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Developing and Implementing AML/CFT Measures using a Risk-Based Approach for New Payments Products and Services¹

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ABSTRACT

The use of new payment methods by the previously unbanked or underbanked holds out much hope for improved financial inclusion and consequently improved standards of living. It is important that new payment methods that enhance financial inclusion not be weighed down by overly burdensome regulation due to financial integrity concerns.

The Financial Action Taskforce (FATF), the global standards setting body for Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT), continues to work toward the objective of aligning financial integrity and financial inclusion objectives. To this end, FATF encourages countries and institutions to adopt proportionate regulations for AML/CFT purposes by providing greater clarity and understanding on the use of a risk-based approach to implementing AML/CFT measures for new payment methods.

Developing and implementing AML/CFT measures using a risk-based approach for new payment methods is still in the early stages of development. Countries and institutions need to be supported to be confident to embrace international efforts on proportional regulation and not be unduly conservative.

This paper analyses and explains FATF's Risk-Based Approach (RBA) for new payment methods to support countries and institutions in their efforts to use a RBA to improve financial inclusion.

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SECTION ONE – INTRODUCTION AND BACKGROUND

1.1. Objectives

This paper provides assistance to regulators to understand and use FATF’s RBA for new payment methods. It also highlights the possible unintended consequences of a RBA, and emphasises the need for applying a RBA in an appropriate way. A RBA should not be perceived as a panacea for all ML/TF risk as a RBA itself may give rise to unintended consequences, such as creating new ML/TF risk, introducing other forms of risk and possibly dampening innovation. Regulators and institutions will need to maintain perspective when applying a RBA to implementing AML/CFT measures. We hope this paper assists them in doing so.

1.2. Aligning Financial Inclusion and Financial Integrity

A number of international efforts have, in recent years, focussed on assisting developing countries to pursue the goals of financial inclusion and financial integrity in tandem and to see the goals as complementary. These efforts seek to avoid financial integrity regulatory measures being unduly burdensome on the end-users of financial services so as to promote greater financial inclusion. Without such efforts, financial inclusion may not be able to continue on an upward trajectory; the financially excluded may remain so.

International efforts directed towards pursuing the goals of financial inclusion and financial integrity in tandem are crucial because developing countries have felt ‘behind the eight ball’ when it comes to addressing ML/FT risks. This is not surprising given developed countries find it difficult to simultaneously get a handle on ML/FT issues and promote economic growth especially with the current rapid rates of technological change.²³

Cooperation facilitated by international fora will continue to help shape guidelines and international standards for AML/CFT. Forums include those provided by the Alliance for Financial Inclusion and the Global Partnership for Financial Inclusion as well as efforts being driven by Queen Maxima of the Netherlands as the UN Secretary General’s Special Advocate for Inclusive Finance for Development.

² Jane K Winn and Louis de Koker, ‘Introduction to Mobile Money in Developing Countries: Financial Inclusion and Financial Integrity Conference Special Issue’ (2013) 8(3) *Washington Journal of Law, Technology and Arts* 155, 156.

³ Note, for example, the case of Australia – a long term advocate for the effective implementation of the FATF AML/CFT standards, a founding member of FATF and a member and permanent co-chair of the APG on Money Laundering. Following the release of the FATF Recommendations in 2012 which clarified existing Consumer Due Diligence (CDD) obligations, Australia has been considering the implications of these revised standards, particularly as they related to CDD obligations as Australia has been identified as not meeting the standards in this area; see Australian Transaction Reports and Analysis Centre, ‘Consideration of Possible Enhancements to the Requirements for Customer Due Diligence (Discussion Paper, May 2013).

One key example of international cooperation is *The Financial Action Task Force (FATF) Guidance on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion (2011)*; prepared in response to the G20 Principles for Innovative Financial Inclusion issued in 2010, and in conjunction with the World Bank and the Asia-Pacific Group on Money Laundering.⁴ This 2011 guidance paper supports countries and institutions in designing AML/CFT measures to comply with the *FATF Recommendations* (international standards on combatting money laundering and the financing of terrorism) and incorporates the idea of the dual goals of financial inclusion and financial integrity.⁵

1.3. Development of a Risk-Based Approach

FATF's 2001 guidance paper was updated in February 2013 to incorporate the updated *FATF Recommendations*, which were revised in 2012 to emphasise the use of a Risk-Based Approach (RBA) as the underlying principle for all AML/CFT systems.

A RBA involves using reduced or simplified Consumer Due Diligence (CDD) for lower-risk products or an exemption from CDD measures in specific instances of proven low ML/TF risk. A RBA is in line with the "proportionality principle" promoted in the G20 Principles for Innovative Financial Inclusion which means achieving "the right balance between risks and benefits by tailoring regulation to mitigate the risk of the product without imposing an undue regulatory burden that could stifle innovation."⁶ A RBA is seen as critical for countries building more inclusive formal financial systems and increasing financial access for the unbanked and underbanked.⁷

⁴ The Asia Pacific Group on Money Laundering (APG) is a FATF-style regional body housed by the Australian Federal Police in Sydney.

⁵ Louis de Koker (2013) provides an overview of the pre-2012 position of FATF and the events which led to greater emphasis being placed on financial inclusion alongside the financial integrity measures for AML/CFT, see "The 2012 Revised FATF Recommendations: Assessing and Mitigating Mobile Money Integrity Risks Within The New Standards Framework", Washington Journal of Law, Technology & Arts, Volume 8, Issue 3 Mobile Money Symposium 2013, p167.

⁶ FATF, 'Guidance for a Risk-Based Approach: Prepaid Cards, Mobile Payments and Internet-Based Payment Services' (Guidance Paper, FATF, June 2013). Also see G20 Principle 8 on Proportionality: Build a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation.

⁷ The Alliance for Financial Inclusion members created the Financial Integrity Working Group (FINTWG) in September 2010 to provide a platform on which to focus on issues of balance financial integrity with financial inclusion. In April 2013, AFI issued a Guidance Note developed by FINTWG for regulators on the risk based approach to AML/CFT for balancing integrity and inclusion: FINTWG, 'Risk-Based Approaches to AML/CFT: Balancing Financial Integrity and Inclusion' (Guidance Note, AFI, 16 May 2013) <<http://www.afi-global.org/library/publications/risk-based-approaches-amlcft-balancing-financial-integrity-and-inclusion>>.

