Financial Inclusion, Developing Economies and Effective Implementation of the Risk-Based Approach in AML/CTF: The Need for Legislative and Regulatory Leadership to Motivate Private Sector Commitment and the Role of Audit

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Executive Summary

Financial inclusion is an oft-discussed issue in the context of income inequality, especially for developing economies that are either poorly-defined or lacking in clear government policy objectives. The purpose of this white paper is to clarify the definition of financial inclusion and discuss the essential roles that both the government and private sector must undertake to meet the financial inclusion objective. From the government sector viewpoint, this paper will discuss the key elements of the risk-based approach in anti-money laundering/counter-terrorist financing (AML/CTF) compliance essential to encourage financial inclusion adoption and illustrate the crucial role of national policy, coupled with clear regulatory guidelines to motivate private sector commitment to this policy issue. At the same time, the paper also explores the business rationale for the banking sector to adopt financial inclusion, including the various new products/services pre-approved and simplified customer due diligence (CDD) requirements by the regulator. Most notably, the paper highlights the essential role of audit in insuring that the banking sector does indeed understand and adopt the parameters of financial inclusion as laid out by the government of the jurisdiction in which the bank operates.

1) Introduction: The Challenges of Financial Inclusion

A strong financial system is the key underpinning of any economy, in providing invaluable services such as savings, credit, payment and so forth for people to meet a wide range of needs. Financial systems that are inclusive are more likely to benefit the poor and other disadvantaged groups, for without such inclusivity, the poor must rely on their own limited savings to invest in their education or even aspire to be entrepreneurs, while small enterprises must rely on limited earnings to grow their businesses. At its most fundamental level, this can contribute to continued income inequality and possible slower economic growth.

While consensus is growing around the importance of financial inclusion, such consensus does not exist around its definition, which can vary depending on the national context and on key stakeholders involved. Definitions have included “banking the unbanked” to “branchless banking,” and numerous other phrases that are sometimes used as being synonymous for financial inclusion, but in fact are not. According to the Financial Action Task Force’s (FATF) Guidance Report on Financial Inclusion (2011), financial inclusion can be broadly defined as providing access to a sufficient range of safe, convenient and affordable financial services to the disadvantaged and other vulnerable groups in any country,
including low income, rural and undocumented persons, who have been underserved or excluded from the formal financial sector. \(^1\)

However, for the purpose of this paper, financial inclusion is defined as having access to a bank account. Such bank account ownership further enables access to additional financial services and can play a key role in leveling the playing field and narrowing the gap between the haves and have-nots. In its 2012 report, the World Bank Group estimates that while 50 percent of adults report having an individual or joint account at a formal financial institution, it still leaves more than 2.5 billion adults without a formal account, with the majority located in developing economies. While account penetration is mostly universal in high income economies—89 percent of adults responded that they have an account at a formal financial institution—only 41 percent do so in developing economies. \(^2\)

Figure 1.

![Account Penetration: Adults with an account at a formal financial institution (%)](image)

Source: Demirguc-Kunt and Klapper 2012.

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Income level disparity, using GDP per capita, account for much of the enormous variation in account penetration globally, where countries with GDP per capita above $15,000, account penetration is substantial at 80 percent and above. But it is not just income inequality that impacts account ownership, distance is also a key factor. Within each country, the use of formal financial services are rather uneven—largely concentrated in densely-populated areas where bank branches, ATMs, etc., make more economic sense from economies of scale viewpoint for financial institutions whose primary objective is profitability. As a result, typically the poor, who cannot afford to live in urban areas, comprise a disproportionate part of the underserved.

Previous studies on the unbanked in the U.S. have shown to have numerous detrimental effects on the economic health of the individual. For example, the lack of a bank account can result in unnecessary repeated transaction fees associated with use of money orders or check-cashing services (Lusardi, 2010). In addition, cash transactions will likely present financial and personal risks for those unbanked, since individuals have no recourse if the funds are stolen (Gross, Hogarth and Schmeiser, 2012).

This raises challenging policy questions for financial inclusion objectives. At the World Bank Group Forum in 2013, more than 50 countries made commitments to financial inclusion targets. World Bank Group President Jim Young Kim stated, “If they fulfill their commitments, if other countries also set bold targets, and if the private sector responds by

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3 Ibid., 12.
unleashing its resources and know-how—then we can reach universal access by 2020.”

The G20 governments agreed that financial inclusion can greatly contribute to the conquest of global poverty. More equal global growth had to be addressed through mainstream banks utilizing their full weight as a key player in any developed or developing economy. It is incumbent on the banks to exercise their imagination to enhance current product offerings and develop new products and services in order for the problem of financial inclusion to be addressed in any meaningful way by 2020. Kim further added, “When low-income workers or poor families gain access to basic financial services, they gain a foothold on the first rung of the ladder toward prosperity.”

The World Bank Group’s 2014 Global Financial Development Report stresses that addressing the needs of the poor/underserved requires addressing market and government failures. For policymakers, it is important to provide an enabling environment of strong laws and regulations, good information and healthy competition among financial service providers. In this way, the private sector can be encouraged to embrace new technologies, such as mobile banking.

This is not to say that the 2.5 billion adults without accounts at formal financial institutions do not conduct any financial transactions; rather, most are using informal means to save, borrow and/or secure their monies. However, it is this reliance on informal channels for execution of financial transactions that contribute to concerns regarding exposure of financial systems to money laundering and terrorist financing vulnerabilities, and thus potentially compromising the financial integrity of the global financial system.

II) RBA: AML/CTF Requirements for FIs Impacting Financial Inclusion

The adoption of a risk-based approach (RBA) in AML/CTF compliance requires the understanding and implementation of the two key pillars—comprised of enterprise-wide risk assessment (EWRA) and an AML/CTF compliance program. But the implementation of these two pillars—based on current legislative and regulatory requirements and coupled with industry practices—can and have been detrimental to the goal of financial inclusion.

