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AML/CFT and Microfinance Institutions

SEACEN / World Bank Regional Advanced Workshop for Banking Supervisors on AML/CFT
April 2007
Kuala Lumpur

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Outline of discussion

- Microfinance institutions (MFIs)
    - Definitions, examples and importance
- Regulation and supervision of MFIs
- AML/CFT risk of MFIs
- AML/CFT regulation and MFIs

Note: The regulation and supervision of MFIs is a complex field. AML / CFT issues cannot be divorced from the general principles. Reference will therefore be made to some of these principles, especially as espoused by CGAP, but, in view of the limits of this presentation, only in very general terms

Microfinance Institutions

Definitions

What is microfinance?

"Financial services for low-income people (usually unsalaried) and their enterprises (usually informal)" (Richard Rosenberg)

"Financial services designed for lower-income clients using the new delivery methodologies developed during the last twenty-five years" (CGAP Occasional Paper 8)

Examples of MFIs

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- CGAP identifies MFIs as a form of "alternative financial institution" ("AFI") – (institutions with a financial and a social/developmental objective):
  - Specialised MFIs
    - NGOs or specially licenced non-bank financial institutions that grew out of microfinance revolution of the 1980s
  - Commercial bank MFIs
    - Some MFIs are banks and some banks have special microfinance (especially microcredit) programmes / services aimed at non-traditional clients
  - Financial cooperatives (including credit unions)
    - Small member-owned savings and loans institution, based on common bond

(cont)

Examples of MFIs (cont)

- Low-capital rural and/or local banks
  - Owned by individuals or members or local government or combination (small scale)
- State development and agricultural banks
  - State-owned to promote agriculture or development, focusing more on credit than savings
- Postal savings banks
  - Using postal infrastructure to support savings and payments/transfers
- Non-postal savings banks
  - Private and public

- AFIs are often regulated separately and less rigorously because they are perceived as lying outside a country's financial mainstream (CGAP)

What makes MFIs unique?

- An MFI's mission usually includes a strong focus on the poor and near-poor (not just lower-income clients or the unbanked)
  - Micro-Credit Summit 2002: 60% of MFI borrowers were "very poor" (category includes people in the lower half of those living below their country's poverty line or with individual incomes below US$ 1 per day)

- Often not financially sustainable as a business
  - If financially viable, tend to become larger and to offer other services (savings, transmission etc)

What makes MFIs unique? (cont)

- Most began with a heavy focus on credit, driven by new technologies that supported the delivery and collection of very small loans to borrowers who could not deliver conventional collateral
  - Payment in order to maintain access to facility, often combined with social or peer pressure
    - Grameen Bank has an average repayment ratio of 99%
    - Compartamos in Mexico has an at risk portfolio at risk of 1%; Banco Los Andes in Bolivia of 2%; ACSI in Ethiopia of 1.75%; CERUDEB in Uganda of 4.21%
  - "Branchless banking" initiatives

What makes MFIs important?

- More than three billion people do not have access to basic financial services such as credit, savings and insurance
- Expanding body of evidence that access to finance supports growth and impacts on poverty (Asli Demirguc-Kunt)
- Increasing access is regarded as so important that the UN:
  - Declared 2005 the “Year of Microcredit”
  - Established an Advisory Group on Inclusive Financial Sectors
- Various national initiatives to increase access to financial services

MFIs and regulation

Regulation of MFIs

- Distinguish between:
  - Prudential regulation (protecting financial soundness of the institution in order to prevent financial system instability or loss to depositors
  - Non-prudential (conduct of business) regulation (e.g consumer protection)

- MFIs are sometimes subject to prudential regulation even when they do not have depositors
  - Unnecessary and expensive (both for regulator and regulated)

- Regulation should ideally be supportive of formation of new MFIs and/or improve performance of existing institutions

Supervision of MFIs

MFIs – some supervisory challenges

"[T]here is a strong and nearly universal temptation to underestimate the challenges of supervising [MFIs] in a way that will keep them reasonably safe and stable" CGAP "Guiding principles on regulation and supervision of microfinance" (2002) -

Examples of challenges:

- Limitations of standard supervisory tools
- Costs of supervision

Standard supervisory tools and their limitations

- Some standard portfolio supervision tools for examining banks' portfolios are ineffective for microcredit
  - Loan file documentation is often too basic to serve as a good indicator of microcredit risk
  - Sending confirmation letters to verify account balances (or existence of client) is impractical given the client profile
  - In essence, the examiner must analyse the institution's lending systems and their historical performance
  - Requires MFI experience and expertise

(cont)

Standard supervisory tools and their limitations (cont)

- Capital calls when MFI is in trouble
  – Many MFI owners cannot respond to such a call
- Stop lending order
  – Strikes at primary reason why clients repay loans and may destroy the MFI
- Asset sales or mergers
  – MFI's management's close relationship with clients may mean that assets have little value in the hands of a new management team

Costs of supervision

Given the number of MFIs, the caliber of examiners required and the methodology, supervision is often more costly than anticipated

This does not mean that MFIs should not be supervised, but rather that regulation and supervision requires careful thought and design

MFIs and AML/CFT risk

AML/CFT risk features of MFIs

- Range of services offered by diverse institutions, each giving rise to different risks, but typical features (generalised) include the following:

- Clients:
  - Low-income, without assets that would normally serve as collateral
  - Self-employed or with uneven streams of income
  - Natural persons for personal and small business use

- Services:
  - Low value transactions
  - Could range from savings, to money transfers, to insurance
  - Sometimes employing new technologies to support “branchless banking”
  - Different services pose different risks

AML/CFT risk features of MFIs

- Institutions:
  - Well-regulated to non-regulated
  - May or may not have access to national payment system
  - Ownership structures basic / complicated, transparent or not
- How would MFIs typically be abused for ML/FT purposes?
- How should we rate risks posed by MFIs relative to those posed by standard FIs rendering similar services?

