FINANCIAL INTEGRITY AND FINANCIAL INCLUSION

(How can integrity and inclusiveness mutually reinforce each other in the financial system?)

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Abstract

The Covid-19 crisis has reversed the gains made in addressing inequality and financial inclusion. Ensuing recovery efforts are leveraging technology to bring the unbanked and underbanked into the formal financial system. As more transactions enter formal channels, it weakens the illicit financial flows and deters ML/TF activities. In view of this complementary relationship between financial integration and financial inclusion, the FATF has provided for in-built flexibility within its standards which can be tailored to benefit low-income individuals and businesses. Through the correct application of the risk-based approach (RBA), financial service providers can lower the barriers of entry into the formal economy. However, conservative and risk averse behavior is promoting derisking to the detriment of the poor and marginalized. This approach undermines the integrity of the financial system which is looking for safe and inclusive solutions to recover from the pandemic. Proportionate 'preventive measures' can lower onboarding costs for regulated financial institutions and improve oversight and enforcement. The effective risk-based implementation of the global AML/CFT standards will address both exclusion challenges and illicit financial flows.

1. Complementary relationship between financial integrity and inclusiveness

The current pandemic has exacerbated income inequalities and deepened social and economic exclusion. The latest estimates from the World Bank point to the rising numbers of '**new poor**' which is expected to touch 150 million by 2021[2]. When these low income households/ businesses access finance through informal sources, huge volumes of (albeit small value) transactions escape regulatory oversight and can be misused by bad actors. This undermines the efforts of regulators, supervisors, and law enforcement officials to effectively track the proceeds of crime. Therefore, the deepening and widening of financial inclusion in a country can contribute to a robust AML/CFT regime.

Given this direct link between formal financial access and greater oversight over financial flows, it is unfortunate that the "incorrect application of the FATF standards" by countries and jurisdictions have contributed to **de-risking** and financial exclusion.[3] De-risking occurs when banks and financial institutions terminate/decline business relationships

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[2] World Bank (2020), Poverty and Shared Prosperity 2020, World bank, Washington DC, www.worldbank.org/en/publication/poverty-and-shared-prosperity.

[3] FATF (2021), Mitigating the unintended consequences of the FATF Standards, FATF, Paris, Documents - Financial Action Task Force (FATF) (fatf-gafi.org).

with special categories of customers perceived as high risk. This wholesale denial of access to formal financial products and services drives transactions underground, furthers exclusion and erodes the integrity of the financial system.

De-risking is particularly **detrimental to correspondent banking relationships (CBR) and money and value transfer services (MVTS)** both of which are crucial to the remittances sector.[4] Banks may decline access to overseas financial institutions and money transfer operators either for commercial reasons or over ML/TF concerns. These services mostly utilized by migrant labor in overseas locations and urban areas is crucial for sustenance of their families. The restrictions drive remittances underground forcing the adoption of informal and opaque delivery channels. This fuels the underground economy and boosts illicit financial flows.

The implementation of counter-terrorism measures may sometimes drive '**overcompliance**' among financial institutions who may **perceive all Non Profit Organizations (NPOs) and charities as risky**. This can have disastrous consequences for delivery of humanitarian assistance particularly in crisis situations like the current pandemic. Thus, while the mutually reinforcing relationship between financial integrity and inclusion is widely acknowledged, the "unintended consequences" of a rigid and defensive approach to fighting financial crime can actually undermine both. [5]

Alternatively, can the AML/CFT regulatory framework be designed in a manner to reduce financial exclusion and bring low income households and families into the formal economy? Can law and enforceable means to detect and disrupt illicit financial flows also lower the barriers for accessing the regulated financial system? This paper begins by examining how the risk based approach (RBA) of the FATF affords sufficient flexibility to design regulatory policy that furthers inclusion without exposing the financial systems to money laundering and terror financing risks. It then discusses technology led approaches to provide financial access to disadvantaged groups while being compliant with FATF Recommendations. It concludes by suggesting that making financial inclusion a key metric for judging effectiveness of an anti-money laundering/countering the financing of terrorism (AML/CFT) regime, should be the strategy for post pandemic growth and recovery.