A) First Key Pillar

EWRA is an undertaking by financial services institutions to measure and understand the money laundering risks posed to them through three key components: products and services/delivery channels, customers and geography. The values gained from a good EWRA are numerous, including providing:

1) An overall view of AML risk across the financial institution (FI), most notably to assist in identifying high-risk areas;

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2) A tool for determining whether sufficient efforts and resources are have been dedicated to identifying and establishing the necessary controls for effective AML/CTF compliance;

3) Program development guidance to ensure efficient allocation of limited resources; and,

4) A rationale to justify to regulators/examiners that the financial institution’s efforts is sufficient.

An example of providing guidance to ensure efficient allocation of limited resources can be illustrated as followed—assuming that the FI has an overall budget of $100 to spend for an effective AML/CTF compliance program. The EWRA conducted shows that a branch operating in a certain jurisdiction (Cayman Island), offering certain products and services to a specific customer base, absorb 20 percent of the overall compliance budget in order to mitigate the AML/CTF risks, yet this FI’s branch only contributes 2 percent to the overall revenue of the FI. Given the disparity in resource costs and revenue contribution, the FI would likely further examine whether the disproportionate compliance cost is driven by specific products and services offered, or customer segments, or a more fundamental question of country risk, or a combination of all three factors. A further analysis of how to reduce the compliance cost could result in the FI making the determination to cease offering certain products and services, or not banking specific customers or customer segments, and/or closing the branch and exiting that jurisdiction altogether if the disparity between revenue contribution and resource cost cannot be reduced in some material way. This is the power of EWRA.

The EWRA process is key to assisting in the development of an effective AML/CTF compliance program. EWRA requires the understanding of two types of risks—inhent and residual. Inherent AML risk is the measurement of the possible exposure of FI’s products/services to be used by money launderers or financiers of terrorism (this is considered the “gross risk” posed to the FI, without taking into consideration all controls and systems the FI would put in place to mitigate these risks). The inherent AML risk does not measure the likely or actual exposure given the controls/restrictions/limitations on your products/services; in short, the inherent risk does not take into account the controls the FI would have implemented within its various business units.

The residual AML risk is the measurement of the likely exposure of the FI’s products/services to be used by money launderers or financiers of terrorism—taking into account all the controls and systems implemented to reduce the gross risk, resulting in a “net risk.” This system of controls is of course also known as the FI’s AML/CTF compliance program. The risk management equation below further clarifies the relationship between inherent AML risk, the AML/CTF compliance program and residual risk. The ultimate objective of EWRA is to assist the FI in minimizing residual risk. The elimination of AML/CTF risk is an impossibility, as an FI would not be able to remain in business without undertaking some risk, but it is a question of appropriate risk.
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Figure 3. AML Risk Management Equation

\[
\text{Inherent AML Risk} \quad \text{minus} \quad \text{Controls/Systems} \quad = \quad \text{Residual Risk}
\]

\[
(Gross \ Risk) \quad (AML \ Program) \quad (Net \ Risk)
\]

It is important to note that EWRA is but one of many types of risk assessments that an FI must undertake to fully comprehend the money laundering/terrorist financing risks posed by its customers, its products/services and geographical footprint. In other words, while EWRA evaluates AML/CFT risk from an AML program point of view, other risk assessments must be also be conducted, such as specific customer risk assessments, which requires the inclusion of transaction monitoring data of the customer’s account activities. Simply put, the figure below illustrates the function of EWRA in the context of all other risk assessments that must be conducted by the FI.

Figure 4. EWRA: The Overall Framework for Effective AML/CTF Compliance Programs

B) Second Key Pillar

The foundation of an effective AML/CTF compliance program is comprised of numerous elements, but the essential ones are these:

- AML management structure/oversight (including board oversight, management accountability, communication, policies and procedures)
- AML program quality (including risk assessment)
- **Know your customer/ customer due diligence (KYC/CDD)**
- Name screening during the client onboarding process (through sanctions and/or the FI’s own “Do-not-do business” lists)
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- Transaction monitoring
- Suspicious transaction report (STR) decision-making and reporting
- AML internal testing and control
- AML training

From a financial inclusion perspective, the key impediment is the KYC/CDD process that an FI requires during the client onboarding process, which can be unnecessarily onerous and time consuming, thus raising the cost of onboarding a new client and thereby disincentivizing the FI to serve the low income or impoverished segments of society. Accordingly, Recommendation 5 of the FATF Standards states that FIs must perform due diligence to sufficiently identify their customers and obtain relevant information to engage in a financial relationship. CDD policy objectives should effectively identify, verify and monitor their clients to properly understand the money laundering and terrorist financing risks they pose. The core KYC/CDD components of “identify,” “verify,” and “monitor,” are intended to be interrelated and self-reinforcing to ensure that the FI is building a comprehensive knowledge base of the customer, which is key to AML/CTF effectiveness.

FATF Standards for general KYC/CDD measures, including identifying the customer and verifying the customer’s identity using “reliable, independent source documents, data, or information,” does not specify the nature of data source for the verification process. Yet, current industry practices highlight that the challenges of meeting identification and verification requirements are driven more by national legislative or regulatory requirements, and not the FATF Standards. For example, FATF Standards do not require customer data such as occupation, income, or address proof. And while a passport or ID card is typically one of the methods used to verify the identity of the customer in a majority of countries, it should be noted that the FATF standards does allow flexibility to use other reliable, independent source documents or information.5 Moreover, a combination of national legislative and regulatory requirements coupled with industry practices have resulted in the depth of customer “identifier” information that are not required by the FATF Standards, namely:

- Legal name and any other names used;
- Correct permanent address (no P.O. Box);
- Telephone number, fax, and email address;
- Date and place of birth;
- Nationality;
- Occupation, public position held and/or name of employer;
- An official personal identification number or other unique identifier contained in an unexpired official document;
- Type of account, nature of the banking relationship; and

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- Signature

The FATF Standards do not specify the exact range of customer data that FIs subject to AML/CFT obligations should collect to properly carry out the identification process. Therefore, the above list of required data can be serious impediments to the goal of financial inclusion.