1.4. The Risk-Based Approach for New Payment Methods

In June 2013, FATF issued a guidance paper specifically focused on understanding how to apply a RBA when implementing AML/CFT measures for new payment methods - *FATF's Guidance for a Risk-Based Approach to implementing AML/CFT measures for Prepaid Cards, Mobile Payments and Internet-Based Payment Services, June 2013*.⁸ These new payment methods are referred to collectively by FATF as New Payment Products and Services (NPPS). The extent to which NPPS are being relied on by many government and non-government organisations in developing countries to drive greater financial inclusion, means it is critical that regulations, such as AML/CFT measures, support NPPS.

The June 2013 FATF guidance paper provides details on how to apply the risk assessment and risk mitigation processes, which underpin a RBA, for NPPS and how to undertake the regulation and supervision of entities involved in the provision of NPPS. FATF uses this guidance paper to encourage the application of simplified CDD for NPPS which are specifically aimed at promoting financial inclusion.

1.5. Getting the Level of Regulation Right – Finding that Balance

The June 2013 guidance paper assists regulators and institutions to make better judgements as to the level of CDD required in order to mitigate ML/TF risk and comply with international standards. It does this by emphasising the importance of conducting risk assessments and risk mitigation processes during the design phase of new payment methods and not just retrospectively, as well as emphasising the importance of avoiding the 'one-size-fits-all' approach to implementing AML/CFT measures.

The June 2013 guidance paper can also better equip regulators to identify institutions that are being unnecessarily conservative in interpreting international standards. The recent case of Dahabshiil has highlighted the implications of financial institutions adopting overly conservative interpretations of AML/CFT measures or what are perceived as overly conservative interpretations; the need for financial institutions to address overly conservative interpretations of regulations was put at centre stage by Mark Goldring, CEO of Oxfam, when he referred to the "failed state of anti-terror banking rules".⁹

⁸ The FATF Paper 'Guidance for a Risk-Based Approach: Prepaid Cards, Mobile Payments and Internet-Based Payment Services' (June 2013) reiterates a great deal of the content of the FATF Guidance Paper, 'Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion' (February 2013) but with an emphasis on applying a RBA to NPPS.

⁹ PR Newswire, 'Dahabshiil Wins Injunction against Barclays' (News Release, 5 November 2013) <<http://www.prnewswire.com/news-releases/dahabshiil-wins-injunction-against-barclays-230688421.html>>, *Dahabshiil Transfer Services v Barclays Bank* [2013] EWHC 3379 (Ch).

1.6. Structure of Paper

The paper is structured as follows:

- Section One, this section, outlines the objectives of this paper and the background behind the development of a RBA for new payment methods.
- Section Two assesses whether FATF's June 2013 guidance paper for NPPS meets calls from regulators and industry bodies for guidance on how to implement the FATF Recommendations in terms of embracing financial inclusion and innovation and remaining confident of positive FATF mutual evaluations.
- Section Three highlights that the process of applying a RBA to implementing AML/CFT measures is still a process in its early stages of development and many issues, or "side-effects", from this process need to be kept in mind and placed in perspective. These issues include:
 - o acknowledging and managing the ML/TF risk which remains as a result of financial exclusion, as the assumption that increased financial inclusion leads to decreased financial exclusion may not hold or hold strongly;
 - o being aware of the unintended consequences of using a RBA when implementing the AML/CFT measures or of assuming a RBA is a panacea for all ML/TF risk; and
 - o the risk of possibly dampening innovation when using a RBA.
- Section Four is the Conclusion.
- Lastly, two appendices are at the end of this paper. The first summarises FATF's description of how the basic components of a RBA, the risk assessment and risk mitigation processes, can be applied for new payment methods. The second appendix summarises FATF's suggestions for regulating and supervising entities involved in providing new payment methods.

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Regulators and industry bodies, representing developing countries, have sought guidance and examples on how to implement the FATF Recommendations in the context of embracing financial inclusion without compromising the desire for positive FATF mutual evaluations. One question to consider then is how well does FATF’s June 2013 guidance paper for NPPS meet these calls for guidance and examples?

The guidance paper has two principal emphases:

1. It further familiarises countries and institutions with a RBA by focussing on two key aspects of a RBA:
 - That the risk assessment and risk mitigation process is most effective if done during the design phases (design phases of both regulation and of product and services); and
 - That a holistic risk-sensitive approach is preferable to a conservative “one-size-fits-all” approach.

These two key aspects of a RBA are discussed below in terms of how they meet the calls for guidance and examples from regulators and industry bodies in developing countries. Appendix 1 to this paper summarises FATF’s description of how the basic components of a RBA, the risk assessment and risk mitigation processes, can be applied in the case of NPPS.

2. It details suggestions for regulating and supervising entities involved in providing NPPS. In particular, the guidance paper elaborates on the following points for regulators:
 - How to assess the impact of AML/CFT regulations on the NPPS market and financial inclusion;
 - How to regulate and supervise the entities involved in the provision of NPPS;
 - How to identify the appropriate authority to be responsible for compliance with AML/CFT supervision of NPPS providers;
 - How to determine the appropriate regulatory response to NPPS; and
 - How to determine which entity is the provider of NPPS and thus subject to AML/CFT requirements.

FATF’s discussion on these points are useful references for a country and its regulators to use in determining the appropriate regulatory response to implementing AML/CFT measures while keeping financial inclusion considerations in mind. A summary of FATF’s discussion of these points is to be found in Appendix 2.

In our view FATF’s June 2013 guidance paper for NPPS largely meets the calls for guidance and further examples on how to implement the FATF regulations responsively and proportionally.

2.1 Risk Identification, Assessment and Mitigation in the Design Phases of Products, Services and Regulations

A RBA is a dynamic and evolving approach. As FATF explains, products or services should not simply be designed to meet AML/CFT regulations, instead they should be designed in consideration of the regulations and ideally the regulations should then reflect the type of NPPS being designed. This distinction in approach may avoid the emergence of regulatory approaches where permissible products and services are determined based solely on what is considered “FATF compliant” at a certain point in time.

A retrospective approach to mitigating risk and designing regulations for the mitigation of risk is a lot more difficult than adopting an industry consultative approach at the outset to design products which are both capable of fostering financial inclusion and maintaining financial integrity.¹⁰ It is far preferable for industry players to involve the regulator early in the process of designing the product or service. A consultative approach helps to build a more productive dialogue between industry players and regulators, and should lead to more sustainable and successful products and services.¹¹ More sustainable and successful NPSS, in turn, contribute to the continued growth in financial inclusion.

