initial regulatory framework impacted on access. In the UK, the impact was felt on the *individual client level* due to difficulties in identity verification (though flexibility was allowed, the "fear factor" regarding enforcement prevented FSPs from using the scope available to them). In the USA case study, however, the access impact is experienced on the *institutional level* through the lack of access of MSBs to bank accounts. Thiscan then undermine MSBs' viability, which in turn can trickle down to the access of their clients (often immigrants and low-income individuals) to formal sector money transfer services.

Both of the case studies furthermore illustrate how government/regulatory entities realised the system's potential impact on access and acted to adapt the framework so as to rectify the situation. Different approaches were however followed in the two countries:

- In the UK, the FSA streamlined and simplified its AML guidance, essentially replacing it with high-level principles to be upheld by regulated providers. The new set of guidance notes allow a broader range of options for client identification and verification, combined with account restrictions and monitoring to facilitate access where limited identification is possible. *Importantly, the FSA addressed the "fear factor" by stating on record that a risk-sensitive approach means that zero failure is impossible – if a firm therefore misjudges risk, enforcement action would be unlikely as long as it acted reasonably and its decisions were informed by industry guidance and other relevant facts*.

- In the USA, likewise, guidance was issued to state that banks are required to followed a risk-sensitive approach in dealing with MSBs and that no banks are required to close MSB accounts, even if such accounts are found to be high-risk. Yet the desired effect has not been achieved and account closures have continued. This can be ascribed to the fact that, in contrast to the FSA, the federal banking agencies did not remove/reduce the responsibility placed on banks to correctly determine the nature of risk posed by their MSB clients. Therefore the guidance has not managed to remove banks' fear of regulatory action or reputational risk. Secondly, the guidance did not manage to reduce the costs to banks. Whereas in the UK a broader range of documents are now accepted, thereby making the requirements placed on them less onerous, the actions required of banks in the USA are expanded by the guidance: the onus is on banks to monitor MSB client accounts, ascertain the level of risk and manage their relationship with the MSB. Most banks have simply found the additional costs (coupled with the reputational and regulatory risk) too high vis-à-vis the revenue generated from such accounts, to maintain the accounts.

CELL-PHONE BANKING IN THE PHILIPPINES

This case study explores the conflicts arising out of technological innovation and managing AML/CFT risks in compliance with the FATF standards.

This case study illustrates:

- The potential of cell-phone banking (and technological innovation more generally) to extend access to financial services
- The dilemma facing regulators when that which they are regulating evolves quicker than the regulation itself and when non-bank entities such as telecoms companies want to provide services that are essentially banking services.
- That the Philippines have managed to overcome this dilemma through a process of negotiated regulation incorporating identity verification by means of generally available documents, face-to-face origination and, importantly, transaction and account balance limits that were agreed between the regulators and the FSP.
- In this way, money laundering and financing of terrorism risk is minimised (or at least not aggravated), while not undermining access to financial services.

Cell-phone banking in the Philippines has enabled the extension of banking and remittance services to lower-income households previously not served by the formal banking sector. Cell-phones have not only been used as communication device to effect transactions on an existing bank account but also to transform airtime systems into an innovative e-money payment system competing with the services offered by banks. All of this has been achieved in compliance with the AML/CFT regulation. The process through which this technology has been adopted presents an interesting picture of how regulators are dealing with the challenges of rapidly changing technology, harnessing the benefits while managing the risks.

Two cell-phone providers (Globe Telecom and Smart Communications - between them accounting for more than 95% of the cell-phone market – Manila Times, 2006) have introduced two different business models involving different partnerships and with different regulatory characteristics. The evolution of these models alongside the regulatory adjustments required to facilitate this will be the focus of this case study.

The rise of cell-phone banking in the Philippines

Pioneering use of cell-phone technology in low-income market. The Philippines is a pioneer in using cell-phone technology to successfully extend financial services to the poor. More than other developing countries where this technology has been introduced[226], the take-up in the low-income market has been significant. Although at 5m users the take-up is much lower than the total cell-phone population (36m), growth has been fast and there is much potential for expansion.

Advanced assimilation and use of cell-phone technology. The country is considered to be the "texting capital of the world", as its population of almost 89.5m (CIA World Factbook, July 2006 estimate) sends more than 300m SMS[227] messages per day. 43% of the population has mobile phones and up to 95% is estimated to have access to a cell-phone through friends or family

[226] E.g. South Africa, Kenya, Zambia and the DRC.
[227] "Short message service", also commonly referred to as "text message" or "texting".

members (Forbes, 2006b). This is facilitated by the low cost of text messaging and the liquidity of the market for low-cost used handsets (Roman, 2006). The fact that mobile phone penetration is so much higher than the estimated 27% of the population that is “banked” (Scanlon, 2006), illustrates the pro-access potential of mobile technology innovation in the banking sector.

Large migrant population remitting into the Philippines. The Philippines is the fourth largest remittances receiving country in the world (IMF, 2006), with approximately 10m overseas Filipino workers (OFWs) in 2004 remitting an estimated $8.5bn (excluding informal remittances) (Roque, 2005). Cell-phone banking presents a particularly convenient way for migrant workers to remit money home, especially since it can be offered at a fee much lower than traditional alternatives.

Mutual benefit. For the telecoms companies, cell-phone banking has the advantage of creating additional revenue per client (in the form of the additional SMSs sent[228]) and of building client loyalty. Retailers, in turn, benefit by earning transaction revenue. It also serves as a cash management tool and draws additional feet to their outlet (CGAP Focus Note, 2006).