III) RBA: Examples of National Efforts to Meet Financial Inclusion

A clear national strategy stating the importance of financial inclusion adoption, coupled with practical measures for executing such a strategy is crucial to its success. A key stakeholder in an effective financial inclusion strategy would be the financial regulator. The financial regulator plays a critical role in the economy of a country. The regulator safeguards the safety and soundness of the banking system upon which the financial stability of the economy heavily depends—by standing between the ordinary citizens and potential financial chaos that could ensue should institutions wishing to offer financial services do not do so in a responsible manner. In addition to the role of maintaining financial stability, the regulator plays a key role in consumer protection and the industry’s financially-motivated objectives. Furthermore, the regulator’s role in developing economies is all the more essential in promoting a country’s social objectives by ensuring that suitable financial services are available to as many of the country’s population as possible.

This section will discuss two examples of the key interplay between a national stated objective of financial inclusion and the role of the key financial regulator as a crucial partner in meeting this stated objective.

A) Philippines

As an archipelago of 7,107 islands, the country has a population of more than 100 million, and 36 percent of 1,634 cities and municipalities do not have a banking office. In its July 2015 publication and launch of “National Strategy for Financial Inclusion,” the Philippines government defined financial inclusion as “a state wherein there is effective access to a wide range of financial products and services by all.” The four key areas identified as being crucial to the success of the National Strategy included policy and regulation, financial education and consumer protection, advocacy programs, and data and measurement (to track effectiveness and results). Further driven by how the strategy is to be executed is its “Financial Inclusion Tactical Plans,” where the key financial regulator, Bangko Sentral ng Pilipinas (BSP – Central Bank of the Philippines) stated that “policies and regulations that

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7 Both Philippines and Kenya have been recognized by the Alliance for Financial Inclusion (http://www.afi-global.org/countries/) as being leaders in establishing and achieving financial inclusion objectives.
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support financial inclusion remain imperative to achieve an enabling environment wherein market-based solutions lead to broader access to responsive and responsible financial products and services by all.”

BSP’s efforts in financial inclusion has been widely-recognized. In 2015, two key policy and regulation initiatives spearheaded by BSP included the focus on an effective and efficient financial infrastructure and liberalizing its client onboarding rules. That infrastructure included the establishment of a National Retail Payments System (NRPS) to encourage the use of e-payment methods targeted at up to 30 percent of all retail transactions—this necessitated BSP’s support of the Payment Systems Act which laid out the legal and regulatory framework for BSP to oversee all payment systems in the Philippines, designate systemically important payment systems and supervise participants of designated payment systems. Financial inclusion addressed through a relatively cheap initial financial transaction access point provided by a safe, efficient, inclusive and reliable payment system, can contribute to the efficiency and stability of the country’s financial system.

BSP’s other key initiative is the liberation of customer onboarding rules so as to streamline information requirements for low-risk customers (e.g., presentation of valid and acceptable identification card). This included support for the use of technology to meet face-to-face onboarding requirements and simplifying documentation requirements already identified and assessed as posing low money laundering/terrorist financing risks, remittance tie ups and Filipino overseas workers and their beneficiaries.

1) Philippine’s RBA Regulatory Framework for AML/CTF

But such a focus on financial inclusion must be balanced with the available supervisory resources necessary to properly mitigate the potential AML/CTF posed by the new entrants into the financial system.

As of June 2014, the number of supervised institutions under BSP’s responsibility totaled almost 6,800 (28,000 locations when divided into headquarters and branches), while the number of AML examiners from the dedicated AML Specialist Group (AMLSG) of the Supervision and Examination Sector (SES) totaled a mere 36 complement. This results in a ratio of one examiner for every 226 covered institutions. With the adoption of financial inclusion as one of its key objective, clearly, the supervisory responsibility of BSP is only

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9 Government of Philippines, Financial Inclusion Tactical Plans: A compendium of financial inclusion-related programs and initiatives of the principal agencies that led the crafting of the Philippine National Strategy for Financial Inclusion, 8.
10 Indeed, in 2014, BSP was recognized as “the first central bank” by the Economist Intelligence Unit (EUI) to establish an office, the Inclusive Finance Advocacy Staff (IFAS), which is dedicated to financial inclusion.
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... going to expand, and most likely exponentially. The sheer resource imbalance between supervisor and supervisee required that SES pursue the principle of risk-focused supervision for AML/CTF. Driven by the guiding principle that “all financial service providers should be properly and proportionately regulated to uphold consumer protection and financial system integrity,” the concept of BSP’s AML Risk Rating System (ARRS) was born.

Rated on a scale of 1 to 4, with “4 – Sound” indicating the strongest RMS, and the most effective operational practices that entail the least degree of supervisory concern, a covered institution is assessed on the four key components (and their subcomponents) as followed:

1. Efficient Board of Director and Senior Management oversight (“Management”),
   - Ability of the compliance office to manage the MLPP;
   - Reliability, timeliness, completeness and helpfulness of MIS;
   - Consistent and effective identification, measurement, monitoring and controlling of risks and problems related to ML and TF (risk management practices); and,
   - Independence, accuracy and usefulness of self-assessment systems that are either proactive (through compliance testing), or reactive (through internal audit).