2. The flexibility afforded by the FATF Recommendations

The revision of the FATF standards in 2012 introduced the **risk based approach**(**RBA**) for the design and implementation of an effective AML/CFT regime.[6] The Recommendations

[4] Ibid.
[5] Ibid.
[6] FATF (2012), International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation, FATF, Paris, www.fatf-gafi.org/recommendations.

themselves along with Guidance and Interpretive Notes (INR) elaborate the RBA through risk profiles based on customer, product and regional vulnerabilities. The '**preventive measures**' in terms of customer due diligence, record maintenance and monitoring and reporting of suspicious transactions are to be applied proportionate to the identified risks. Whenever the risk level is high, enhanced due diligence measures (EDD) will have to be applied to mitigate the risk. Alternatively, in situations of 'proven low risk' or 'lower risk', flexibility has been provided through allowing of exemption of AML/CFT processes or use of simplified measures respectively.[7]

The FATF has clarified that exemption from application of some of the Recommendations may be provided in either of two situations.[8] Whenever there is '**proven low risk** of money laundering or terror financing' , which occurs 'in limited or justified' circumstances and 'in relation to a particular kind of activity of a financial institution or DNFBP provider' the exemptions apply.[9] The other situation arises when a financial activity (not applicable to the transfer of money or value) is carried out '**on an occasional or strictly limited basis**'.[10] While the Interpretive Notes make it clear that Money and Value Transfer Services (MVTS) cannot avail of this exemption, there is no definition of what construes financial activity carried out on an 'occasional or strictly limited basis' .

While exemption from applying the full range of AML/CFT safeguards is permitted in low risk situations, for '**lower risk**' activity, customers or products, simplified CDD measures may be sufficient for risk management and mitigation. The FATF standards provide an illustrative list of 'lower risk' situations by product type, customer profile and geographic regions.[11] While not exhaustive, these indicators can be applied to provide basic and entry level financial offerings which can enable the unbanked and underbanked access formal financial services in a safe and reliable manner.

Minimal and low value ('small') accounts, credit instruments and insurance products have the potential to benefit the poor and vulnerable and lift them out of poverty. From a risk perspective, not all of these inclusive products and services will qualify for simplified measures across all components of the 'standard' CDD process. While identification and verification requirements may be relaxed by permitting alternate forms of ID (as discussed in Section 5 below) or by deferment of authentication, normal levels of transaction monitoring may be necessary to mitigate for instance, the risk of terror financing. The flexible and proportionate measures inherent in the risk based approach (RBA) for 'low risk' and 'lower risk' financial activities can help countries achieve their financial inclusion objectives without compromising the integrity of their financial system(s).

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7 FATF Recommendations, Recommendation 10, Interpretive Note, Para 17.

8 FATF Recommendations, Recommendation 1, Interpretive Note, Para 8

9 Ibid.

10 Ibid.

11 FATF Recommendations, Recommendation 10, Interpretive Note, Para 16 to 18.

3. Assessment of risk

The FATF does not prescribe any criteria/rules for identifying 'low risk' and 'lower risk' situations and the onus is upon countries to make their own assessments based on the unique characteristics of their financial sector and its participants. A comprehensive national risk assessment (**NRA**) covering all sectors is therefore crucial for proper application of the flexible and proportionate measures provided within the risk based approach (RBA). Recommendation 1 emphasizes the need for countries/jurisdictions to 'identify, assess and understand the money laundering and terror financing risks' and take actions to mitigate those risks. The FATF does not prescribe any Methodology, but provides general guidelines that countries can follow in framing their risk assessments.[12]

The **World Bank** and the **IMF** have prepared a **NRA tool** and **Methodology** respectively which countries can follow or develop their own risk assessment with reference to the FATF Guidance on the topic.[13] The World Bank's NRA tool specifically addresses financial inclusion in Module 9, through the '**Financial Inclusion Product Risk Assessment Module**' (**FIRM**). Module 9 offers a structured and step-wise method to evaluate the risk of financial inclusion products.[14] When the product has high risk features such as anonymity, international transactions and non-face to face account opening, the module recommends redesign features such as transaction thresholds and increased monitoring of cross border financial flows. This 'systematic and evidence-based' assessment identifies 'low' risk products to which simplified due diligence measures can be applied.

Whichever Methodology is applied, the assessment has to be dynamic to incorporate evolving threat patterns and vulnerabilities. The current pandemic has demonstrated how rapid adoption of digital services increases the susceptibility of public and private networks to online fraud and cyberattacks.[15] When newly banked individuals/businesses tap into telecommunication networks they are exposed to attacks of unprecedented volume and velocity. It is therefore vital to conduct a holistic assessment of the inherent risks associated with innovative digital products and services before their release for mass adoption. The

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[12] FATF(2013), Guidance, National Money Laundering and Terror Financing Risk Assessment, FATF, Paris, www.fatf-gafi.org/media/fatf/content/images/National_ML_TF_Risk_Assessment.pdf.