SmartMoney

Smart Communications is the largest mobile phone operator and has a subscriber base of roughly 20 million people. The SmartMoney product was launched in 2000 and now has in excess of 3.5m clients. It is offered in partnership with a large Filipino bank, Banco de Oro and also provides the option to obtain a MasterCard debit card[229]. Essentially the product offers a bank account on which transactions can be effected through a cell-phone.

Extensive features and distribution network. The product combines the full features of a transaction account with access to the account features through the cell-phone. Users can make cash deposits or withdrawals, load airtime, transfer funds to another phone (which, in turn can be cashed in), make bill payments and remit funds back home from abroad. Funds are transferred directly to the recipient’s SmartMoney-Banco de Oro account, and can be cashed at selected outlets, including gas stations, department stores and even McDonald’s (InfoDev, 2006)[230]. The network includes 700,000 agents where airtime can be loaded, and 20,000 agents/retailers where the rest of the transactions can be conducted (Smart CEO, quoted in Infodev, 2006). The wide distribution network[231] is regarded as one of the key contributors to success.

The Smart remittance product, named Smart Padala (“send”), has proven very popular. Only launched in 2004, it is already used by about 1m OFWs (InfoDev, 2006). Smart has partnerships with Travelex and a range of other money remittance agencies and banks in 17 countries abroad. Each of these agencies holds a SmartMoney account in the Philippines. An OFW deposits cash at an office of one of these agencies by completing a Smart Padala cash slip and showing an ID/passport. The recipient’s SmartMoney account[232] held with Banco de Oro in the Philippines is then credited (confirmed by an SMS) and he/she can then visit any of

[228] Both cell-phone banking models in the Philippines work on the basis of SMS-communication.
[229] Should they opt for the debit card, deposits and withdrawals can also be made at ATMs and the card can be used for all normal debit card purposes.
[230] More information on the way in which transactions are made is provided in the Globe discussion (as it is basically the same for the two models).
[231] This is partly the result of the fact that SmartMoney’s banking partner, Banco de Oro, is owned by the largest retailer in the Philippines, whose shopping centres attract in excess of 1m clients per day (CGAP Philippines Savings Assessment, 2005).
[232] Effectively a transfer from the agent’s Philippine SmartMoney account to the recipient’s SmartMoney Account.

the 20,000 outlets to redeem the cash (upon showing an ID)[233]. When cash is redeemed, the client transfers the amount from their SmartMoney-Banco de Oro account to the retailer's SmartMoney-Banco de Oro account by means of an SMS instruction. Therefore the international remittance (from cash paid in to cash paid out) essentially involved two "money transfer" transactions[234].

Fee structure (obtained from InfoDev, 2006). All costs are transaction related. No monthly, admin or opening fees are charged apart from the ongoing annual fee of about $4, should the debit card option be chosen. The following transaction charges apply:

- P2.5 ($0.05) for every client-initiated transaction (inter-account transfers, etc).
- P1 ($0.02 – the standard SMS fee) for retail purchases using the phone; no charge if the card is used.
- 1% of the transaction value for cash deposits or withdrawals through a cashier (accruing to the retailer); free cash deposits using the card.
- P3 ($0.06) for cash withdrawals at a Banco de Oro ATM, and P11 ($0.21) at other ATMs.

G-Cash

Globe Telecom, with its 12m subscribers, launched the G-Cash product towards the end of 2004 and has gained about 1.3m users. The product is not linked to a bank account and creates an e-money payment system competing with the services offered by banks.

More limited distribution network than SmartMoney, but added functionality. G-Cash offers basically the same services and functionality as SmartMoney, but has also teamed up with some organisations (such as utility companies or education organisations) to enable consumers to pay bills via G-Cash. Globe currently has about 400 partners with 3,000 outlets where G-Cash transactions can be made (Globe CEO, quoted in an interview with InfoDev, 2006). G-Cash has furthermore reached an agreement whereby micro-loan clients of banks belonging to the Rural Banker's Association will soon be able to make loan repayments via G-Cash. G-Cash's remittance product can be used to/from 15 countries via Globe's 27 remittance partners' 200 outlets abroad. Unlike SmartMoney, G-Cash does not offer a debit card.

E-money backed by deposit in bank account. Globe's system keeps records of the e-money balances of all its clients. Globe sells e-money to wholesalers (using normal bank transactions to effect payment for the e-money), who in turn sell it to retailers (on the same principle as airtime). The retailer then on-sells the e-money to the consumer in exchange for cash (once again according to the same principle as airtime). For all transactions, authorisation and confirmation are given by means of an SMS. Therefore the instruction to the system to conduct the transaction is sent via SMS, as is communication of the fact that the transaction has been successful. Transactions are settled via the e-money account balances of the clients or retailers/agents on Globe's settlement system, G-Exchange. When clients deposit cash at a retailer, their e-money account will be credited, while the retailer's e-money account will be debited. The sales of e-money by G-Cash is the only actual flow of value[235] (wholesalers and retailers are likely to buy e-money in bulk). G-Cash has deposit accounts with a number of

[233] In stead of redeeming cash, the balance can of course also be used to make a funds transfer or conduct any of the other transactions possible on the SmartMoney account.
[234] More details on the transaction settlement is given in the discussion of the G-Cash remittance product (which works according to the same principle as the Smart product).
[235] That is: this is the only point at which value is transferred from one bank account to the other. For the rest it is all 'accounting' entries on the e-money clearing system (i.e. within the e-money payment system and not within the bank payment system).

banks where the pooled funds that back its e-money accounts are kept and which are used for settlement purposes (CGAP, 2006).