2. Sound AML/CTF policies and procedures embodied in a board-approved Money Laundering and Terrorist Financing Prevention Program (MLPP)
   - Coverage of MLPP (as to Philippines’ AML legislative and regulatory requirements);
   - Risk management practices related to ML/TF prevention are incorporated in MLPP; and,
   - Extent of dissemination of MLPP and level of awareness

3. Robust internal controls and audit (Controls and audit)
   - Independence and support;
   - Coverage; and,
   - Timeliness of communication of internal audit reports

4. Effective implementation (Implementation)
   - Assessment of risk-based and tiered customer acceptance and identification;
   - Ongoing monitoring of transactions and activities of customers;
   - Assessment of covered transaction reporting system;
   - Assessment of suspicious transaction reporting system;
   - Assessment of record keeping and retention system; and,
   - Assessment of continuing education and training program

14 Ibid., 18-24.
As the key financial regulator, BSP’s transparent risk-based supervisory approach, coupled with stated commitment to financial inclusion efforts, encourages the players of Philippines’ financial system to similarly commit to financial inclusion efforts and invest in new products/services and technologies—confident in the knowledge that they have a sufficient understanding of the regulatory expectations for effective AML/CTF compliance, with minimal fear of reprisals in the form of enforcement actions for unintentional missteps as they onboard the impoverished/underserved population as new clients.

B) Kenya

Announced in 2007, *Kenya Vision 2030* detailed Kenya’s long-term development blueprint for the country aimed at transforming its society into “a newly-industrializing, middle-income country providing a high quality of life to all its citizens in a clean and secure environment.”\(^{15}\)

The blueprint envisaged a deeper and broader financial sector that contributes to economic growth and improves the livelihood of its citizens. In 2006, only 26 percent of adult Kenyans had access to formal financial services, compared to 38 percent having no access at all, and commercial banks were closing down rural branches due to high operational costs.\(^{16}\) There was little the Central Bank of Kenya (CBK) could do to halt these closings, and it did not have much latitude in the legal or regulatory framework to manage new products that are introduced by nonbanks.

C) CBK and M-PESA: Key players in Kenya’s Financial Inclusion Objective

Against this backdrop, and demonstrating its commitment to financial inclusion objectives, CBK played an integral role in developing an enabling legal and regulatory environment for mobile financial services, when it considered the application by the Commercial Bank of Africa, Safaricom Limited and Vodafone Group to authorize M-PESA, a mobile-enabled money transfer and payment service, despite the statutory weakness of the Central Bank of Kenya Act to empower CBK to issue regulations on payment services in general.\(^{17}\) This authority was in fact not granted until the enactment of the National Payment System in 2012.

To address concerns of traditional banks that nonbanks were permitted to accept deposits without the proper regulation as required under the Banking Act, CBK clarified that the point at which the cash given to an agent was converted to mobile money, with bank noted and coins exchanged at par value for an equivalent amount of mobile money, the electronic value would be reflected on the customer’s mobile money wallet, and accessible only by the customer through their phone, thusly remaining securely in the customer’s possession and control. Critical to this understanding is that the mobile money model adopted does not permit the service provider nor the agent who accepts the cash exchange for e-money to treat as their own money to be used for lending, investing or other activities for their own

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\(^{17}\) Ibid.
purposes. Furthermore, to address the potential increased money laundering/terrorist financing vulnerabilities with this payment system, CBK required from Safaricom to adopt a comprehensive AML/CTF and risk management program, along with appropriate measures to ensure sufficient system security, maintain business continuity plan, and manage solvency risk. Furthermore, CBK gathered all the key stakeholders from various departments, including Banking and National Payments.

The CBK assembled a cross-functional team of experts from various departments, including Banking and National Payments, Bank Supervision and Legal, to review the application for M-PESA.

From the beginning, CBK envisioned M-PESA as a low-risk money transfer service and various measures were taken to lower its risk profile, including:

- Limits on the size (value) of mobile money transactions;
- Daily limits on mobile money transaction values (only two transactions at the highest transaction level were permitted per day);
- Maximum balance limits on mobile wallets (to discourage the use of mobile money wallets as a substitute for bank accounts);
- Risk compliance monitoring and adherence to stringent AML/CTF policies; and
- Submissions of monthly regulatory returns to the CBK, including an ‘inactivity report’ of residual funds held inactive over periods ranging from >30 to >90 days.

Figure 5. **Kenya’s Mobile Money Business Model**

Source: Muthiora, 2015.

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18 Ibid., 10.
19 Ibid., 11.
A key element of its success and adoption by the public is that the cash exchanged was held in a trust account under the custody of a trustee, creating a layer of protection for customer funds since the funds held in the trust were separate from the funds of the service provider. As such, the service provider was unable to use the funds for its own purposes; more importantly, the funds exchanged were safe from claims by creditors in the event of insolvency. As the size of the trust account increased as the M-PESA service grew in acceptance, the trustee, with permission from CBK, was permitted to spread the funds across several banks to reduce the risk of a single custodial bank failure.

CBK, as the key financial regulator of Kenya, demonstrated a willingness to lead the effort in new product development and a deep understanding of the business models, the various risk factors they posed, and the appropriate risk mitigants, in order to meet the needs of the underserved. It also recognized the crucial importance of collaboration across various departments, in light of the lack of certainty regarding its regulatory authority to regulate new payment services. CBK provided the leadership necessary to achieve the goals of Kenya Vision 2030.

As a result, access to formal financial services has increased from 26 percent of Kenya’s bankable population in 2006 to 67 percent in 2013, predominantly enabled by mobile phone financial services. What began as money transfer services has now become a platform with a menu of financial services that includes money transfers, payments of goods and services, savings, credit, insurance, pensions, and even capital market products. That said, much more remains to be done, as 25 percent of Kenya’s bankable population still cannot access any form of financial services.

Figure 6. Central Bank of Kenya’s enabling regulatory approach allows 23 million people (74 percent of adult population) to use mobile financial services via 90,000 agents.

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20 Ibid., 4.
21 Ibid., III.
As stated by Professor Njuguna Ndung’u, Governor of CBK, “When regulators embrace a leadership role in developing the market, they become innovative and take reasonable risks inherent to making the changes needed to create a more inclusive financial sector. Although regulators’ main concern is always the safety and soundness of financial systems, those that have made the most progress have been willing to explore new routes or to use new tools to enhance traditional financial activities.”