[13] Ibid.

[14] FATF (2013-2017), Anti-money laundering and terrorist financing measures and financial inclusion - With a supplement on customer due diligence, FATF, Paris, fatf-gafi.org/publications/financialinclusion/documents/financial-inclusion-cdd-2017.html

[15] FATF (January 2021), 'Covid-19 and the Changing Money Laundering and Terrorist Financing Risk Landscape', Remarks by David Lewis at the MENA Regtech Virtual Executive Boardroom, www.fatf-gafi.org/publications/fatfgeneral/documents/mena-reg-tech-2021.html.

World Bank's NRA tool provides a template to carry out such an evaluation so that the risks inherent in inclusive products and services are mitigated through design/redesign features prior to their launch.

4. Simplified due diligence and other measures

Simplification of 'preventive measures' based on determination of 'lower risk' offers alternatives to meeting the CDD requirements which are less onerous for both the financial institution and the customer. The FATF standards explain how **Know-your-customer (KYC) processes** may be **simplified** both at onboarding stage and during subsequent monitoring.[16] Thus **the identity of the customer and the beneficial owner** need not be verified immediately but **within a 'reasonable time'** after 'establishment of the account-based relationship'. This can be permitted in 'lower risk' situations and may be reviewed when transaction volume and values(s) exceed a defined threshold.(see Box 1, for India's basic bank account design).

> Box 1 : **INDIA's 'small accounts' – key features**
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> ID requirements – **identity verified using self attested photograph** in the presence of a designated bank official at the time of opening of the account.The officially valid documents (OVDs) of driving license, passport, etc prescribed for opening a regular bank account are to be produced within 24 months otherwise the account is closed.
>
> Transaction limits –
>
> (i) The aggregate of all credits does not exceed 1,00,000 Indian Rupees (INR)/ 2000 USD approx.
> (ii) The aggregate of all withdrawals and transfers does not exceed 10,000 INR / 200 USD.
> (iii) The balance at any time does not exceed 50,000 INR/ 1000 USD.
> (iv) The account cannot receive any foreign remittance.
> (v) Full KYC/CDD on suspicion of ML/TF.
> (vi) The account can be opened only in a branch which has implemented Core Banking Solutions (CBS) whereby branches are networked through computerized bank servers. This permits monitoring of accounts across branches and banks.
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> Source: Guidance, FATF. 2017. "Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion." (November).

Beyond relaxation of identity verification, **simplified measures** can be implemented in **transaction monitoring** through **reduction in controls and updates** which may be reviewed on suspicion of a ML/TF risk. In contrast to enhanced diligence, no additional information is requested, and inferences are made about the beneficial owner (BO) and the intended nature of the business relationship based on customer information only. This is

[16] FATF Recommendations, Recommendation 10, Interpretive Note, Para 21.

commensurate with the risk posed by low-income clients who are generally 'natural persons' and hence may be exempted from BO determination rules applied to legal entities like companies/trusts.

A crucial component of 'preventive measures' are monitoring of cross border wire transfers to prevent the transfer of funds to sanctioned persons and entities. The FATF standards seek to ensure the traceability of international fund transfers through communication of customer/originator and beneficiary names, account numbers and other details alongwith the payment information.[17] However for '**occasional cross-border wire transfers' under the 'de minimis threshold' of 1000 USD/EUR, reduced requirements** are applicable. In such cases, financial institutions must ensure that the originator/customer and beneficiary information are transmitted but are not required to verify the same. This simplification of the 'travel rule' directly benefits the low income families who rely on remittances for meeting their basic needs.

The implementation of effective **record management** is a key obligation of regulated financial institutions.[18] FATF standards require maintaining the details of customer identities and transactions for at least a period of 5 years. Efficient record maintenance and retrieval systems can ensure timely response to law enforcement requests for customer information and strengthen the efforts to detect, deter and prosecute financial crime. However, the physical retention of identity and transaction records can be burdensome and may disincentivize Financial Service providers (FSPs) from servicing low income individuals and businesses. The FATF standards permit **electronic storage and referencing** of documents whereby low capacity FSPs particularly mobile money agents can comply merely by maintaining handwritten details.[19]

This simplification of the CDD process and other preventive measures will reduce the costs of onboarding low income clients for financial institutions and incentivize them to offer inclusive products and services. The unbanked will also benefit from low cost and efficient financial services and reduce their reliance on informal channels. The widening and deepening of financial inclusion will increase the reach and effectiveness of efforts to fight ML/TF. The correct application of proportionate FATF standards will thereby buttress efforts by countries/ jurisdictions to meet their financial inclusion goals.