2.2. Holistic and Risk-Sensitive Approaches Rather than Conservative “One-Size Fits All” Approaches

Conservative “one-size-fits-all” approaches have been the default position of many countries and institutions when implementing AML/CFT measures. A FATF review of evaluations from 2005 to 2011 found that very few countries had adopted a RBA; instead most countries had mandated the same obligations for all financial institutions regardless of their products or customers.¹²

Conservative institutions will not tend to adopt simplified CDD if left to their own devices as they will tend to over-estimate risk. Then when conservative regulators deal with these conservative institutions

¹⁰ Emery S. Kobar, ‘The Role of Anti-Money Laundering Law in Mobile Money Systems in Developing Countries’ (2013) 8(3) *Washington Journal of Law, Technology & Arts* 303, 314.

¹¹ See Mitha’s findings from his experience in the field: Next Generation Newswire, ‘MMT Explained Part 15: Navigating the Regulatory Minefield with Aiaze Mitha’ (September 25 2009). <<http://www.pressrelease365.com/pr/financial/banking/mmt-mobile-money-transfer-dubai-roshan-regulatory-3735.htm>> and Aiaze Mitha, ‘The Transformative Role of Mobile Financial Services and the Role of German Development Cooperation’ (Report, Federal Ministry for Economic Cooperation and Development, January 2011) <http://www2.gtz.de/dokumente/bib-2011/giz2011-0068en-mobile-financial-services.pdf>.

¹² FATF Guidance, ‘Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion’ (Guidance Paper, FATF, February 2013) 17.

the outcome may be an over-estimation of risk.¹³ Regulators may be reluctant to require institutions to relax their approach in such instances.¹⁴

GSMA has identified the conservative approach of regulators as one of the main challenges with respect to mobile money:

“Many regulators shy away from a risk-based implementation of existing FATF principles and remain too conservative, because they lack guidance and are concerned about negative effects of a more flexible approach on their evaluation ratings.”¹⁵ _

The Alliance for Financial Inclusion’s Pacific Financial Inclusion Working Group (PFIWG) also expressed this concern about the effect on evaluation ratings in a letter to the Asia/Pacific Group on Money Laundering in August 2010. This letter sought specific guidance on a number of questions surrounding a RBA.¹⁶

FATF’s guidance paper attempts to address these concerns. While the guidance paper stops short of *requiring* a simplified AML/CFT regime for cases of “lower risk”¹⁷, it provides more detailed examples to enable countries and institutions to become more familiar with simplified CDD for NPPS in instances of “lower risk”, particularly when financial inclusion is at stake.

2.3 Regulators to Take the Lead Role

FATF’s June 2013 guidance paper equips regulators to take a lead role in implementing a RBA and to respond when institutions are being overly conservative. This lead role for regulators is in the spirit of proportional regulation and is important to advance financial inclusion.

It is important to recognise that this is a relatively new and different role for financial regulators and requires a change of mind-set on their part. Historically banks have innovated in pursuit of higher profits and the role of a financial regulator has been to maintain the safety and soundness of the financial system. However, the promotion of financial inclusion requires the provision of financial services to customers who may offer little in the way of profitable opportunities. Meeting this challenge requires

¹³ Note, e.g., the case of Fiji where ‘over-conservatism’ was found both at the country level and institution level in terms of applying the risk based approach. See The World Bank, ‘Detailed Assessment Report: Anti-Money Laundering and Combating the Financing of Terrorism’ (Report, July 2006) <<http://www.apgml.org/documents/search-results.aspx?keywords=Fiji>>[360], [361], [382] (This reference was supplied by Wameek Noor, CGAP, World Bank, as part of his preliminary comments on the general themes of an earlier draft of this paper.)

¹⁴ De Koker, above n 5, 177.

¹⁵ GSMA, MMU, February 2011, *Response to FATF questionnaire on financial inclusion*, 1 - 2.

¹⁶ <http://www.afi-global.org/sites/default/files/piwg_apg_letter_0.pdf>

¹⁷ See FATF, ‘Guidance for a Risk-Based Approach: Prepaid Cards, Mobile Payments and Internet-Based Payment Services’ (Guidance Paper, FATF, June 2013) section VI, section B, 26, 27.

the design of highly efficient NPPS with such low transaction costs that the business can still be done profitably.¹⁸

Supporting NPPS and other payments mechanisms for financial inclusion purposes needs to be at the forefront of regulators' policy actions. For example, if financial institutions citing non-compliance with AML/CFT regulations close accounts that are used to facilitate financial services such as remittances for lower risk end-users, regulators should be swift to question the account closures and assess whether simplified CDD could have been applied. Non-compliance with AML/CFT regulations is not a valid reason for closing accounts when a framework for proportional regulation exists but is not being used by the account providers. Regulators must encourage the use of simplified CDD where appropriate.

AFI has also been active in promoting the use of a RBA through its Financial Integrity Working Group (FIWG). FIWG meets on a regular basis and its May 2014 meeting provided a focused forum for members (financial regulators) to share perspectives and experiences in developing a RBA for implementing AML/CFT measures for financial inclusion. A particular focus was on conducting effective national risk assessments and designing effective simplified CDD. Representatives from the international standards setting body, Bank for International Settlements (BIS), were also at the meeting. These efforts to build regulators' understanding and knowledge on these issues and continue to work with standard setting bodies will contribute to the goal of developing a RBA for AML/CFT which can advance, not hinder, financial inclusion efforts.

FATF's new evaluation methodology, which is being used for the first time in the 2014 mutual evaluations, may also encourage countries and institutions to use a RBA and not focus as much on the outcome of their mutual evaluation report.¹⁹ The new evaluation methodology combines the existing assessment of technical compliance with a new assessment of the effectiveness of the AML/CFT regime.²⁰ The Methodology will be used by the FATF, the FATF-Style Regional Bodies (FSRBs) and other assessment bodies such as the IMF and the World Bank.

¹⁸ Rodger Voorhies, Jason Lamb and Megan Oxman, "Fighting Poverty Profitably – Transforming the economics of payments to build sustainable, inclusive financial systems, Special Report, Financial Services for the Poor, Bill and Melinda Gates Foundation, September 2013.