IV) **RBA: Profitable Reasons for FIs to Adopt Financial Inclusion**

Banks operating in a post-2008 financial crisis world face unprecedented pressures to identify new business opportunities to grow and be profitable whilst meeting the increasing regulatory demands to be AML/CTF compliant. The 2.5 billion unbanked adults mentioned at the beginning of this paper present an untapped consumer base that banks should target to generate organic growth. But to tap into this new customer segment while at the same time minimizing costs, banks must re-evaluate their legacy models and innovate. In addition, banks can confidently undertake this process with the support and transparency of legislative and regulatory frameworks, as exemplified by BSP and CBK.

**A) Three Delivery Models to Address Financial Inclusion**

The World Bank Group has identified three standard banking models available in today’s global financial system to deliver services to the unbanked: branch-based distribution,
correspondent-based distribution; and mobile financial services, with the latter being the most recent innovation.

The branch-based distribution model, considered the traditional approach to banking with its brick and mortar financial institutions. Until the 1980s, for most countries, they were the only regulated entity allowed to offer checking accounts. While this traditional branch-based distribution approach remains the dominant model, is limited in its reach to the poor and rural areas because cost/benefit analyses building and staffing physical branches show low returns on investment. As a result, this has forced traditional banks to limit their physical networks to more urban areas.

The correspondent-based model is not limited to just the banks, but also include service providers that deliver services on behalf of another financial institution. Banking correspondents can allow transactions, accept deposits and gather documents as a service supplier for a main bank. This model has been used increasingly in rural areas where it is too costly for the banks to expand through branches. Yet these correspondent arrangements face challenges especially in the AML/CTF compliance areas. In addition to the business concern of commission structure being typically too high for the poorest customers, KYC/CDD requirements necessitate special training for staff in the outlets. Consequently, the services available are limited, and often consist of no more than money transfer, which is a low-margin (if any) profitability product.

The most recent innovation in the financial services distribution model is the mobile technology. The speedy adoption of mobile technology, coupled with its wide geographical reach, has enabled millions of people access to financial services, typically characterized as “m-finance,” as exemplified by Kenya’s M-PESA. Indeed, this technology platform has made possible the provision of additional financial services outside the typical payments services of mobile money, but also mobile insurance and mobile credit and savings. Consumers with mobile access are now able to conduct basic financial transactions, such as balance enquiries and money transmission (receive, transfer and deposit money).

B) The Future of Banking

It is clear that many mainstream banks consider banking the unbanked as a huge and risky undertaking, and therefore relegate any effort in this to Corporate Social Responsibility programs and offering credit lines to intermediaries. Repeating experiments to serve the unbanked by providing low-cost services from high-cost business models are sure to

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25 The Indonesian bank, Bank Danoman, has been expanding services through portable branches to grow its business while minimizing branch costs.
26 Ibid.
27 Ibid., 10.
guarantee, at best, minimal change, and at worst, complete failure. However, Capco and Ashoka (2015) argues that commercial banks can re-engage in assisting meeting both financial inclusion and business objectives, but this can only be achieved if such re-engagement is done on a different basis, recognizing the following:29

- New operating models can be exported back to the mainstream of their businesses to strengthen and lighten their heavyweight operating models;
- The risk of pioneering new solutions is already being taken by non-banks; mainstream banks no longer have to experiment—they can free-ride.
- The pathway to profitability in the unbanked sector is now faster and more certain thanks to the rising income of the bottom 40 percent. 30
- The accelerator effect of mainstream banks proactively participating in new ecosystems will contribute to the social and economic aspirations of the unbanked and make them more attractive customers.
- Mainstream banks need to recognize and leverage the innovations from recent years and re-set their perceptions of the unbanked market

Mainstream banks have begun to recognize the need and potential business opportunities of the unbanked, and this can further be strengthened by regulatory and global initiatives to promote financial inclusion.

30 http://www.centerforfinancialinclusion.org/fi2020/mapping-the-invisible-market/growing-income-growing-inclusion
1) Supporting Alternative Service Providers

In a minimal AML/CTF risk-related approach, Standard Chartered Bank (SCB) has committed to financial inclusion through the providing of credit to 32 microfinance institutions (MFIs) in 10 countries, with 20 MFIs located in India, Nepal and Bangladesh. Seventy two percent of these MFIs are NGOs and NBFIs, with banks coming a distant third at 16 percent. More than half of all of these institutions cited existing business growth, increased access to financial services, and employment generation as explicit social objectives, regardless of geography.

Figure 7. SCB MFIs by Legal Status


While it is currently not a core business of SCB, with no expected business or revenue synergy with its mainstream banking activity, this initiative exploits a specific competency in wholesale credit lines, and the wholesale banking business capability of the bank, which is at the core of its founding historically. Capco/Ashok (2015) argues that there is no inherent cost accreted to the wholesale funder, as no new systems or distribution channels needed to be built. But the net impact as an ‘economic multiplier’ is nevertheless contributing positively to the expansion of the alternative providers’ system.

2) Developing Mobile Banking Platforms

Similar to the efforts of Kenya Vision 2030 and M-PESA, banks have been piloting projects on mobile banking. For example, 12 mainstream banks in Africa and Latin America have partnered with Wizzit (a South African Social Enterprise) to use its mobile banking platform to launch mobile payments and money transfer services, as well as to enable lending and deposit-taking. Designed from the start as a client-centric technology, the platform has

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made mobile banking feasible for about 7 million previously unbanked customers and has solved much of the distribution challenge. These experimental approaches adopted by the banks can be characterized in the following way.33

- ‘Launch and Done’ – This model is an essentially monoline strategy, where the bank is single product focused (e.g., mobile payments) because their core business model allows only incremental flexibility towards the unique demands of the unbanked value chain. Unwilling to change their core business model (which is designed primarily for the middle income market) they see their sweet spot as being a product-line extension only.

- ‘Land and Expand’ – This model reflects the bank’s understanding that the unbanked and under-banked can be a potential pipeline for mainstream services but they do recognize that the unbanked customer needs to be ‘nurtured’ into a sound credit risk. They ‘pick one product’ to co-create trust with the customer and they provide financial education to enable the unbanked to become more comfortable expanding their financial product usage. A good example is the use of microfinance as a foundation for building relationships and trust. Very small loans (e.g., to buy a mobile phone) can act as a stepping stone to a second service, such as providing emergency credit.