5. Alternate ID

Absence of acceptable proof of identity has been one of the primary hurdles to opening an account with a regulated FSP. The 2017 **Global Findex** Survey found that **26 percent** of

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[17] FATF Recommendations, Recommendation 16, INR 16.6(c) stipulates additional information of originator's address, or national identity number or customer identification number or date and place of birth.

[18] FATF Recommendations, Recommendation 11.

[19] FATF (2013-2017), Anti-money laundering and terrorist financing measures and financial inclusion - With a supplement on customer due diligence, FATF, Paris, fatf-gafi.org/publications/financialinclusion/documents/financial-inclusion-cdd-2017.html, Para 111, Page 39.

unbanked individuals in low-income countries cited lack of official **identity documentation as the primary barrier** to obtaining financial services. The FATF Recommendations themselves are not restrictive and merely stipulate the use of 'reliable source documents, data or information'. [20] It has been left to the individual countries/ regions to clarify through their Regulators the list of acceptable documents which can reliably verify the identity of a customer at the 'commencement of' and during the continuation of the 'business relationship'.[21]

Many of the regions facing exclusion challenges are also low income countries lacking robust foundational IDs. The unbanked population comprises of migrant labor who are unable to furnish official IDs and permanent residence addresses. Developed countries particularly Europe are facing similar issues with influx of refugees mainly from high risk conflict regions. These asylum seekers need to be registered to avail government assistance for food and shelter. The FATF Guidance on Financial inclusion issued in 2013 provides country examples of use of alternate ID documents to facilitate financial inclusion.[22] (See Box 2).

Fiji and **Malawi** accept letters from **village referees** and traditional authorities respectively. [23] Malaysia permits non-citizens to submit refugees' cards, student cards, work permits and letters from college/university. In India, a 'small account' is a basic no frills offering which can be opened by submitting a self-attested photograph and affixing the signature/thumbprint in the presence of a designated bank official. These are temporary accounts with limits on account balance, transaction type and volume but these restrictions can be removed and full functionality granted upon submission of complete identification documents.

In some countries like Mexico, Tanzania, Ghana, Pakistan and Myanmar, different levels of accounts are opened based on transaction limits, customer and method of opening the account.[24] The first level is a basic account with minimal document submission and transaction limits. The ceilings and CDD requirements increase in the intermediate levels with 'full CDD' accounts in the last level/tier where the transaction and volume limits are the highest. While basic accounts can offer limited financial services to first time account holders, the last level/upper tier can service merchant and agent accounts as in Ghana and Tanzania.[25] Here the customer is required to visit the bank and submit complete

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[20] FATF Recommendations, Recommendation 10, Page 14.
[21] Ibid.
[22] FATF (2013-2017), Anti-money laundering and terrorist financing measures and financial inclusion - With a supplement on customer due diligence, ANNEX 7: 'COUNTRIES' INITIATIVES TO ADDRESS THE CUSTOMER IDENTIFICATION/ IDENTITY VERIFICATION CHALLENGES', FATF, Paris,
fatf-gafi.org/publications/financialinclusion/documents/financial-inclusion-cdd-2017.html.
[23] Ibid.
[24] 'Risk-based Customer Due Diligence – Regulatory Approaches', CGAP Technical Note, October 2019, Patrick Meagher.
[25] Ibid.

documents as required for regular accounts. This **'tiered CDD'** approach can promote the adoption of regulated financial services and further financial inclusion.

These examples illustrate that a range of options are available to verify the identity of the customer at the time of account opening and during continued monitoring of transactions. **National regulators** should therefore move away from the '**zero tolerance**' approach and take the lead in guiding the Financial Service providers (FSPs) to properly assess and identify risks and apply exemptions/simplified measures as appropriate. This will discourage derisking tendencies and enable a flexible and proportionate AML/CFT regime.