As with Smart an OFW has to visit a G-Cash accredited agent/retailer abroad to conduct an international remittance. The overseas agent has a G-Cash account in the Philippines and buys e-money from Globe. After having shown an identity document/passport, the remitter makes a cash payment to the agent. The agent, in turn, effects a transaction between their G-Cash account in the Philippines and the recipient's G-Cash account. The instruction for the transaction is sent from the agent to G-Exchange via SMS. The G-Exchange system then generates an SMS confirmation sent to the recipient[236]. The net value of transfers is cleared via transfers between the agent's bank account and Globe's bank account. Because the money transfer agent saves on wire transfer expenses and information flows via the SMS system, G-Cash (or Smart) remittances can be offered at a lower fee than traditional wire transfer remittances (Forbes, 2006b).

The following diagram captures the cash, e-money and information flows in the G-Cash model, indicating the flows where (i) a G-Cash transfer is made between clients' G-Cash accounts (top half of the diagram), and (ii) when a cash-related transaction is made at a retailer[237]:

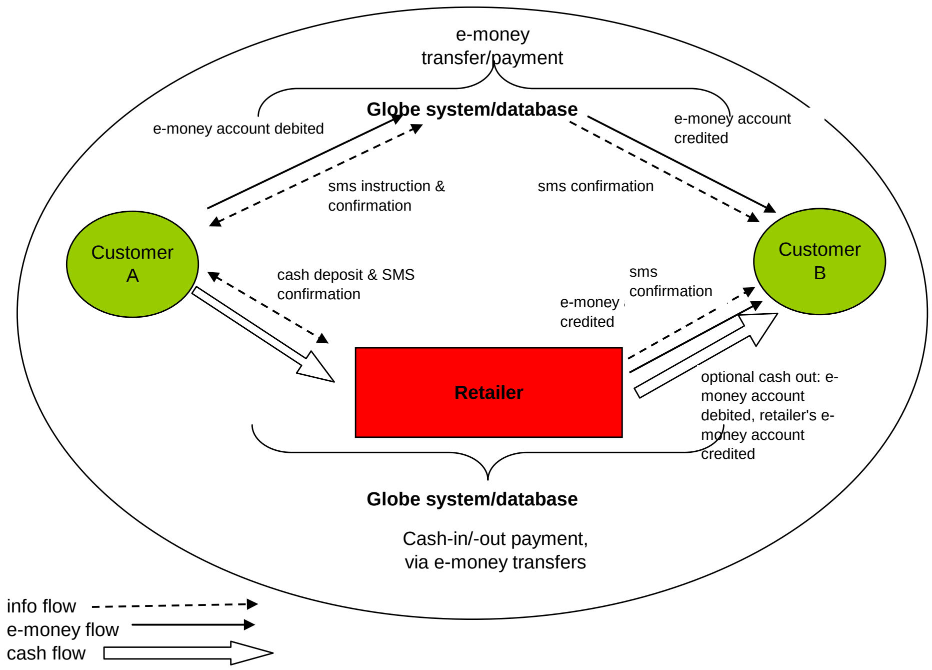

Figure 6 Information, e-money and cash flows/transfers in the Globe G-Cash model.

Source: Genesis Analytics, based on information gathered on the products from various sources.

Fee structure. The retailer receives a transaction fee, which is a flat amount of P10 ($0.19) for each transaction below P1000, and 1% of the value for transactions in excess of P1000 ($19.33). Globe receives only the revenue of the SMSs generated by the transaction (P1, or

[236] This message can include a salutation such as "happy birthday".
[237] Note that the flow of funds between retailers and Globe, in exchange for G-Cash balances, is not indicated on the diagram. An international remittance would entail the same flows as that of the bottom half of the diagram, except that the information flow will be from abroad.

$0.02, per SMS)[238]. The international remittance agent receives a transaction fee that may differ from agent to agent, but is generally lower than the fee charged for a "traditional" wire transfer.

The Filipino AML regime

Joint challenges of AML compliance and facilitating innovation. The development of cell-phone banking in the Philippines coincided with the development of the country's AML/CFT regime. The Philippines was placed on the FATF NCCT list in 2000, to be removed only in 2005. Thus AML and KYC requirements have been a priority to Filipino policy makers and regulators over the past few years. Yet, at the same time, two initiatives heralded as among the most innovative and successful in the mobile commerce scene have been implemented.

The AML Act[239] holds that "covered institutions" (which includes *inter alia* banks and "money changers, money payment, remittance and transfer companies and other similar entities", as which G-Cash is classified) must:

- Establish and record the <u>true identify</u> of their clients "based on official documents"[240]. This duty is detailed in the regulation[241], which lists a number of aspects on which information should be supplied[242], but does not require the information to be verified apart from providing an official photo identity document (e.g. an identity document or passport). Both of these requirements are satisfied by account origination and cash transaction procedures in the SmartMoney and G-Cash models.
- <u>Keep records</u> of all transactions for at least five years.
- Prohibit the opening of accounts without <u>face-to-face contact</u>[243]. Accounts may however be opened by an agent of the "covered institution".
- Report all <u>covered transactions</u> (defined as any cash or "other equivalent monetary instrument" that exceeds 500,000 pesos (roughly $10,000) within one banking day) to the AMLC.
- Report all <u>suspicious transactions</u> to the AMLC. Suspicious transactions are defined as transactions with covered institutions, regardless of the amounts involved, where, among others, the client is not properly identified or the transaction deviates from the client's profile. Therefore the covered transaction threshold does not need to be exceeded for a suspicious transaction report to be generated.
- There are no explicit requirements for <u>account monitoring</u>, though deviations from the clients' profile or past transactions may determine whether a transaction is suspicious, thereby implicitly implying the need for account monitoring.