²⁰ "The technical compliance assessment will address the specific requirements of each of the FATF Recommendations, principally as they relate to the relevant legal and institutional framework of the country, and the powers and procedures of competent authorities. These represent the fundamental building blocks of an AML/CFT system.....The effectiveness assessment will assess the extent to which a country achieves a defined set of outcomes that are central to a robust AML/CFT system and will analyse the extent to which a country's legal and institutional framework is producing the expected results." (<<http://www.fatf-gafi.org/topics/mutualevaluations/key/fatfissuesnewmechanismstostrengthenmoneylaunderingandterroristfinancingcompliance.html>>)

SECTION THREE – ISSUES FOR FURTHER CONSIDERATION WITH A RBA

A RBA should not be perceived as a panacea for all ML/TF risk and a RBA itself may have unintended consequences such as creating new ML/TF risk, introducing other forms of risk and possibly dampening innovation. How these unintended consequences arise is explained in this section.

3.1 ML/TF Risk Due to Financial Exclusion Reasons

By supporting the adoption of formal payments channels it does not automatically follow that there is a decrease in the use of informal channels and a decrease in ML/TF risk for financial exclusion reasons. End-users adopting legitimate channels do not necessarily stop using illegitimate channels, one reason for this being the preference for flexible and anonymous informal employment and cash payments.²¹

Developing successful NPPS ecosystems to replace informal channels will be important in mitigating ML/TF risk due to continued use of informal channels; NPPS can offer more than just a viable alternative to informal systems such as the hawala systems which simply transfer cash from A to B. NPPS can offer the possibility of storing value electronically, and enabling the end-user to improve budgeting and payments mechanisms compared to cash held under the mattress. Financial products and services can be wrapped into the NPPS, such as savings, credit and insurance, thereby creating the demand for an electronic store of value. Such NPPS “ecosystems” are still in their nascent stages, and how to achieve mass adoption, and have “cash-in” stay “in”, is still being resolved. However, the goal of moving towards a strong NPPS ecosystem is very worthwhile because in a strong NPSS ecosystem financial inclusion will flourish and ML/TF risks be will reduced.

3.2 Unintended Consequences from Using a RBA - Creation of New ML/TF Risks

Some risk mitigating processes may inadvertently introduce new ML/TF risks. Countries need to keep these unintended consequences in mind when applying the methodologies and respond accordingly.²²

Financial integrity is not necessarily strengthened with the use of a RBA as risk control measures may themselves produce new risks which need to be addressed. For example, there have been cases where products using transaction and balance limits to mitigate risk are actually targeted for money laundering purposes. While the amounts laundered through such products is probably a lot less than amounts

²¹ See Louis de Koker and Nicola Jentzsch, ‘Financial inclusion and Financial Integrity: Aligned Incentives?’ (2013) 44 *World Development* 267.

²²De Koker, above n 5, 187.

laundered through others methods available, it is important to be aware of the possibility that products using simplified CDD may attract money laundering activity simply because simplified CDD is known to be used.²³

The benefits of simplified CDD may be minimal in some instances *because* transaction monitoring still needs to be done to ensure no clients are on the banned list of terrorists and persons associated with proliferation of weapons of mass destruction and transaction monitoring is most effective when institutions know enough about a client to identify suspicious activity. For example, in an instance where a transaction is frozen because the client's name appears on the banned list and then investigations into the transaction become difficult because simplified CDD has been used and there is insufficient information to verify the true identity of the customer, the investigation becomes costly for the provider and potentially unnecessary if the customer is found to have a name that simply happens to match one on the banned list. Similarly, persons on the banned list may be able to undertake transactions because simplified CDD is being used.²⁴

FATF notes that for mobile payments there is a range of data which can be collected and may be useful to monitor customer activity – such as the sender's and receiver's phone numbers, the receiver's SIM card and maybe even the precise location of the transaction. FATF notes this information is not required under its *Recommendations* but its collection could be useful, so long as doing so complies with privacy legislation.²⁵ This suggestion raises real issues of consumer protection. While these issues are beyond the scope of policies focusing on financial inclusion, FATF's suggestion that a greater range of customer data be collected than what is required to meet the ML/TF risks, may needlessly expose developing countries to greater data protection/consumer protection problems than already exist.²⁶ Many jurisdictions may not have strong privacy laws or their privacy laws may not be well enforced due to capacity issues and so there could already be a need for more effective policies for data protection, without increasing the amount of data being collected. This need should not be exacerbated as an unintended consequence of adhering to AML/CFT regulations.

FATF's suggestion may not make much difference for providers of NPSS in developed countries where data protection standards are more developed. However, for developing countries, a key motivation for using NPSS is to financial access for the banked and underbanked by providing a safer and more secure means of storing value and making payments. In these markets, NPSS should not be an excuse for governments to collect greater amounts of financial information for political purposes under the banner

²³ Ibid 188.

²⁴ Ibid 187-8.

²⁵ FATF, 'Guidance for a Risk-Based Approach: Prepaid Cards, Mobile Payments and Internet-Based Payment Services' (Guidance Paper, FATF, June 2013), 22.

²⁶ Further elaboration on this point can be found in De Koker's discussion on client identification processes increasing the risk of data theft: De Koker, above n 5, 187.

of complying with AML/CFT standards; certainly not without strong privacy protections as a counter balance.²⁷

3.3 AML/CFT Measures and Innovation

Regulatory measures and requirements, such as those for AML/CFT, should also be kept in perspective. AML measures in and of themselves rarely determine the success or failure of financial inclusion initiatives. Instead, AML measures should contribute towards supportive environments for innovation and financial inclusion. The actual innovations and entrepreneurship will still be needed and will depend on a number of factors; compliance with AML measures will be just one factor to consider.²⁸

Along similar lines, GSMA in its response to the FATF Financial Inclusion questionnaire emphasised the need for principles to be technologically neutral and allow for risk based implementation (i.e. risk focused rather than activity focused principles). “[A]llowing market forces to interact and find new ways to serve customers will best ensure innovation benefiting the unbanked.”²⁹

Innovations are continuing with respect to methods confirming people’s identification. India’s Aadhaar program is one such example. This program involves biometric identification processes where fingerprints and eye scans are being used to confirm a person’s identity. Already 500 million people’s fingerprint and iris scans have been collected. Early findings suggest this program can reduce fraud which prevents government aid from reaching the intended recipients.³⁰ Technologies will continue to develop and improve in terms of how to identify people. Regulators and standard setting bodies need to make sure regulations stay independent of the technology so regulations remain relevant and do not unnecessarily stifle innovations.