AML/CFT challenges of MFIs

- MFIs are sensitive to AML/CFT regulation:
  - AML/CFT regulation may be very expensive for institutions that are already marginal, sometimes more expensive than for FIs
  - Clients of MFI's are very cost-sensitive
  - Regulation may be unrealistic, given the reality of the MFI
    - May force institutions to close or to go underground
    - May force MFI to raise its service fees, thereby losing clients

- Clients of MFIs are often sensitive to regulation
  - CDD requirements may be overly onerous, unrealistic or unattractive

- MFIs v FIs
  - Insensitive intervention may create unlevel playing fields, prevent competition or create space for AML/CFT abuse

AML/CFT regulation and access to financial services – a FIRST study

Background (FIRST study)

- 2006-2007 FIRST project
  - How to facilitate FATF implementation in developing countries without undue impact on access to financial services
- History
- Project manager: Genesis Analytics
- Steering committee
- Countries: Indonesia, Kenya, Mexiko, Pakistan, South Africa,

Key insights (FIRST study)

1. Indiscriminate AML/CFT implementation undermines access to financial services

2. Financial exclusion undermines the effectiveness of AML/CFT

Methodology (FIRST study)

- Assessed impact on:
  - Access (demand-side)
  - Usage (demand-side)
  - Market efficiency (supply-side)
- Impact of AML/CFT vs other factors
- Formal and informal financial services
- Products:
  - Transaction banking
  - Remittances

Implementation evolution (FIRST study)

Phase 1
- Developed country templates promulgated
- No significant domestic policy-making process

Phase 2:
- Selective government enforcement
- Determined by capacity, foreign exposure or presence of a champion
- FSPs unable to comply and skittish

Phase 3
- Regulation gradually adjusted to domestic realities and capacity
- Impact on access mitigated

These phases repeat themselves in sub-sectors as international standards are adjusted/ new ones introduced.

Drivers of impact (FIRST study)

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1. Failure to develop indigenous/domestic AML/CFT policy
   (1) Do not coordinate with other policy objectives, eg access & immigration; access and tax
   (2) Limited risk appreciation
   (3) Adopt developed country templates
   (4) Tailor regulation to those currently served
   (5) Ignore / underestimate complexity of financial sector

2. Inadequate supporting public infrastructure
   (1) Weak primary institutions in the rest of the economy,
   (2) including supervisory capacity

Drivers of impact (FIRST study)

3. Large-scale informality
   (1) Creates alternatives to usage of formal sector financial products
   (2) Existing reasons why consumers either cannot get into the formal financial sector, or choose not to do so (pointer)
   - "Fear and loathing"

4. Openness of the domestic economy/ linkages to international financial markets
   (1) Foreign ownership causes domestic banks to comply with AML/CFT standards set by the parent jurisdictions

Mitigating responses (FIRST study)

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1. Remove the demand for informal financial services
   - "Making markets work for the poor"
   - Matricula card
2. Create lower regulatory barriers for smaller & non-bank players
3. Risk-based approach
4. Exemptions for low-risk, low-value accounts
   - Verification mechanisms available to vulnerable groups (South Africa)
5. Healthy relationships between the regulator and regulated + skills set of regulator

Levels of AML/CFT implementation (FIRST study)

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1 Coverage
Regulatory framework exists
FSPs visible to the regulator

2 Traceability of transactions
Basic institutional regulation in place
Basic identification of clients
Transaction records accessible

3 Profiling and monitoring
More extensive clients identification and profiling
Transactions monitored for AML/CFT purposes (often manually)

4 Traceability of transactions and clients
High levels of verification with integrity possible
FSPs can interdict transactions

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MFIs and AML/CFT regulation: Key principles

Key principles

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1 It is important to safeguard MFI against AML/CFT abuse

2 Care must be taken that regulation is realistic, effective, supportive of market development and flexible

- Regulation must ideally be embedded in a holistic policy on financial market development
- AML/CFT risks should be assessed
- Treat like alike
- Consider the impact on access

3 Risk-based approach:

- Understand risks posed by different types of institutions and different services
- If risks are low, allow simplified or reduced measures

Key principles (cont)

4 Create appropriate exemptions

- Consider appropriate minimum thresholds

5 Gradual, managed implementation may be less costly than a Big Bang approach

6 Regulation is best drafted and implemented following a partnership approach

- Relationship of trust increase the flow of high-quality information

7 Regulation must match the capacity of the regulator and the regulated

Key principles (cont)

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8 AML/CFT regulation should not be viewed or adopted in isolation

- How does it fit with prudential regulation (if required) or non-prudential regulation?

9 Examiners must be knowledgeable about MFIs to ensure proper supervision and correct interventions

Points for discussion

- What is the country's policy regarding MFIs?
- Are all MFIs being regulated?
- Who is responsible for supervision of MFIs?
- Who should be responsible for supervision of MFIs?
- What is required for the effective regulation and supervision of MFIs?

THANK YOU