The regulation of Filipino cell-phone banking

The regulation of Smart and G-Cash is done by BSP (as banking regulator), in cooperation with the AMLC where AML/CFT measures are concerned[244]. As SmartMoney was launched in

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[238] Philippine peso amounts as stated on www.myglobe.com.ph/gcash/. USD equivalents calculated applying the average PHP/USD exchange rate for 2006 to date, as available on www.oanda.com/convert/fxhistory.
[239] AML Act of 2001 (Republic Act no. 9160), as amended in 2003 by Republic Act no. 9194.
[240] Sec. 9a.
[241] According to the "Revised Implementing Rules and Regulations to R.A. no 9160, as amended by R.A. no 9194", issued by BSP in 2003.
[242] Name; date & place of birth; nationality; address; nature of work & name of employer or nature of self-employment; contact numbers; tax identification number, social security system number or government service and insurance system number; specimen signature; source of funds; and names of beneficiaries in case of insurance contracts and whenever applicable (as contained in Rule 9.1c of the Revised Implementing Rules and Regulations).
[243] Rule 9.1.f

partnership with Banco de Oro, its financial regulatory aspects are all handled by Banco de Oro and aligned with its normal KYC and other requirements. Under its normal banking licence, Banco de Oro takes full responsibility for audit, account security, fraud management and other aspects (InfoDev, 2006). The fact that it is not directly affiliated with a bank means that G-Cash is an accountable ("covered") institution under the AML Act (AMLA). As G-Cash posed a unique proposition for which no specific rules existed, Globe had intensive interactions with the BSP and the AMLC before launching the product.

Specific AML requirements on cell-phone accounts. In addition to the general AML requirements, the regulators imposed the following negotiated measures on cell-phone banking accounts*:*

- The AMLC has access to both Smart Communications and Globe Telecom's databases and records to check for suspicious transactions and has instructed them to install electronic monitoring systems to guard against suspicious accounts and transactions (Cabuag & Estayo, 2005)[245].
- Systems must have the capability to detect whether there is one subscriber using several SIM cards, or should more than one cash-in/cash-out transaction take place at more or less the same time using one subscriber name. The systems must therefore be able to track transactions.
- Both products furthermore incorporated transaction limits (negotiated with BSP, not the AMLC) to limit ML/FT risk[246]. In Globe's interactions/negotiation with the regulators, it was agreed that transactions will be capped at P10,000 (approximately $189) each with a maximum of P40,000 per day and P100,000 per month (Roman, 2006). Because of Smart's banking status, its transaction limits are higher: ten transactions per day are allowed to a maximum value of P100,000 (approximately $1,933) (Forbes, 2006a).
- BSP furthermore sets KYC requirements so as to ensure the security and integrity of the system. Both initiatives require face to face origination and that an official identity document be shown (and a form with information on the client be filled out) for cash-related transactions.
- Both systems are furthermore closed loop systems with payments only possible between existing cell-phone subscribers.
- BSP has the powers to investigate KYC and security systems. In this regard, it has established a "Core Information Technology Supervision Unit" (CITSU), which evaluates new products through a series of product presentations and may look at the telecom company's databases to establish whether the necessary security, integrity and confidentiality measures are in place, and that KYC and AML requirements are adhered to (Jimenez & Roman, 2006; Chemonics, 2006).

The success of the negotiated system is ascribed to the open relationship between the BSP and the AMLC and between the regulators and the two companies. In addition the transaction limits minimise the risk of abuse.

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[244] Apart from the AML aspects as regulated by the AML Act, cell-phone banking, as a form of electronic banking, is covered under the Electronic Commerce Act of 2000. The General Banking Law of 2000 also applies to Banco de Oro and hence its partnership with Smart for the SmartMoney initiative. Furthermore, some BSP Circulars have been issued that relate to technology risk management (Circular 511 of 2006) and consumer protection for e-banking (Circular 542 of 2006).

[245] Note that the instruction for SmartMoney and G-Cash to monitor accounts exceeds the requirements place on covered institutions in general by the regulation (as discussed above).

[246] As well as to limit the risk to clients that their money will be lost, should Smart or Globe go bankrupt.

Now that the regulatory framework for cell-phone banking has been established, BSP feels that they are comfortable with the product and any new companies wishing to enter the arena may be accredited by the Association of Banks (after having informed the BSP of their intention).

What can we learn from the way in which AML/CFT was reconciled with cell-phone banking in the Philippines?

The adoption of innovative new technology for the provision of financial services to the low-income market has been facilitated in the Philippines by a regulatory approach which does not aim to constrain the technology, but to manage the relevant risks. In particular, there are five key features of the Philippine market and AML regime which are of interest:

- The financial services providers knew who they wanted to serve. They were explicitly targeting low-income consumers and, hence, they knew that the product needed to be simple and inexpensive. This allowed them to negotiate a regulatory environment to facilitate this.
- Negotiated regulatory implementation. The Philippines regulator was not threatened by the new technology and was willing to enter into negotiations with the providers. This allowed them to gain a thorough understanding of the product features and the nature of the risk involved. The regulations were implemented accordingly.
- Limited verification. The Philippine AML regime does not require verification of address and identity is verified through official documents that are readily available. The absence of verification beyond the ID document reduces the hassle factor and cost significantly (both for the client and for the provider).
- Face-to-face origination. Although the AML regulation insists on face-to-face origination, it allows origination to be done by agents of the FSP. This facilitated the use of retailer and other distribution networks to distribute the product.
- Account restrictions and transaction monitoring. Risks were managed by introducing account restrictions and by implementing systems to monitor the transactions and client profile. The fact that this product is targeted at the lower-income market allowed the setting of fairly low thresholds and restrictions which limit the risk while still allowing the typical transactions to be conducted on this account.