FATF’s suggestion that the risk assessment process for NPPS be done on a case by case basis so the specific features of the NPPS can be taken into account may be overly burdensome for countries struggling with a plethora of NPPS on offer. Countries may opt instead to establish a standardised tiered KYC framework against which institutions determine where their products or services fit and apply the accompanying level of AML/CFT measures accordingly. Focusing on limiting risk by design in this way may assist regulators who feel overwhelmed by the prospect of regulating new players, products and services when they have limited capacity or stretched resources with which to meet existing regulatory functions and responsibilities. This point is made by FATF and reinforced by Kobar, that regulators with

²⁷ De Koker, above n 5, 192.

²⁸ See Kobar's discussion on this issue of innovation, entrepreneurship and AML measures: Kobar (2013), 303.

²⁹ GSMA, ‘FATF Project on Financial Inclusion: FATF Guidance on AML/CFT and Financial Inclusion’ (Report, GMSA, January 2011) 1.

³⁰ Andrews, Ed, ‘Think ID Theft Is a Problem Here? Try Protecting One Billion People’, Stanford Graduate School of Business (1 May 2014) < http://www.gsb.stanford.edu/news/headlines/think-id-theft-is-problem-here-try-protecting-one-billion-people?utm_source=twitter&utm_medium=social-media&utm_campaign=wein-india-id>

limited capacity and resources need to define what “non-traditional service providers” can do so as to reduce risk and provide comfort for regulators allowing in these new players.³¹ This is also in line with the recommendation earlier in this paper of doing the risk mitigation during the product design phase.

A careful balance should be sought between regulators prescribing what new players can and cannot do and the benefits of encouraging innovation from new players. Developing a low risk product for the unbanked is usually a better solution, risk-wise, than leaving the unbanked to use informal channels as the low risk product will usually present lower ML/TF risks. Products to promote financial inclusion do not always need all the ‘bells and whistles’.

SECTION FOUR - CONCLUSION

Regulators need to encourage institutions to use a RBA and not be unnecessarily conservative in their interpretation of AML/CFT regulations. A conservative interpretation of AML/CFT regulations will impede the development of NPPS ecosystems and compromise the continued growth of financial inclusion.

³¹ Kobor, above n 10, 315.

APPENDIX 1 - RISK ASSESSMENT AND RISK MITIGATION PROCESSES FOR NEW PAYMENT METHODS

FATF Recommendations are international standards on combatting money laundering and the financing of terrorism. The FATF Recommendations include AML/CFT preventative measures such as Customer Due Diligence (CDD)³², record keeping and reporting of suspicious transactions. Entities that fall within the FATF definition of a “financial institution” are covered by the FATF Recommendations.³³ In defining “financial institutions”, FATF lists activities or operations which are to be covered for AML/CFT purposes. Insofar as NPPS providers conduct money or value transfer services, or issue and manage a means of payment, they are considered a “financial institution” as defined by FATF.

A RBA is used to determine the extent to which CDD measures are applied. Transaction monitoring and suspicious activity reporting is essential in all cases, irrespective of the assessed level of risk.

The general principle behind FATF’s risk-based approach to AML/CFT measures and supervision is that when higher risks are identified and assessed then enhanced CDD measures are **required** to manage and mitigate risks, and when risks are lower then simplified CDD measures **may be acceptable**³⁴ and in certain situations **exemptions** from CDD are possible, i.e. no “one-size-fits-all”.

³²In line with Recommendation 10, the four CDD components are:

- “i) identification and verification of the customer’s identity;
- ii) identification of the beneficial owner;
- iii) understanding the purpose on the business relationship; and
- iv) on-going monitoring of the relationship.” FATF, ‘Guidance for a Risk-Based Approach: Prepaid Cards, Mobile Payments and Internet-Based Payment Services’ (Guidance Paper, FATF, June 2013) 28.

³³ See Box 1: FATF Definition of “financial institutions”: FATF, ‘Guidance for a Risk-Based Approach: Prepaid Cards, Mobile Payments and Internet-Based Payment Services’ (Guidance Paper, FATF, June 2013) 12.

³⁴ Ibid section VI, A. In the FATF Guidance Note on AML/TFM and Financial Inclusion (2013), it is explained that simplified CDD may be applied in scenarios of lower risk and where the country allows the institution concerned to apply a simplified regime: FATF Guidance, ‘Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion’ (Guidance Paper, FATF, February 2013) 22 [47]. The tone is one of treading cautiously. This could be confusing for institutions - it either is acceptable or it isn’t and in the absence of certainty, institutions may err on the ‘it isn’t acceptable’ side. Also, the FATF Guidance note on Financial Inclusion has a footnote which refers to the issue of low risk products possibly being exposed to criminal abuse simply because criminals are aware simplified CDD may be applied (a double-edged sword for some institutions): “Data on the criminal abuse of lower risk financial products should be collected and analysed to determine whether the assessments properly reflected the risks present, See de Koker, L. (2009)”: FATF Guidance, ‘Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion’ (Guidance Paper, FATF, February 2013) 22 n 42.

FATF emphasises that the identification and assessment of risk should be done *prior* to risk mitigation measures being applied and ideally *during* the design phase of the product or service. This process allows for a product or service to be designed so it needs only simplified CDD to be applied or the product or service may be designed with such basic functionality that an exemption from measures and regulations is permissible. More generally, for all products and services, there should be an understanding of the risk present before mitigation measures and regulations are applied. The aim is for a risk mitigation response which is proportional to the risk posed by the product or service.

“Progressive” Risk Assessment or “Tiered Know-Your Customer (KYC)”

	Risk Assessment		
	High ↓	Lower ↓	Low ↓
CDD Level	Enhanced CDD	Simplified CDD*	Exemption^

* FATF only goes so far as to say the simplified CDD “may apply” and still leaves it as “optional” to use enhanced CDD.
 ^ Must meet specific circumstances to gain exemption. Chapter Three, page 13, of the Guidance paper outlines the specific instances in which exemptions from AML/CFT measures are possible.