3) Empowering the New Consumer

The future of poverty reduction will have to move away from the traditional handouts, and providing financial service access points to the 2.5 billion unbanked requires that banks and other service providers view the consumer as the main proactive participant in their own effort to rise out of poverty. As such, financial institutions should not only focus on providing consumers with access to financial services, but equally more important, providing them with the means to receive basic financial education, and tailoring the products needed by this segment accordingly. As the consumer’s wealth and stage of life progresses, so should the type of financial education the consumer receives.34 SCB’s financial inclusion efforts reflected in its partnerships with MFIs illustrates the kind of insights that financial institutions can gain by partnering with social entrepreneurs.

V) The Third Line of Defense: The Role of Audit in Financial Inclusion

In AML/CTF compliance, the three lines of defense is well established and understood. Within the FI, the overriding tone and message is that the first line of defense is the

32 Capco/Ashoka (2015),16-17.
33 Ibid., 17
business units, as they engage with the customers directly and do (should) know them best, with the second line being compliance, and followed lastly by internal audit as the third (and final) line of defense. However, one could argue that in fact, internal audit is the first line of defense from a regulatory review and examination viewpoint. That is to say that during the examination process, any issues of concern identified either during the pre-onsite or onsite examination process would have led the examiner to begin by requesting all the internal audit reports relating to those issues. As such, the internal auditor would indeed be expected to demonstrate an understanding of its role in the context of financial inclusion.

A) Key Components of AML Audits

Figure 8. AML Independent Testing Framework

Figure 8 above illustrates the cycle of 10 steps of an effective independent AML, during which several steps are available to the auditor who can and should evaluate financial inclusion efforts of the institution.

For example, in reviewing the risk assessment process and results—whether they relate to enterprise-wide, specific customers, and/or new product development—the auditor should be review and address the following:

- Is there a National Risk Assessment (NRA) for the countries in which the FI has a presence?
- Assuming the existence of an NRA, does the FI’s risk assessments incorporate issues (products/services, customer segments, geography, etc.) identified in the NRA?
- Is there a national strategy and/or stated objective for financial inclusion? If so, has the FI’s risk assessment incorporated the accepted new products approved (MPESA), and risk-rate them according to stated requirements of the financial regulator? Has the FI’s risk assessment incorporate the new simplified KYC/CDD requirements per regulatory guidance? Has the FI’s risk assessment for specific
customer segment incorporated the characteristics identified by the financial regulatory as being low-risk? (e.g., Are BSP’s guidelines on simplified KYC/CDD incorporated into the risk assessment? Are BSP’s ARRS properly incorporated in the risk assessment process as well as the policies and procedures?)
- Has the business units properly risk-assessed their customers? (e.g., Do staff of SCB’s wholesale banking unit understand MFIs and properly risk-rated them?)

While there are many other components of the AML independent testing framework in which the auditor can and should insert financial inclusion-related questions, the one key component is the role of training, and testing of the business units in understanding financial inclusion and having incorporated such stated objectives in their client onboarding and acceptance processes. For example:

- Do the FI staff understand financial inclusion and its implications?
- Is the FI staff aware of its institutional position on financial inclusion, and why?
- Do the FI’s business units that are crucial to financial inclusion objectives understand their role? (e.g., SCB’s wholesale banking business and their engagement with MFIs) Are they aware of the product/services developed specifically to meet the needs of the poor/unbanked? Are they trained on the products/services that should be offered to this customer segment? What policies and procedures are in place to enforce the role these business units must accept?

B) **Audit Framework for FIs Addressing Financial Inclusion**

This paper proposes the following guidelines for audit to test various key components essential to financial inclusion adoption and thereby minimizing the potential AML/CTF risks posed by such a policy objective. Links to the websites of relevant public authority and supporting documentation are required, where possible, to properly substantiate comprehension and implementation of the requirements.

1. The AML/CTF Regulatory Environment in Country X
   a. What is the relevant AML/CTF law and regulations and when did they become effective?
   b. Has there been revisions to the regime since its implementation? Provide a link to the relevant website. If so, what are the revisions and how do they compare to the requirements of the previous AML/CTF regime? Explain and provide documentation of such analysis.
   c. Who is the primary regulator of the AML/CTF regime? For (a) banking; (b) other financial services; (c) Designated non-financial businesses and professions (DNFBPs)
   d. Are there practical guidelines by official sources in AML/CTF requirements, in addition to those provided by FATF?
   e. Has the primary regulator approved a risk-based approach?
   f. Has the country been subject to a FATF or FATF-style Mutual Evaluation?
g. Has the country undergone a national risk assessment? If so, what are the key risks (products/services, sectors) identified? What are the recommended controls, if any?

h. Has a national policy of financial inclusion been announced and when does it go into effect?

i. Has regulatory guidelines been announced to assist in the financial inclusion objective? If so, when do they go into effect? What are the regulatory guidelines?

j. What are the measures to be utilized by the primary regulator to ensure compliance of financial inclusion?

2. Country X’s AML/CTF Regime - CDD Requirements
   a. Are there minimum transaction thresholds required for CDD?
   b. Are there minimum transaction thresholds under which CDD are not required?
   c. What are the high level requirements for customer information verification for individuals and corporates (legal entities)?
   d. What methods are approved for independent authentication of copies of customer identification information?
   e. What are requirements for beneficial ownership in terms of identification and verification?
   f. Under what circumstances are simplified/reduced CDD permitted?
   g. What customer information identification are permitted under simplified CDD?
   h. Who and under what circumstances are required for enhanced Due diligence (EDD)?
   i. What products/services/relationships require EDD?