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GLOSSARY

AML/CFT	Anti-money laundering/Combating the financing of terrorism
CDD	Client due diligence
CGAP	Consultative Group to Assist the Poor
DFID	Department for International Development
FinMark Trust	The FinMark Trust is an organisation created in March 2002 in South Africa with funding received from the United Kingdom Department for International Development (DFID). It is an independent trust with the mission of "making financial markets work for the poor". This is achieved through
FIRST Initiative	Financial Sector Reform and Strengthening (FIRST) Initiative
FIRST Initiative Management Unit	This division of the FIRST Initiative is responsible for the technical-assistance project-related activities of the FIRST Initiative.
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSA	Financial Services Authority (UK)
FSP	Financial services provider
FT	Financing of terrorism
KYC	Know Your Client
MFI	Micro-finance Institution
ML	Money laundering
MSB	Money Services Business
MTO	Money transfer operator
Indonesia terms	
BPRs	Second tier, "rural" or peoples banks
CTR	Cash transaction reporting
FKDKP	Communication Forum of Bank Compliance Directors
KTP	Indonesian identity card
PPATK	Pusat Pelaporan dan Analisis Transaksi Keuangan, Indonesian financial intelligence unit.
STRs	Suspicious transactions
TPPU	National Co-ordination Committee on Anti-Money Laundering
Kenya terms	
CBK	Central Bank of Kenya
ESAAMLG	The Eastern and Southern African Anti Money Laundering Group
FOSA	Front office service activities
FRC	Financial Reporting Centre
POSTA	National Post Office of Kenya
ROSCA	Rotating Savings and credit schemes
SACCO	Savings and Credit Co-operatives
Mexico terms	
ABM	Mexican Bankers Association
CNBV	National Banking and Securities Commission

CNSF	Insurance sector regulator
COFEMER	Federal Regulatory Improvement Commission
CONSAR	Pension funds supervisor
IFE	Federal Electoral Institute
LACP	Ley de Ahorro y Credito Popular
SAT	Tax Administration Service
SHCP	Ministry of Finance
SOFOLES	Non-deposit taking specialised credit institutions
UIF	Unidad de Inteligencia Financiera (Financial Intelligence Unit)
Pakistan terms	
APG	Asia/Pacific Group on Money Laundering
ANF	Anti-Narcotics Force
BBA	Basic Bank Account
CDNS	Central Directorate of National Savings
CNIC	Computerised National Identity Card
NAB	National Accountability Bureau
NADRA	National Database and Registration Authority
NSS	National Savings Scheme
NWFP	North West Frontier Province
OPF	Overseas Pakistanis Foundation
SBP	State Bank of Pakistan
South African terms	
CMA	Common Monetary Area
FSB	Financial Services Board
FSC	Financial Sector Charter
FIC	Financial Intelligence Centre
FICA	Financial Intelligence Centre Act, 2001
NCR	National Credit Regulator
POCA	Prevention of Organised Crime Act, 1998
PCDTARA	Protection of Constitutional Democracy against Terrorist and Related Activities Act, 2004
SADC	Southern African Development Community
SARB	South African Reserve Bank
Case Study Terms	
CIV	Client verification and identification
FSA	Financial Services Authority of the United Kingdom
MSB	Money Service Business
NMTA	National Money Transmitters Association in the United States

MEETING LISTS

SOUTH AFRICA

Organisation	Persons met
National Treasury	Raadhika Sookoo, Jonathan Dixon
South African Reserve Bank	Micheal Blackbeard (Deputy Registrar of Banks: Support, Bank Supervision Department), Wilfred Lautenberg (Assistant General Manager, Bank Supervision Department)
Financial Intelligence Centre (FIC)	Adv. Pieter Smit (Legal), Ursula McCrystal (Forensic and Risk)
Banking Association of South Africa	Stuart Grobler
Standard Bank	Gideon Serfontein (Director: Operational Risk Services), Nadio Hoff (Compliance Officer)
Standard Bank	Saanjeev Orie (Senior Manager: Low Income Products), Gary Austin, Manager: Compliance and Operational Risk, Banking Products Group)
ABSA	Roy Melnick (Forensic and AML),
ABSA	André Snyman (ABSA Capital, Regional Head: Indian Sub-Continent, Asia Pacific and Latin America), Haroon Ravat (ABSA Capital, Regional Head: Middle East and North Africa)
ABSA	Dave Liebenberg (Flexi-Banking Services: Delivery and Distribution)
Firstrand Group	Linidiwe Zikhali-Ngobese (Group Money Laundering Control Officer)
Nedbank	André Wentzel (Nedbank Group Regulatory Risk Services)
Nedbank	Alfred Ramesedi (Middle Market)
Capitec	Jan-Hendrik de Beer (Compliance Officer)
African Bank	Charles Chemel (Formerly with Banking Association of South Africa)
Teba Bank	Thabo Moorisi (Chief Compliance Officer)
Wizzit Bank	Terry Kilpatrick (Chief Compliance Officer), Kevin Bingham (Bank of Athens, Compliance Officer), Kevin Smith (Consultant)
Post Bank	Isaac Kgaphola (Manager: Compliance)
Rennies Bank (renamed Bidvest Bank)	Erica Gibbons (Compliance Officer)
MoneyGram International Limited	George C. Pearson (Regional Compliance Officer, Middle East and Africa), Nikki Spottiswoode (Marketing Manager Middle East and Africa)
KPMG	Kevin West (Director: Forensic), Manet Basson (Manager, Financial Advisory Services: Forensic)
Compliance Risk & Resources (Pty) Ltd	John Symington (Compliance Consultant)