Risk Assessment – Identify, Assess and Understand Risk

FATF’s RBA involves the use of a risk assessment framework for identifying, assessing and understanding the risk.³⁵

Risk Assessment in the Design Phase of Products and Regulations

FATF emphasises that the risk assessment should be done both when designing the AML/CFT regulations for NPPS and when designing the NPPS itself. Assessing and mitigating risk in the design of the product or service can avoid having to redesign products or services in the future to comply with AML/CFT regulations.

Risk Assessment on a Case by Case Basis for NPPS

FATF also recommends the risk assessment be done on a case by case basis so the specific features of the NPPS can be taken into account. FATF argues the case by case approach is necessary for NPPS as they lack the homogeneity of more traditional payment instruments.

³⁵ Louis de Koker lists a range of risk assessment models which have been developed to assist regulators and providers in undertaking risk assessments, including models by the World Bank, the GSMA, USAID and the FATF Guidance itself: de Koker, above n 7, 186. FATF Guidance on AML/TFM and Financial Inclusion includes further details and examples on the developing a risk assessment: FATF Guidance, ‘Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion’ (Guidance Paper, FATF, February 2013) 19.

A Holistic Approach to Risk Assessment

Risk factors, risk mitigants and the *functionality* of the particular NPPS in question will all contribute to the level of ML/TF risk posed by a particular NPPS. FATF recommends that a holistic approach, that combines all these factors, be taken as it should lead to a more balanced response to mitigating the risk. FATF's risk matrix, taken from FATF's 2010 New Payment Methodologies typologies report, can be used to identify the risks associated with NPPS. The matrix identifies risk factors, risk mitigations and associated risk levels and use of the matrix is in keeping with what FATF refers to as a holistic, risk-sensitive approach.

The FATF guidance paper explains various risk factors specific to NPPS and provides examples for each of the broad categories of NPPS – prepaid cards, mobile payment services and internet payment services. Table 1 below lists these risks factors and provides examples on how these risks may arise in the specific case of mobile payments for illustrative purposes.

Table 1 – Risk Factors Specific to Mobile Payment Services

Risk Factor	How the Risk Factor arises (in the case of mobile payment services)
Non-face-to-face relationships and anonymity	Risk posed by anonymity occurs on using or reloading Level depends on the functionality of the service and any existing risk mitigation measures in place such as consumer due diligence and funding thresholds.
Geographical reach	Global reach exposes the service to ML/TF. Jurisdictions have different levels of controls for AML/CFT. If the provider's jurisdiction has weak controls and its customers are in another jurisdiction with stronger controls, the stronger controls will be compromised. FATF notes this cannot be easily avoided, but can be identified.
Methods of funding	If the origin of funds is obscured (e.g. cash is used) or if account to account transfers are permitted then risk of ML/TF increases. Not necessarily avoidable with NPPS, but necessary to identify.
Access to cash	The more interconnection or interoperability that a service provides means there are more ways to withdraw cash from the service and hence greater ML/TF risk.
Segmentation of services	If many parties are involved in the provision of a NPPS, this increases the risk of losing customer or transaction information along the payments chain or being unable to retrace information. It is not always clear which of the parties involved in the provision of a NPPS are the ones subject to AML/CFT measures, or which entity they should be reporting to, or even the country in which the responsible regulator is based. Using agents for account opening or cash-in/cash-out can further

	cloud regulatory responsibilities. FATF notes that the training, management and control of agent networks become important in this regard.
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Risk Mitigation to Follow Risk Assessment

Proportional risk mitigation means a risk mitigation response which is proportional to the risk posed by the product or service. For this reason risk mitigation needs to follow the risk assessment. In line with the dual focus on financial inclusion and financial integrity, FATF emphasises that proportional risk mitigation also be aimed at maintaining the functionality of the product; making sure it is still convenient and easy to use. FATF also suggests the best time to mitigate risk is ideally in the design phase and at the least before the product or service is launched.

FATF identifies four areas to focus on for risk mitigation, again providing examples specific to NPPS, see Table 2 below. These examples assist countries and institutions to understand how to be satisfied that the chosen level of CDD is appropriate for a particular service or product. FATF's approach is to assume that the appropriate level of CDD will largely be determined by the level of functionality for a product or service, as the level of functionality will usually determine the level of ML/TF risk. These relationships between the level of CDD, the functionality of the NPPS and the level of ML/TF risk are shown below in Diagrams 1 and 2 for the purpose of illustrating these assumed relationships. It is important to note that saying the level of ML/TF risk is positively correlated with the level of functionality of a NPPS is as assumption and it does not necessarily always hold.

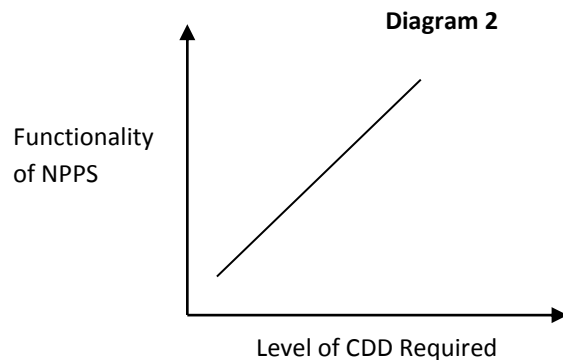
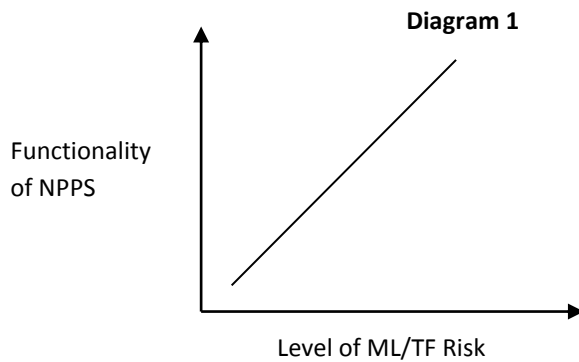