Box 2

Country	**Alternate ID documents**
Fiji	Letter from a village referee such as village headmen, religious leader, Current or former employer
Lesotho	The customer merely states his address and income details.
Malawi	Letters from traditional authority
Malaysia	Bank certificates and communal or neighbors' address for rural areas
USA	Matricula consular cards issued to migrants from Mexico
Sweden	Identity is verified through the Migration Agency
Germany	The 'proof of arrival' is sufficient
Netherlands	Issues a prepaid debit card to be used by registered refugees for food and clothing. This "Money Card' is capped and can be used in stores. It is automatically cancelled once the asylum seeker's status changes.

Source: FATF (2013-2017), Anti-money laundering and terrorist financing measures and financial inclusion - With a supplement on customer due diligence, ANNEX 7.

6. Digital ID

Establishing different levels of identity verification based on account functionality and features can be an effective strategy to address immediate exclusion issues in low capacity regions. Multilateral institutions like the World Bank and FATF are supporting the implementation of **Digital ID systems with high levels of 'assurance'** offering secure, flexible and convenient means of verifying an individual's identity that can be used for tiered CDD.[26] Advances in biometrics, high speed communication networks, blockchain

[26]The World Bank's ID4D program and latest FATF Guidance urge responsible innovation in this direction.

FATF(2020), Guidance on Digital Identity, FATF, Paris, **www.fatf-gafi.org/publications/documents/digital-identity-guidance.html** technology and AI can help establish and access identity attributes in non-face to face situations and remote settings.[27]

Digital ID systems enable supervisors, regulated entities, and service providers to accommodate a wide range of attributes and offer flexible assurance frameworks for different components of the CDD process. As an example, a low risk situation may warrant simplified methods for identity proof but higher 'assurance' for authentication in view of threats of identity theft and impersonation in the region.[28] Such systems can enable onboarding of financially disadvantaged groups while maintaining adequate safeguards against threats of money laundering and terror financing.

Digital IDs can be designed to be **'progressive'** and **'portable'** with multiplier effect on advancing financial inclusion.[29] A progressive ID is dynamic and enriches the customer profile through transaction data and digital footprints. These can augment financial institutions understanding of 'newly banked' customers and enable them to provide customized financial services which benefit those at the bottom of the pyramid. With portability, both service providers and potential customers benefit from streamlining of onboarding processes which can be the gateway to effective **collaborative customer due diligence (CCDD)** in the future.[30]

This pooling of resources facilitates the sharing of customer data, strengthens the intelligence gathering process and improves the quality of STR filing. By creating a centralized and shared repository of customer identification, it lowers transaction costs and improves the efficiency of CDD processes. This is the case with the **eKYC utility used in India** through which customer ID details including biometrics once captured and stored can be accessed through a 'microATM' based on customer consent.[31] The widespread use of Digital IDs also improves transaction monitoring and tracking of the proceeds of crime. A robust and reliable Digital ID can be a powerful instrument for previously undocumented persons to access the formal economy in a safe and cost effective manner.

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[27] Ibid.

[28] Ibid.

[29] Ibid.

[30] CGAP (2018), Collaborative Customer Due Diligence: The way forward, www.cgap.org/blog/collaborative-customer-due-diligence-new-ways-forward.

[31] Ibid. A 'micro ATM' is a mini version of an ATM which can be carried to remote locations by a banking representative/correspondent. It functions like a point of sale (PoS) terminal, bankingschool.co.in/information-technology/micro-atms-and-their-uses-in-rural-india/.

7. New payment products, services, and delivery channels

The current pandemic has seen rapid adoption of digital technologies on an unprecedented scale. The penetration of mobile networks has enabled rural areas and remote locations access formal payment channels. **Branchless banking and mobile money through agents** are fast, reliable and can save time and travel costs. East Africa particularly Kenya with M-pesa has made great strides in financial inclusion through mobile money (Box 2 below). The development of real-time rapid payment systems has helped small merchants and vendors acquire both customers and credit. They also enable low cost and efficient remittance services which can benefit those at the bottom of the pyramid. Both domestic transfers of government benefits (G2P) and cross -border remittances(P2P) have the potential to lift people out of poverty.

M-Pesa—launched in Kenya in March 2007 by Safaricom (part of the Vodafone group)—now has almost 30 million users in 10 countries.

Value of mobile money transactions during the reference year (percentage of GDP)

COUNTRY/YEAR	KENYA	TANZANIA	UGANDA
2009	23	2	2
2013	44	51	35
2017	47	52	62

Source: IMF. 2017. Financial Access Survey, Mobile Money Note.