KENYA

Organisation	Persons met
Afripayments	Caroline Cherotich (Director)
Amal Group of Companies	Mohamed A. Waldo (Consultant)
Central Bank of Kenya	Cassian J. Nyanjwa (Assistant Director, Bank Supervision) Daniel K. A. Tallam (Manager Alternative Financial Services/Microfinance, Bank Supervision) James O. Manyonge (Legal Officer, Financial Institutions Supervision) G.Omino (Assitant Director, Treasury) Rebecca K. Obare (Policy Analyst, Financial Institutions Supervision - also on the AML task force) Steve Mwaura (Payment Systems)
CFC Bank	Lawson Naibo (Internal Audit Head)
Commercial Bank of Africa	Phillip K. Ole Perrio (Manager - Security Services, Audit and Security)
Co-operative Bank	Jared Obong'o (Compliance Manager) Francis Ngambi (Marketing)
DFID	David Ferrand (Technical Manager FSD)
Equity Bank	Julius Turuchiu (Security Officer)
	Papius Muhindi (Head of Risk Management)
	Major (Rtd) Marcus Mutua (Head of Security and Administration)
ESAAMLG	Wayne Blackburn (UN Mentor ESAAMLG)
Financial and Legal Sector Technical Assistance Project (FLSTAP)	Bob Porter
Genesis Analytics	Richard Ketley (Director)
Harambee SACCO	John O. Odima (Principal Loans Officer)
Independent Consultant	John Kashangaki
Independent Consultant	Andrew Lovegrove
Kenya Bankers Association	J.K. Wanyela (Executive Director)
Kenya Commercial Bank	John Ndegwa (Senior Manager, Compliance) David Korir (Fraud Investigator)
K-Rep Bank	Michael K. Mutisya (Support Manager) Antony Wamatu (Internal Auditor) Annabelle W. Mugo (Management Trainee) Fredrick O. Nyasaka (Internal Auditor)
Ministry of Finance, Government of Kenya	Henry K. Rotich (Economic Affairs Department) Barrack O. Amollo (Under Secretary and Head of the AML Task Force) Hellen A. Olima (Senior Insurance Officer)
National Bank	George Mutua (GM, Operations and Business Development) Steve Ndile (GM, Audit and Security) Philip K. Bor (Manager, Corporate Banking and Custody Services)
National Registrar of Persons, Government of Kenya	Kisabuli Mumia (Senior Assistant to Principle Registrar of Persons)
NIC Bank	Patrick N. Mwaniki (Head of Internal Audit)
POSTA Kenya	Enock O. Kinara (Product Manager Financial & Agency Services)
Kenya Post Office Savings Bank	A. Nyambura Koigi (MD)
Standard Chartered	Walter Mungai (Head of Operational Risk Assurance, East Africa)
UNDP	Abdusalam Omer

PAKISTAN

Organisation	Persons met
Bank Alfalah Limited	Falak Sher (Chief Compliance Officer) Syed Habib Mustafain (Relationship Manager)
BMA Capital	Ahsan Javed Chisty (VP & Chief Economist Equities)
Canadian High Commission	Francois P. Dupuis (First Secretary Development) Yasin Janjua (Development Economist)
Citigroup International	Zubyr Soomro (MD) Yawer Shameem (VP & Country Compliance Officer) Saleem Merchant (VP)
Dubai Islamic Bank	Syed Liaquat Ali (Chief Internal Auditor)
Habib Bank	Mudassir H. Khan (Senior VP & Chief Compliance Officer) Jamil Iqbal (Senior Executive VP) Nadeem Ahmad (Executuve VP and Head Regulatory/Operations Compliance Division)
Habib Bank Asset Management	Shahid Ghaffar (CEO)
Independent Consultant	Sadia Khan
Inter-American Dialogue	Dr Manual Orozco (Senior Associate)
KASB Bank	Muneer Kamal (President & CEO)
Khanani & Kalia International (exchange company)	Naeem Butt (Head of Operation)
Khushali Bank	Ghalib Nishtar (President)
Ministry of Finance, Government of Pakistan	Nazrat Bashir (Joint Secretary)
National Accountability Bureau, Government of Pakistan	Omer Bin Zia (Deputy Director) Lt. Col Aftab Haseeb (Additional Director)
National Bank of Pakistan	Muhammad Rafique (Senior VP) Khalid Mahmood (Senior VP)
National Database and Registration Authority	Brig (Retd.) Saleem Ahmed Moeen (Chairman) Brig Aleem M. Ahmad (Member & DG Projects) Syed Shayan Kamaal (Project Director, PS Directorate)
NBP Exchange Company	Muhammad Naeemuddin (MD)
Overseas Pakistanis Foundation	Mohammed Yar Bhutter (Director)
Pakistan Microfinance Network	Syed Mohsin Ahmed (GM) Moazzam Iqbal (Manager-MIS & Administration) Mehr Shah (Capacity Building Specialist)
Pakistan Postal Services	Fazli Sattar Khan (Deputy Director General & Secretary Board)
Securities Exchange Commission of Pakistan	Razi-ur-Rahman Khan (Chairman) Amber Darr (Executive Director - Law) Muhammad Ashraf Tiwana (Joint Director - Law) Shafaat Ahmad (Executive Director) Hasnat Ahmad (Joint Director) Ahmed Qadir (Deputy Director)
State Bank of Pakistan, Agricultural Credit Department	Saleem Ullah (Director)
State Bank of Pakistan, Banking Inspection Department	Amer Aziz (Director)
State Bank of Pakistan, Banking Poilcy Department	Inayat Hussain (Senior Joint Director) Syed Mansoor Ali (Joint Director)
State Bank of Pakistan, Exchange Policy Department	Azhar Kureshi (Director) Syed Samar Hasnain (Senior Joint Director) Najm-us-Saqib Shabbir (Joint Director) Muhammad Akmal (Joint Director)
Tameer Micro Finance Bank	Nadeem Hussain (President & CEO)
The World Bank	Isfandyar Zaman Khan (Specialist Finance and Private Sector Development, South Asia)
UNDP	Faiza Effendi (Assistant Resident Representative/Chief, Poverty Reduction & Gender Unit)
Union Bank	Shaukat Tarin (President and Group CEO) Waqar A. Khan (Executive VP & Head of Compliance) Sami Ahmed Siddiqui (Country Compliance Manager)