Table 2 – Risk Mitigation Applied to NPPS

Risk Mitigation	Risk mitigation for NPPS
<p>Consumer Due Diligence (CDD)</p> <ul style="list-style-type: none"> - Enhanced for higher risk - Simplified for lower risk - Exemption for low risk under specific circumstances 	<p>If risk is assessed as ‘lower’ then simplified CDD can be applied.</p> <p>Simplified CDD basic but cover the four basic components of CDD.³⁶ FATF notes that while covering the four basic components may still seem burdensome, it does help the provider identify if their product or service is being used for no apparent or legitimate reason.</p> <p>FATF notes simplified CDD means the identification, verification and monitoring requirements can be <i>less intensive</i> and <i>less formal</i> and <i>assumptions can be relied upon</i> about the use of basic products and services.³⁷</p> <p>Customer identification can be verified <i>following</i> the establishment of a business relationship, not only before or during, provided the ML/TF risks are effectively managed. This enables a smoother process for establishing and conducting business with end-users.</p>
<p>Loading, value and geographical limits (Functionality)</p>	<p>Placing limits on the amount loaded, reloaded, transferred or withdrawn by value and frequency and limiting where the product can be used. Combinations of these limits are also effective in mitigating risk.</p> <p>Where distributors or agents carry out the CDD obligations for the provider, the issuer should then ensure those distributors and agents are in its AML/CFT programme and their compliance with AML/CFT measures should be monitored.</p>
<p>Source of funding (functionality)</p>	<p>FATF notes that cash as a source of funding increases the ML/TF risk, however, in line with its holistic view and being supportive of financial inclusion, FATF acknowledges cash as a funding source does not immediately translate to the product being classified as “higher risk” and so if cash is the funding source, then it suggests combining this functionality with other limits, such as those noted above, in order to achieve a lower risk rating and eligibility for simplified CDD.</p>
<p>Record keeping, transaction monitoring and reporting</p>	<p>Transaction monitoring and suspicious activity reporting is essential irrespective of the level of CDD deemed appropriate for the NPPS.</p>

³⁶ See n 33 above for list of these four components.

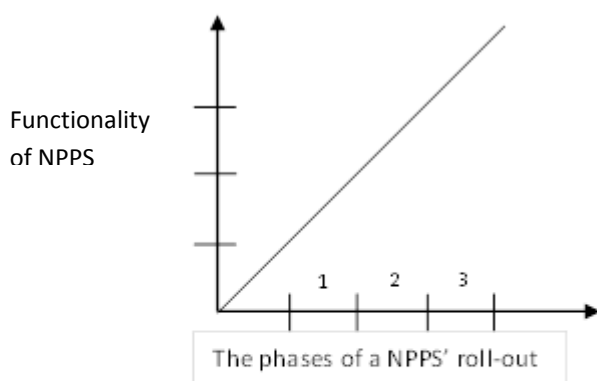
³⁷ See FATF’s Interpretive Note to Recommendation 10 for further examples of where risk is lower: FATF, ‘International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation’ (Recommendation Paper, FATF, February 2012) 64 [17].

Risk Mitigation and Implications for the Usefulness of NPPS

FATF acknowledges that limiting the functionality of the NPPS can decrease its usefulness and it does not intend the implementation of the FATF recommendations to outweigh the intended benefits of the NPPS, as this will reduce financial inclusion. To address this concern FATF suggests the following:

- A tiered approach to the provision of the product or service. For example, see Diagram 3 below - in Phase 1, the product is rolled out with certain restrictions on its usage (functionality) and so simplified CDD applies, then in Phase 2 the functionality is increased and so too the level of CDD and so on for Phase 3.
- A simple product, with basic functionality, and correspondingly simple CDD, be made available with the sole intention of increasing financial inclusion, however, the product is designed to allow the user to add additional functionality after an increased level of CDD is applied to that user (Diagram 3 can also be used to convey this idea, however, it is the end-user moving through the phases rather than the provider rolling the product out in phases).³⁸

Diagram 3



Functionality refers to loading, duration, limits on cash withdrawals, transfer limits, geographical limits

The required level of CDD increases for each phase of the products' or services' roll-out

Phase 1 Very basic functionality -> Low risk -> Exemption from CDD

Phase 2 Broadened functionality -> Lower risk -> Simplified CDD

Phase 3 More wide functionality -> Higher risk -> Enhanced CDD

³⁸ In the survey done by AFI's FINTWG of 12 regulators using a RBA for implementing AML/CFT measures it noted that 'financial institutions have found that customers do not tend to provide additional information once an account is open.': FINTWG, 'Risk-Based Approaches to AML/CFT: Balancing Financial Integrity and Inclusion' (Guidance Note, AFI, 16 May 2013) <<http://www.afi-global.org/library/publications/risk-based-approaches-amlcft-balancing-financial-integrity-and-inclusion>> 4.

APPENDIX 2 - REGULATION AND SUPERVISION AND A RBA

Impact of AML/CFT Regulation on NPPS Market and Financial Inclusion

FATF reiterates that risk based proportionate regulation should be supportive of innovation. Specifically, risk based proportionate regulation should avoid having a negative impact on the operation of existing products, avoid limiting the development of new products and, in particular, avoid working against the idea that NPPS can drive greater financial inclusion.

The FATF Guidance on Financial Inclusion and the G20 Principles for Innovative Financial Inclusion are also briefly summarised in the guidance paper as these are two key documents explaining and promoting the proportionality principle. FATF notes that the proportionate regulatory approach may open the market to an increased participation by providers and end-users (unbanked and underbanked) and this increased use of “legitimate channels” can result in “lowering the risks of ML/TF that are linked to financial exclusion”.³⁹ However, these relationships may not necessarily hold. In particular, an increase in the use of legitimate channels does not necessarily mean there is a corresponding reduction in the use of illegitimate channels.⁴⁰ Section Four of this paper notes further issues to consider with respect to building the accessibility, usage and impact of the NPPS market.

Regulating and Supervising Entities Involved in Providing NPPS

For regulating and supervising NPPS providers, FATF focuses a country’s attention on the four areas below. These four areas are considered by FATF as the most applicable in determining how the FATF Recommendations apply to NPPS:

- Further understanding a RBA from the perspective of a country’s responsibilities (Recommendation 1 and 15);
- Understanding when CDD is required and what level of CDD is required (Recommendation 10);
- Licensing and registration requirements, including those for agents (Recommendation 14); and
- FATF Recommendations specifically focused on Wire Transfers, because NPPS share common features with Wire Transfers, i.e. both may be categorised as MVTs providers and subject to the same AML/CFT measures (i.e. Recommendation 16).

These four areas are discussed below, in turn.

³⁹ FATF Guidance, ‘Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion’ (Guidance Paper, FATF, February 2013) 26.

