CGAP Brief
April 2006

AML/CFT Regulations: Balancing Security with Access

Across the world, new measures are being introduced to combat money laundering and the financing of terrorism. Once the concern primarily of banks, governments have expanded regulations and requirements for compliance since the late 1990s. Now all financial service providers, including those working with low-income communities, are—or will—be affected.[1] As a result, the new international framework and national measures for anti-money laundering (AML) and combating the financing of terrorism (CFT) could have far-reaching effects.

What are the regulations?

The Financial Action Task Force (FATF) is an international body that recommends standards for national regulation on AML/CFT.[2] Currently, there are 40 FATF recommendations on anti-money laundering and 9 special recommendations on combating the financing of terrorism.[3] While each country may adapt the international AML/CFT standards developed by FATF in designing its national regulation, in general, financial service providers are required to do the following:

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

What is the concern?

The introduction of new or tightened AML/CFT regulations may have the unintended consequence of reducing the access of low-income people to formal financial services. Besides the additional costs of compliance to financial service providers, standard customer due diligence rules may be difficult to apply for typical microfinance clients, especially in countries that have weak national identification systems. For example, it may be impossible to verify the physical addresses of clients who share living quarters or have no utility bill, land title, rental agreement, or other legal proof of residence. Serving such clients may become too burdensome for many financial service providers.

How to balance access and security?

Regulators and financial service providers serving low-income clients need to work together to strike a careful balance between meeting law enforcement objectives of AML/CFT regulation and serving client needs.

Gradually implement regulations. Country regulators should tailor AML/CFT regulations to their country context and gradually implement the new regulations to give institutions time to adapt their internal procedures and minimize disruptions for their clients.

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

[2] FATF and so-called FATF-style regional bodies perform evaluations of countries' AML/CFT regulatory regimes and enforcement activities to assess their level of consistency with FATF's recommendations. An unfavorable assessment can have a serious adverse impact on a country's reputation within the global financial system.

[3] FATF 40 Recommendations on AML can be found at www.fatf-gafi.org/dataoecd/38/47/34030579.PDF and 9 Special Recommendations on CFT can be found at www.fatf-gafi.org/document/9/0,2340,en_32250379_32236920_34032073_1_1_1_1,00.html

Take a risk-based approach for appropriate exemptions. AML/CFT risks of financial service providers vary by country, institutional type, and financial services provided. In certain circumstances, where there are low risks, countries may decide that financial institutions can apply reduced or simplified measures.

- Product or institutional exemptions: Credit and insurance services may be less vulnerable to abuse, while international money transfers and deposits may carry relatively higher risk. For example, countries could exempt non-depository institutions that offer low-risk financial products and have no direct link to the payments system.
- Minimum transaction thresholds: Small-balance transactions may also carry lower risk. FATF recommendations recognize governments' discretion to exempt low-value transactions that fall below a certain threshold from AML/CFT requirements.

South Africa and the United Kingdom provide good examples of how a country's AML/CFT regulations can be modified to take into account better the situation of low-income clients.

In South Africa, low-income clients often have no tax registration number and cannot produce third-party address verification. South African authorities have now adopted a more flexible approach to client identification and verification and introduced a compliance exemption that relaxes requirements for "mass banking clients"—those clients with small balances and small size transactions. After this exemption, the four largest banks and the South African post office launched the so-called Mzansi account in late 2004. Impossible to offer before the exemptions, the Mzansi account has proven very successful, with more than 1.6 million previously unserved clients opening a basic transaction account. A uniform threshold exemption established in their country's AML/CFT regulation frees financial institutions from having to make the judgment call themselves, and as the South African experience shows, this can reduce real and perceived obstacles to serving low-income clients.

In the UK, the Financial Services Authority (FSA), banks, law enforcement, and consumer groups studied the issue and agreed to accept only one proof of a customer's address from a wider range of documents. Further, FSA and bank associations provide guidance on compliance to institutions subject to AML/CFT regulation, to reduce the likelihood that financial service providers might spurn low-income clients out of uncertainty as to their regulatory obligations.

Conclusions

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

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References

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For more information on anti-money laundering and combating the financing of terrorism …

Visit www.cgap.org to access relevant material, including "AML/CFT Regulation: Implications for Financial Service Providers That Serve Low-Income People," by Jennifer Isern, et al. Focus Note 29, 2005.