Organisation	Persons met
United Bank	Bahauddin Khan (Group Executive Operations and Business Support) Ahmed Hafeez (Group Head Business Development and Strategic Initiatives) Muhammad Ejazuddin (SEVP/Group Executive Audit and Inspection) Najeeb Agrawalla (Executive VP, Business Head - Commercial Bank)
Zarco Exchange Company	Syed Zamir Haider (MD)

INDONESIA

Organisation	Persons met
CEMFIOWS (Centre for Microfinance and Indonesian Overseas Workers Studies)	Dr Dipo Alam (Chairman)
PPATK: representatives from legal and compliance departments	Nella Hendriyetty, Evi, Rasyid, Fithriadi, Ivan
BCA: international remittances division	Eva Sumampouw (Division Head, International Payments), Haryanto Tanudjaja (Senior Manager, International Payment Specialist)
Bank Indonesia: Banking Research & Regulation Directorate Bank Supervision Departments & Payment System Directorate	Betty Parinussa (Executive Researcher, Banking Research and Regulation Bureau), Antonius Moerdianto, Ny Yulia Usmanij, Ida Nuryanti and 4 others, as well as Patricius Randa,(Head of Department, Compliance Desk, BRI)
Attorney General's Office	Thomson Siagian (Head of Transnational Crime & AML Task Force) and Yusfidli (also part of task force, as well as International Legal Cooperation).
Depkominfo (Department of Communication and Information Technology)	Cahyana Ahmadjayadi (DG for ICT Applications); Lolly Amalia Abdullah (Director for Information System, Software & Content); Muhammed Neil El Himam (Section Head, Software Program)
McKinsey Jakarta Office (ad hoc short meeting)	Larry Burger (Head)
IMF, Jakarta Office	Armando Morales (Resident Representative)
Bank Indonesia: Directorate of rural bank supervision	Libraliana Badilangoe (Executive Bank Analyst – took the lead); Nugroho (Assistant Manager, Rural Bank Licensing, Research and Regulation Division); Ayahandaani Kussetyowati (Bank Analyst).
Financial Sector Volunteer Corps	Ms Dian Adhitama
PPATK	Dr Yunus Husein (Head), Djoko Kurnijanto (International Relation Officer), Susno Duadji (Deputy Head), Dr I Gde Sadguna (Deputy Head), Tri Priyo (Director of Inter-Agency Cooperation)
Nitra Dana Utama (a large BPR)	Suherman & Soebroto Gondo (Directors), as well as their supervisor [BPR regulator] from Bank Indonesia
World Bank Jakarta Office	Chitra Buchori and team (Social Development Team); Yoko Doi and Djauhari Sitorus (Financial Development team)
Coordinating Ministry of Econ affairs (DC & LdK)	Dr Mohamad Ikhsan (Deputy Minister, as well as director from the Institute for Economics at the University of Jakarta)
Bank Indonesia	Mrs Murniastuti (Head of Banking Research and Regulation Bureau), Rosalia (Senior Analyst/Researcher)
PPSW	Endang Sulfiana
BNI	Tonny Indartono (Senior Vice President & Division Head, International Division); Dr I Supomo (Managing Director), Herry Trianto (Head of Financial Institutions), Pieter Siadari (Deputy General Manager)
Citibank	Tjit Siat Fun (Assistant Vice President & Senior Compliance Officer); Nirah Wiryoatmodjo (Compliance Director)
Bapepam-LK	Dr A Fuad Rahmany (Chairman) and Gonthor Azis (Head of international affairs and public relation division)
Financial Crime Prevention Project (USAID sponsored, located in the PPATK)	Ken Lawson and Hezti Oktivianti Dewi
Donor meeting (IMF, World Bank, AusAID - ADB and USAID could not attend)	Stephen Schwartz (IMF country representative); Djauhari Sitorus (World Bank); Jivan Sekhon (Second secretary: governance, AusAID)
Bank Mandiri	Mr Bambang Setiawan (MD); Mrs Mustaslimah (Group Head of Compliance); Himawan Subiantoro (Department Head of Compliance)
Ali Budiardjo, Nugroho, Reksodiputro Counsellors at Law	Gregory Churchill
Federation of Indonesian Associations of Banks	Bambang Setijoprodjo (Chairman) and other members
Bank Central Asia	Edmund Tondobala (Deputy Division Head, International Banking Division); Arif Singgih (Senior Advisor); Yonatan Hermanto (Head of Internal Legal Counsel and Compliance); Rustiningsih Singgih (Head of International Business Solution); Subur Tan (Director)