3. FI’s Policy and Procedures for Financial Inclusion
   a. What announcement has been made on this policy objective by FI? Are geographies specified in which would financial inclusion would be applicable?
   b. Who owns this policy? When does (did) it go into effect?
   c. What products/services are and/or would be offered to meet financial inclusion?
   d. What potential AML risks were identified and mitigated in determining products/services appropriate for meeting financial inclusion?
   e. Which business unit(s) would be impacted by financial inclusion?
   f. What are the CDD requirements for these products/services? What types of customer information and verification are required?
   g. What customer segments are considered for financial inclusion?
   h. What is the approval process for client onboarding of these customer segments or the use of products/services designated for meeting financial inclusion objectives?
   i. What are the transaction monitoring thresholds of such customer segments and their use of products/services? What threshold would trigger an alert?
j. What type of training has been provided regarding financial inclusion? How frequent is this training?

4. Testing FI’s Policy and Procedures for Financial Inclusion
   a. Identify the products/services developed for the purpose of financial inclusion
      i. Maximum threshold allowed for deposits
      ii. Maximum threshold allowed for remittances
      iii. Frequency allowed for deposits per day, per month in aggregate
      iv. Frequency allowed for remittances per day, per month in aggregate
      v. Are transaction monitoring thresholds mapped accordingly?
   b. Identify the customer-segments targeted for financial inclusion
      i. Geographical location
      ii. Types of employment (formal and informal)
      iii. Expected sources of income (formal and informal)
      iv. Type(s) of acceptable forms of identification
   c. Evaluate the risk assessment conducted for these products/services
      i. Expected transaction volume
      ii. Expected transaction value
      iii. Expected customer volume
      iv. Expected geographical concentration
      v. Preventive controls identified for CDD process
      vi. Detective controls implemented for risk management
   d. Evaluate the CDD processes
      i. Customer identification information requirements—standard vs. simplified CDD vs. as permitted by regulatory guidelines
      ii. Approvals required for account opening
      iii. Circumstances under which exceptions to client identification requirements are permitted (by regulatory guidelines vs. by the FI), and whose approval is required
   e. Training Policy
      i. What type of training is provided to staff on financial inclusion? Duration of training?
      ii. Who develops the content of training (policy, products/services, etc.)?
      iii. How frequent is training provided?
      iv. What is the assessment mechanism, if any?
   f. Sampling—5 percent of FI’s Individual Customer Accounts
      i. Percent using products/services identified for meeting financial inclusion (“Subgroup”)
      ii. Standard average transaction volume or value of the total sample vs. average transaction volume or value of the subgroup
      iii. CDD requirements of total sample vs. subgroup
      iv. Exceptions to CDD requirements of total sample vs. subgroup
      v. Approval process of total sample vs. subgroup
      vi. Geographical profile of total sample vs. subgroup
vii. Monitoring alerts of total sample vs. subgroup
viii. Frequency of monitoring/review of total sample vs. subgroup
ix. Average daily and monthly balance of total sample vs. subgroup
x. STRs filed on total sample vs. subgroup
xi. Nature of STRs files on total sample vs. subgroup, if applicable
xii. Type and frequency and duration of training provided—for total sample vs. Subgroup

The last component of these audit guideline—sampling—would reveal whether the expected activities and behavior of the customer segment targeted for financial inclusion is consistent with risks and controls identified during the risk assessment process, and if there are inconsistencies, the FI would be able to identify the revisions required to policies, procedures and monitoring requirements.

In the case of Central of Kenya’s adoption of M-Pesa to meet the objective of financial inclusion, an audit was conducted to address potential abuse of the service for money laundering activities. The audit process included an examination of the entire M-Pesa IT platform from ‘front to back,’ with a particular view to ensure that it could operate safely in the Kenyan market. The auditors tested the end-to-end encryption of the SIM card functionality, which held all of the confidential customer data; reviewed the use of hardware security modules at the M-Pesa servers; and ensured that all business processes had embedded security procedures, including live backup. Most importantly, they checked that all of the M-Pesa systems allowed for comprehensive reporting and management so that every transaction could be monitored, individually and in aggregate, thereby ensuring that CBK could request accurate information regarding the system audit trail, particularly liquidity management, clearing and settlement, and AML procedures.

In addition, the audit also revealed that the majority of customers used the service for domestic remittances: on average sending about $25 per transaction, twice per month, which is consistent with the expected parameters established by CBK for low-risk customers. Interestingly, a customer satisfaction survey included feedback that 21 percent of those surveyed (3,000 customers), used the service to “store money”—which contradicts CBK’s objective of not having M-Pesa substituting as bank accounts. However, audit’s review of inactive accounts showed that only 1.6 percent (60,000 out of 4 million customers) remained inactive for more than 30 days, and that the average residual amount held in these accounts after 30 days was just about the equivalent of $2, and thereby re-affirming that CBK’s objective for financial inclusion was no not displacing the role of banks.

C) Using Audit to Test FI Adoption of Financial Inclusion: The Case of India

It has been widely argued that regulatory AML/CTF requirements have placed undue burden on financial service providers, most notably banks, and in fact, have led to the “creation of

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categories of clients whose businesses cannot justify the associated compliance costs,” and thusly the de-banking of whole customer segments. However, it is important to note that even in jurisdictions where there is clear national stated objective of financial inclusion, and its crucial role in economic development, as well as clear regulatory guidelines to provide for the development of new products and thereby less onerous KYC/CDD requirements, FIs have either not adopted the financial inclusion objectives into its business plans and/or FIs have not executed properly the business plans even when these plans have incorporated financial inclusion objectives, including new low-cost product offerings and reduced KYC/CDD requirements.

India is well-known for its adoption of financial inclusion since the 1960s, most notably dominated by a supply-side, credit-driven focus. However, beginning in 2005, the government revised its strategy to focus on savings for low-income households that is consistent with global trends, and established the “No Frills Account” (NFA)—a basic savings account to increase financial inclusion. Banks were asked to relax their proof of identity and address requirements for low-income customers who maintained low balances. A national household survey found that a large proportion of non-users of financial services reported lack of sufficient identity and address proof as the reason for not having a bank account. In addition, such documentation requirements are more likely to lead to the exclusion of women (status defined by husband and his family) and migrants (who have residence documents in their place of birth) as well as low-income or informally employed individuals (who are less likely to possess multiple identity documents).