Branchless banking and mobile money services are provided through agents who lower the cost of 'last mile connectivity' for financial service providers. The FATF standards allow financial institutions to rely on 'third parties' to perform parts of the due diligence process or introduce business as long as the ultimate responsibility rests with the delegating institution.[32] These 'third parties' can be non bank agents but must be adequately supervised and able to immediately furnish the identity documents to the financial institution. The use of agents exposes the financial system to AML/CFT risks and hence supervisors must satisfy themselves that financial institutions use appropriate screening and monitoring mechanisms to safeguard against such risks.[33]

Mobile and digital payments which are gaining popularity among low income groups and vendors particularly for utility payments and small purchases also carry ML/TF risks. In 2010, the FATF published a Guidance on 'New Payment Methods' and identified third party funding, non-face-to-face nature of products and complicity of providers or their

[32] FATF Recommendations, Recommendation 17.

[33] CGAP (2018), Regulation for Inclusive Digital Finance, CGAP, Washington DC, www.cgap.org/topics/collections/regulation-inclusive-digital-finance.

employees as high risk factors and suggested countermeasures like value limits and strict monitoring as mitigation factors.[34] The **mobile network operators** (MNOs) must implement CDD measures and be vigilant against suspicious transactions to protect their customers and networks from fraud and illicit finance.

There is growing consensus and interest in the use of digital currencies for conducting financial transactions. A recently released policy paper by the BIS points to strong interest in **Central Bank Digital Currencies** (CBDCs) as an instrument to increase financial inclusion among Emerging Markets and Developing economies (EMDEs).[35] The Sand Dollar, a CBDC by the Central Bank of Bahamas (CBB) was introduced in 2020 to provide financial access for 390,000 citizens of 'The Bahamas' spread across 30 islands including remote ones.[36]These instruments are transparent, liquid and stable with potential for mass adoption. The ML/TF risks posed by them are similar to those associated with central bank denominated currencies or cash.[37] However this needs further examination as new models/design features emerge.

An emerging class of virtual assets which facilitate anonymized peer-to- peer (P2P) transfers are gaining popularity as an alternative to bank intermediated payment systems. Large financial institutions and BigTechs are looking at leveraging their existing platforms to host virtual assets called '**stablecoins**' on a commercial scale. In a report dated June 2020, FATF has examined the ML/TF risks from mass adoption of 'global stablecoins' and discussed methods for mitigation of those risks.[38] The revised FATF standards applicable to virtual assets (VAs) and virtual asset service providers (VASPs) have been found to be sufficient for risk management and control and the report has urged the need for their immediate and effective implementation. [39]

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[34]At that time the 'New Payment Methods' studied were prepaid cards, internet payment systems and (to a lesserdegree) mobile payments.

FATF (2010), FATF Report on Money Laundering Using New Payment Methods, FATF, Paris, www.fatf-gafi.org/documents/documents/moneylaunderingusingnewpaymentmethods.html.

[35] Ready, steady, go? – Results of the third BIS survey on central bank digital currency,Boar, Codruta, and Andreas Wehrli. 2021. "Central Bank Digital Currency." (114), Page 7.

[36]Ibid.

[37]FATF (2019), Money laundering risks from "stablecoins" and other emerging assets, Annex B: Central bank digital currencies,www.fatf-gafi.org/publications/fatfgeneral/documents/statement-virtualassets-global-stablecoins.

[38] Ibid.

[39] FATF (2019)In October 2018, Recommendation 15 was amended and the definition of 'virtual asset' (VA) and 'virtual asset service provider' were added followed by an Updated Guidance and Interpretive Note in June 2019. The latest are red flags identifying criminal use of these virtual assets. FATF (2020), Money Laundering and Terrorist Financing Red Flag Indicators Associated with Virtual Assets, FATF, Paris, France, www.fatf-gafi.org/publications/fatfrecommendations/documents/Virtual-Assets-Red-Flag-Indicators.html.

As jurisidictions adopt the revised Standards, the exchanges and other intermediaries will be brought within the licensing requirements, CDD and reporting obligations. This will likely compensate for arbitrage through plugging of regulatory loopholes and also mitigate the risk from unlicensed intermediaries. However rapid technological development is introducing innovative financial products and processes and the FATF has alerted about the need for ongoing review of existing standards for necessary updation/revision. The virtual assets have the potential to democratize financial systems and processes but without adequate controls can be easily misused for illegal activities.