Organisation	Persons met
World Bank Jakarta Office	P.S. Srinivas & Yoko Doi
BRI (Bank Rakyat Indonesia)	Dede Suherman (General Manager, Compliance Desk); Bambang Spoepeno (Managing Director)
Ministry of Manpower and Transmigration	Mrs Lisna Yoeliani Poeloengan (Director of Indonesian Overseas Workers Empowerment) and 2 colleagues
Bank Mega	Adhiputra Tanoyo (Senior Vice President, Risk Management Head)
Bank Swadesi	Wikan Aryono (Director); L.G. Ropas (Commissioner); Suroso (Director); Lisawati (President Director)
BRI Unit	Office staff, accompanied by Mr Dede Suherman from head office
FKDKP (Forum for Compliance Directors)	Mr Bambang Setijoprodjo (Chairman, Bank Ekspor Indonesia); Mr Tutwuri Anggarwani (Bank Ekspor Indonesia); Ms Anika Faisal (Secretary of FKDKP, Compliance Director of Bank Danamon), Ms Lucy Susiana Noor (Bank Danamon); Mr Rendi Hellianto (Permata Bank) and others
Bank Danamon	Ms Anika Faisal (Compliance Director) and Ms Lucy Susiana Noor
Bank Niaga	Mr C Heru Budiargo (Executive Director Compliance & Human Resources); Ms Ismiantari Soerjadi (Assistant Vice President, Compliance Management Group)
Pos Indonesia	Arief Supriyono (Direk Bisnis jasa Keuangan); San Herib (Direktur Bisnis Komunikasi); Soebandi (Direktur Bisnis Kurir/Operasi) and other colleagues
PPATK feedback meeting	Dr Yunus Husein (Head); Mr Garda Paripurna

MEXICO

Organisation	Persons met
Mexican Bankers' Association	Héctor Hernandez Gatica (Compliance)
Banamex	Héctor Hernandez Gatica (Compliance and AML Director) and Guillermo Horta Montes (Anti-money laundering head)
Secretaría de Economica (Microfinanzas)	Héctor Díaz Escobar Figueroa; C.P. Jorge Charles Creel (Consultor de Apoyos Financieros)
Secretaría de Hacienda y Crédito Público (SHCP)	Guillermo Zamarripa Escamilla (Head of Banking and Savings Directorate)
BANSEFI	David Estefan G. (Director of Technical Coordination)
Centro de Estudios Monetarios Latinoamericanos (CEMLA)	Kenneth G. Coates (Director General), Corina Artech Serra (Credit Information Systems Coordinador), René Maldonado (Coordinador), Ana Laura Sibaja Jiménez (Western Hemisphere Payments and Securities Settlement Forum Coordinator)
Comisión Nacional de Seguros y Fianzas (CNSF)	Luis Eduardo Iturriaga Velasco (Director General Juridico Consultivo, de Contratación, Intermediarios y Coordinación Regional
Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros	Marco Carrera Santa Cruz (Director of Market Studies)
Federal Regulatory Improvement Commission (COFFEMER)	Gustavo Adolfo Bello Martínez (Senior Regulatory Policy Officer), Eduardo Esteban Romore Fong (Director of Special Studies
HSBC	Leopoldo Rodríguez Barosa (Compliance Officer?)
Kroll	Karla Sotomayor Romano (Associate Managing Director)
Banco de México	Guillermo Giiémez Garcio (Deputy-governor), Eduardo A. Gómez Alcázar (Manager of Financial System Provisions)
Mexico Country Office, World Bank	Anna Wellenstein
Institute for Mexicans Abroad	Carlos González Gutiérrez (Executive Director), Luisa Medina Mora
Planet Finance	Pedro Valdez (Deputy Director for Development)
FinComún	Martha Pastelin Palacios (Director of Operations)
Unidad de Inteligencia Financiera (UFI)	Concepción Patiño Cestafe (Head of Unit)
Banco Compartamos	Lizette Escamilla Miranda (Compliance officer)
Asociacion Mexicana Casas de Cambio	Salvador Arroyo
Servicio de Administración Tributaria (SAT)	Paulina Morfin (SAT), Luis Naranjof (SAT), María Elena Plata (AML Compliance Director, Western Union), German Valdés Sánchez (Team Leader, Foreign Exchange Services, Ammerican Express), José Ramón Bordes Abascal (Compliance Director Mexico, American Express)
BANSEFI	Aarón Silva
Asociación Nacional de Centros Cambiarios y Transmisores de Dinero	José Carlos Armenta Fong (General Manager), Carmen Guerrero Hernández (Legal advisor)
Santander	Francisco Javier Lorenxo Muradas (General Director, Commercial Banking)
Tecnológico de Monterrey	Dr. Mauricio de la Maza Ambell (Director of Masters in Finance)
Comision Nacional Bancaria y de Valores (CNBV)	Pablo Gomez del Campo Gurza (Director of Prevention of Illicit Operations), Andres Colmenero Becerril (Development of Systems for Prevention of Illicit Operations), Mario A. Bolaños Michelena (Development of Systems for Prevention of Illicit Operations)
Finsol	Jorge Aguirre Bauer (Assistant Director of Risk Control)
Banco Azteca	Alejandro Vargas Durán, Fernando Torres Ramírez