In response to the banks’ claim that the due diligence requirements of KYC/AML policies—and the associated penalties for violation—form one of the challenges in opening accounts for low-income households, the financial regulator, Reserve Bank of India (RBI), proposed to limit or even waive the penalty for accepting incomplete or invalid documents (Rajan, 2014). And in 2013, the RBI’s Committee on Comprehensive Financial Services for Small Businesses and Low Income Households recommended waiving the requirement for proof of current address in order to open accounts. To further address the seemingly-onerous KYC requirements that were considered impediments to financial inclusion objectives, the government has also been actively promoting a free national biometric ID card, called Aadhaar, which would function as proof of ID as well as address.40

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In an audit conducted in urban South India to examine the barriers faced by customers in purchasing a low-cost savings product, it was found that banks did indeed have a high ability to influence financial access outcomes, even when product availability and eligibility rules are non-discretionary. Most of the banks refused to market the regulator-mandated basic accounts, even when the customers asked for “basic accounts.” Furthermore, in more than half (55 percent) of the bank branches visited, customers were turned away when they attempted to negotiate for an alternative, affordable savings product—in half of the cases, the bank refused to accept the customer’s valid identity or address proof, while in the other half of the cases, the bank refused to market an alternative low-cost product. For the accounts that were opened, the banks demanded excessive identity and address documents, withheld key information about the product’s terms and fees, and imposed significant time, effort, and incidental costs on the customers.41

The India case is a clear example of the important role that audit can play to ensure careful monitoring and targeted enforcements of the country and/or the bank’s financial policy implementation. Despite the clear regulatory guidelines on acceptable CDD for these low-value accounts, the audit process revealed the lack of adoption of these procedures by most Indian FIs. By utilizing the audit framework laid out above, the auditor can assist in identifying why there is resistance by the business unit to make available these types of already regulatory-approved accounts to these customer segments. For example, were there internal announcements by the banks offering this product on this policy objective for financial inclusion? Was the owner of this policy identified? When was it adopted and enacted? Was the policy objective made clear to bank personnel and why it was important to the bank (for business growth, corporate social responsibility, to meet regulatory requirements, etc.)? Was there clear communications to the business unit responsible for rolling out this type of account? Was there proper training provided to the client-facing staff of this business unit on the features of this account, and for whom this type of account is appropriate? Was their training on the CDD requirements for this type of account? Was there a policy to monitor client-facing staff and their account-opening processes with customers? What is the enforcement mechanism on client-facing staff and their supervisors to comply with the roll-out of these regulator-approved accounts? What are the recent enforcements actions by RBI on non-compliance with these account-opening guidelines? And the questions continue.

The important role of audit cannot be overstated in meeting the objective of financial inclusion. As the independent evaluator, audit provides the framework to identify the objective, the communication, the policies/procedures/monitoring and training required to understand and mitigate the expected increased money laundering risks associated with financial inclusion adoption.

VI) Conclusion

Financial inclusion, financial integrity and financial stability are not only achievable but are also mutually reinforcing. This is only possible through the legislative and regulatory leadership necessary to encourage private-sector participation in such an important objective. Recognizing the potential economic value of serving the 2.5 billion unbanked requires this public and private partnership. The potential harm to financial and economic stability of not providing financial access points to the unbanked cannot be overstated. In her address to the Plenary Meeting of the Financial Action Task Force, H.M. Queen Máxima of the Netherlands, UN Secretary-General’s Special Advocate for Inclusive Finance for Development, noted that “international migrant workers are expected to send home about $450 billion this year through formal services, paying fees as high as 20 percent. They are also expected to send an additional $150 billion through informal channels, even though these are known to be not very safe for [the] sender or receiver.”

By moving individuals from the shadow economy into the formal financial system, greater opportunities emerge for introducing underserved populations to a broad suite of formal financial services, and ensuring those services are accompanied by suitable consumer protections. Thus, financial inclusion, financial integrity, and financial stability can act as complementary objectives.

It is also important to note that while this paper has been focused on financial inclusion efforts of developing economies, the issue of the unbanked are not limited to developing economies. It should also be noted that a quarter of all U.S. households—some 68 million adults—do not have a bank account, representing a mix of working and middle-class families, poor and unemployed segments of the population impacted by the recent economic crisis, as well as the young and immigrants. It was estimated that in 2012, they spent about $89 billion just on interest and fees for alternative financial services, such as payday loans and check cashing exchanges just to make ends meet. The average underserved household spent an estimated $2,412 annually just on interest and fees for these alternative financial services.

Furthermore, a new concern for financial inclusion objective is the growing refugee crisis around the world, which is currently estimated to total 19.5 million as of the end of 2014, but the number of “forcibly displaced” worldwide totals 59.5 million. The issues raised in this paper operated on the fundamental assumption of having citizenship (if even documentation may be lacking), as well as focusing on adults. However, addressing financial exclusion based on these parameters does not address the current financial

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45 Ibid.
exclusion of refugees. Of note is the focus on adults—young people represent huge opportunities for growth in the global economy, but they encounter major financial inclusion barriers. And in particularly with refugee children, more than 34,000 refugee teenagers annually become the heads of their households after their parents are killed, and millions more manage the family's affairs because their parents are disabled or are lacking physical or mental capacity from war injuries or trauma. These refugee children need banking services as well, but they are excluded because of age, lack of identification and often poverty. Our definition of financial inclusion ought not to discriminate against capable children.
Financial Inclusion, Developing Economies, and Effective Implementation of the Risk-Based Approach in AML/CTF: The Need for Legislative and Regulatory Leadership to Motivate Private Sector Commitment & the Role of Audit

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