8. Assessment of effectiveness of financial inclusion

While technology and enabling legislation can mitigate the risk posed by innovative products and services, evaluation is key to realistic goal setting and optimal outcomes in widening and deepening inclusion. Globally, the AML/CFT regimes have benefitted from the monitoring carried out by the FATF and FATF style Regional Bodies (FSRBs) through the '**mutual evaluation**' process.[40] A team of assessors comprising experts from the FATF/FSRBs or WB/IMF evaluate countries' technical compliance with and effectiveness of implementation of the FATF recommendations.[41] The Mutual Evaluation Report, the 'MER' is submitted to the FATF plenary for adoption.

The starting point is the **Scoping Note** which lays the groundwork for understanding the 'risk and context' of a country's vulnerability to money laundering and terror financing prior to the on-site visit by the team of assessors. The FATF 'Methodology' includes a country's efforts in addressing financial exclusion as a contextual factor to be incorporated in determining the overall risk level.[42]The actual assessment exercise for determining effectiveness of the country's efforts in fighting ML/TF is based on benchmarking progress on '**Core Issues (CI)**' in respect of **11 Immediate Outcomes (IOs**).[43]

The 'measures taken to promote financial inclusion' are explicitly mentioned as a specific factor to be considered in forming conclusions on the 'Core Issues' applicable to all the IOs.[44] Generally speaking the performance on all the outcomes (IOs) will directly or indirectly reflect the progress achieved by a country/jurisdiction in enabling the unbanked

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[40] Assessors may be drawn from FATF/FSRBs or from International Financial Institutions (IFIs) like the IMF and WB. FATF (2021), Consolidated Processes and Procedures for Mutual Evaluations and Follow-Up "Universal Procedures". FATF, Paris, www.fatf-gafi.org.

[41] Ibid.

[42] 'FATF (2013-2020), METHODOLOGY For assessing technical compliance with the FATF's Recommendations and the Effectiveness of AML/CFT Systems, www.fatf-gafi.org.

[43] Annexure A.

[44] Ibid.

and underbanked to access/engage with the formal economy.[45] Specifically **IOs 1,3 and 4** can be **directly linked to the policies targeted to benefit the poor and marginalized**.[46]

The Immediate Outcome 1 measures the extent to which there is an understanding at the country level of the risks of money laundering and terror financing and domestic co-ordination to combat these risks. A comprehensive national risk assessment (NRA) will demonstrate a good understanding of sectoral, state, and overall risk. Immediate Outcome 3 examines whether supervisors are effective in monitoring the risk based application of the FATF standards by regulated entities such as financial institutions and designated non-financial businesses and professions (DNFBPs). When determining the level of effectiveness in meeting IO3, the FATF/FSRB/IFI assessors can point out cases of 'over compliance' which contribute to derisking and exacerbate exclusion. Immediate Outcome 4 refers to the application of proportionate 'preventive measures' by regulated entities and enables assessors to scrutinize the justification for applying simplified due diligence (SDD) measures.

The Global Findex 2017 identifies the total unbanked adult population at 1.7 billion, nearly half of which live in seven developing economies (Table 2).[47] Three of these namely India, Nigeria and Indonesia have not undergone mutual evaluation under the Fourth Round. The remaining namely Bangladesh, China, Pakistan, and Mexico have undergone assessments under the 4th round of mutual evaluations. As the ratings in the table illustrate, all the four have 'low' rating in IO4 which relates to application of 'preventive measures' in a risk based manner. Although Bangladesh has made substantial efforts to address both the finance and gender gap through microfinance institutions and others have sought to leverage digital ID (Pakistan) and tiered accounts (Mexico), much more needs to be done to improve access to regulated financial services. [48]

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45 CGAP (2014), AML/CFT and Financial Inclusion: New Opportunities Emerge from Recent FATF Action, CGAP, Washington DC, www.cgap.org/sites/default/files/researches/documents/Focus-Note-AMLCFT-and-Financial-Inclusion-Sept-2014_0.pdf.

46 Ibid.

47 World Bank (2017), Global Financial Inclusion (Global Findex) Database, World Bank Washington, http://globalfindex.worldbank.org/9781464812590.pdf , accessed April 2021

48 FATF (2016), APG-MER-Bangladesh-2016, FATF, Paris, www.fatf-gafi.org/media/fatf/documents/ mer-fsrb/APG-MER-Bangladesh-2016.pdf.