⁴⁰ See reference in de Koker (2013) n 7 to Louis de Koker and Nicola Jentzsch, ‘Financial Inclusion and Financial Integrity: Aligned Incentives?’ [*World Development*](#), 2013, vol. 44, issue C, pages 267-280.

RBA from Perspective of a Country's Responsibilities

The content in this section of the guidance paper expands on existing FATF guidance on a RBA.⁴¹ Both the country and its institutions should undertake risk assessment processes and these two levels of risk assessments should inform each other. FATF calls on countries to move away from “one-size-fits-all” solutions and to adopt AML/CFT regimes specific to their local context using a RBA.

Consumer Due Diligence

An outline is provided of what countries should require of institutions with respect to CDD, including when and how to apply the simplified or enhanced CDD. FATF notes that funding and transaction limits are useful to allow for the use of simplified CDD, however, without sufficient CDD suspicious transactions may go unnoticed or these channels may even then be specifically targeted for illegitimate uses due to an awareness that transactions go through them largely unnoticed.⁴² FATF provides suggestions on how to mitigate the risk of suspicious transactions going unnoticed in this instance by, for example, restricting the number of NPPS allowed to be sold in a single transaction. FATF also suggests regulators be alert to who, or what, is doing the CDD to determine whether simplified CDD is adequate:

- The example is given where staff at a retail outlet responsible for selling the NPPS may not be adequately trained to do CDD (there may also be a high turnover of staff at such outlets, also making it difficult to keep training up to date). This is a common issue for NPPS.
- FATF also notes that if CDD is carried out using electronic verification then providers should ensure the information is accurate and from a reliable source.

Licensing and Registration

The provider should be licensed or registered, supervised and subject to AML/CFT measures if the NPPS falls within the definition of MVTS (Money or Value Transfer Service, see definition in Glossary to FATF Recommendations). This applies to providers of prepaid cards, mobile payment services and internet based payment services. For agents, Recommendation 14 gives two options: either agents are licensed or registered or the MVTS provider should maintain a list of its agents and this list should be accessible by the relevant authorities. MVTS providers need to comply with the requirements of Recommendation 16 either directly or through their agents.

It is the responsibility of the country to ensure that under their legal framework the NPPS provider is responsible for its AML/CFT obligations and is accountable for the actions of its agents. For example,

⁴¹ FATF is referring here to its ‘Guidance on ML/TF Risk Assessment’ and the ‘FATF Guidance on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion’.

⁴² See Section Four for further discussion on this point - De Koker has noted this conundrum that simplified control measures aimed at reducing regulatory burdens may actually increase the attractiveness of the product to abuse: de Koker, above n 7, 188.

where agents are used to distribute the product or service, then those agents should be included in the providers' AML/CFT programme.

Wire Transfers

FATF highlights that p2p transfers done using a NPPS, such as a prepaid card or mobile money device, are similar to a wire transfer. Recommendation 16 outlines the requirements for wire transfers. For cross border wire transfers where a minimum threshold is adopted, verification of the customer and beneficiary are not required when transfers are below the threshold. FATF suggests incorporating this requirement into the design of the NPPS. If transfers can exceed the threshold then the NPPS will need to ensure the transfer can include and maintain required and accurate originator and beneficiary information with the message.

Identifying the Appropriate Authority for the Regulation and Supervision Role

FATF suggests that supervisory frameworks should clarify the authority responsible for compliance with AML/CFT supervision of NPPS providers. FATF highlights that different entities may offer similar types of NPPS and so the country may have different authorities responsible for supervising compliance with AML/CFT requirements as supervision may be entity based. If this is so, FATF recommends there be mechanisms in place for effective cooperation between the regulators/authorities.

FATF acknowledges that local context will ultimately determine who does what. However, FATF emphasises that simply because a country has a large contingent of MNOs offering mobile payment services, this doesn't necessarily mean the communications authority is best placed to monitor MNOs for AML/CFT compliance. An assessment of the capacity of the authority should be made and training and education in AML/CFT provided, if necessary, to develop expertise. FATF adds that close cooperation with the financial supervisors is also essential to ensure consistent and co-ordinated approaches.

FATF highlights the challenges posed by internet-based payment services as they may offer services in one jurisdiction but be based in another and there may be differences in the strength of the AML/CFT supervision. One option is to require providers to be licensed in, subject to the AML/CFT regulation and supervision of, the jurisdiction in which they offer their services irrespective of where they are located. Another option is to prohibit internet-based payment services from offering services in their jurisdiction without a physical presence (a local office) in that jurisdiction.

Level of AML/CFT Measures Proportional to the Level of Risk

FATF reiterates here that the level of the measures should be proportional to the risk posed. FATF uses the example of NPPS which has functionality closer to that of a bank account – for such NPPS there will be a greater need to apply comparable regulation, including full CDD measures.

FATF notes that different jurisdictions take significantly different approaches with respect to applying a RBA to AML/CFT regulation for NPPS (See Annex 1 of the Guidance paper for the detailed examples).

Different approaches are acceptable to FATF so long as the approaches comply with FATF Recommendations - a country needs to be able to demonstrate how it and its institutions comply with the FATF Recommendations taking into consideration the local context.

Determining the NPPS Provider Subject to AML/CFT Obligations

FATF notes that countries are responsible for ensuring their legal frameworks specify “clear legal responsibilities for the oversight and control of relevant entities subject to AML/CFT requirements” and that the providers are subject to “adequate regulation and supervision” (Recommendation 26).

FATF acknowledges it can be difficult to determine which entity is responsible for implementing the preventative measures for AML/CFT because of the *range* of entities involved in the provision of NPPS and because of the *complexity* of NPPS. Where it is not clear which entity is the provider, FATF suggests “countries should consider the following factors in determining the appropriate NPPs provider(s):

- a) The entity which has visibility and management of the NPPS;
- b) The entity which maintains relationships with customers;
- c) The entity which accepts the funds from (the) customer, and
- d) The entity against which the customer has a claim for those funds.”⁴³

FATF notes there may be more than one entity responsible for the provision of NPPS and therefore subject to AML/CFT requirements.

FATF explains with further guidance for each category of NPPS (prepaid cards, mobile payment services and Internet-based payment services).

⁴³ FATF Guidance, ‘Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion’ (Guidance Paper, FATF, February 2013) 34.

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