FATF www.fatf-gafi.org/media/fatf/documents mer4/MER-Mexico-2018.pdf,

Table 2

COUNTRY	Whether 4th Round Mutual Evaluation Completed?	IO1 RATING Understanding of risk	IO3 RATING Supervision of FIs and DNFBPs	IO4 RATING Extent of preventive measures by FIs and DNFBPs
BANGLADESH	YES	MODERATE	MODERATE	LOW
CHINA	YES	SUBSTANTIAL	MODERATE	LOW
INDIA	NO	-	-	-
INDONESIA	NO	-	-	-
MEXICO	YES	SUBSTANTIAL	MODERATE	LOW
NIGERIA	NO	-	-	-
PAKISTAN	YES	LOW	LOW	LOW

9. CONCLUSION

The current pandemic has highlighted how the double blow of a health crisis and economic recession has perpetuated poverty and income inequalities. Globally stimulus packages and mass vaccinations show promise and 'The World Economic Outlook' published in 2021 makes a stronger projection for 2021 and 2022 than in October 2020. [49] With new virus strains dampening the optimism, sustained efforts have to be made to address the needs of those at the bottom of the pyramid. As social distancing becomes the 'new normal' **digital financial transformation is key to enabling financial access** for the unbanked and the underbanked.

The success of digital products and services is premised upon safe and reliable solutions which are not hijacked by illegal actors. The rapid adoption of digital and mobile payments during the pandemic augurs well for economic recovery and closing the finance gap. The **FATF standards provide adequate flexibility** to regulators and regulated entities for incentivizing low income customers to adopt formal financial services. However overly cautious approaches to implementation of the FATF recommendations have been cutting off access even for those who are desirous of entering the formal economy.

The **latest round of mutual evaluations** conducted for countries which face maximum challenge of financial exclusion points to ineffective application of the risk based approach by regulated entities. Financial institutions and designated non finance business and professions have to apply simplified due diligence procedures for onboarding low income groups. Failure to do so effectively will boost the cash based informal economy to the detriment of regulatory oversight over illicit financial flows. This will also expose the poor and vulnerable to exploitation in the hands of money launderers and financiers of

[49] Global growth is projected at 6% for 2021 and 4.4% for 2022 up from -3.3% for 2020.

terrorism. An **effective AML/CFT regime** is a therefore **a sine qua non for giving inclusion a 'fair shot'.**

LIST OF ACRONYMS

AML/CFT	Anti-Money Laundering and Countering the Financing of Terrorism
CDD	Customer Due Diligence
CGAP	Consultative Group to Assist the Poor
DNFBP	Designated Non-Financial Business or Profession
EMDE	Emerging Market and Developing Economy
FATF	Financial Action Task Force
FSPs	Financial Service Providers
FSRB	FATF-Style Regional Body
GPFI	Global Partnership for Financial Inclusion
IMF	International Monetary Fund
IN	Interpretive Note
INR.X	Interpretive Note to Recommendation X.
KYC	Know Your Customer
MNO	Mobile Network Operators
RBA	Risk Based Approach
STR	Suspicious Transaction Report
WB	World Bank

Annexure A

Immediate Outcomes Indicating an Effective AML/CFT Regime

1. Money laundering and terrorist financing risks are understood and, where appropriate, actions coordinated domestically to combat money laundering and the financing of terrorism and proliferation.

2. International cooperation delivers appropriate information, financial intelligence, and evidence, and facilitates action against criminals and their assets.

3. Supervisors appropriately supervise, monitor, and regulate financial institutions and defined nonfinancial businesses or professions (DNFBPs) for compliance with AML/CFT requirements commensurate with their risks.

4. Financial institutions and DNFBPs adequately apply AML/CFT preventive measures commensurate with their risks and report suspicious transactions.

5. Legal persons and arrangements are prevented from misuse for money laundering or terrorist financing, and information on their beneficial ownership is available to competent authorities without impediments.

6. Financial intelligence and all other relevant information are appropriately used by competent authorities for money laundering and terrorist financing investigations.

7. Money laundering offenses and activities are investigated, and offenders are prosecuted and subject to effective, proportionate, and dissuasive sanctions. 8. Proceeds and instrumentalities of crime are confiscated.

9. Terrorist financing offenses and activities are investigated, and persons who finance terrorism are prosecuted and subject to effective, proportionate, and dissuasive sanctions.

10. Terrorists, terrorist organizations, and terrorist financiers are prevented from raising, moving, and using funds, and from abusing the nonprofit sector.

11. Persons and entities involved in the proliferation of weapons of mass destruction are prevented from raising, moving, and using funds, consistent with the relevant UN Security Council Resolutions.

Source: FATF Assessment Methodology, p. 15