



Anti-Money Laundering and Combating the Financing of Terrorism in Certain SADC Countries

Focus Note 2: Risk-based approaches to AML/CFT

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1. Introduction and overview

FinMark Trust commissioned and funded the development of the focus notes contained in this report in order to highlight key considerations relating to anti-money laundering (AML) and combating the financing of terrorism (CFT) in 13 Southern African Development Community (SADC) countries. This was undertaken in light of findings from a detailed review of the regulatory frameworks in these jurisdictions.

In various studies undertaken by FinMark Trust, the implications of AML and CFT regulatory requirements are often cited as a constraint to the development, growth and access to financial services and products. It has been reasoned that an inappropriate or inconsistently applied regulatory environment for domestic and cross border AML/CFT controls has a detrimental impact on the strategic objective of increasing financial integration and access to financial services within the region.

FinMark Trust would like to investigate whether the harmonisation and more appropriate calibration of the AML/CFT regulations across and within the SADC countries could enhance legal certainty and regulatory predictability. It has been motivated that, in the light of the expansion of African and international financial service providers in the SADC region, this legal harmonisation would have a positive impact on the development and release of financial services and products in the region.

The following focus notes, covering AML/CFT regulatory requirements in the SADC countries, have been developed to draw attention to key matters:

- Focus Note 1 - Financial inclusion and AML/CFT;
- Focus Note 2 - Risk-based approaches to AML/CFT;
- Focus Note 3 - AML / CFT due diligence and related matters;
- Focus Note 4 - Mobile services / technology; and
- Focus Note 5 - Harmonisation of regulatory frameworks in the SADC region.

A brief description of each of the focus notes is set out below.

Figure 1: Proportionate AML/CFT responses

Focus Note	Brief Description
1. Financial inclusion and AML/CFT	Considerations that are relevant in determining whether and how AML/CFT regulatory requirements in the participating countries are a financial inclusion constraint or not are discussed. Various studies that have been carried out indicate that AML/CFT legislation, implemented in response to the FATF Recommendations, has resulted in a conservative approach to compliance with this legislation by the regulated institutions. This is viewed in relation to levels of financial inclusion and economic conditions in SADC.
2. Risk-based approaches to AML/CFT	The adoption of a risk-based approach to the regulation of ML/TF is no longer optional. This is now required in terms of international standards ¹ . Key aspects thereof are considered with a view to identifying regulatory harmonisation opportunities as set out in Focus Note 5 - Harmonisation of regulatory frameworks in the SADC region. Where financial inclusion friendly AML/CFT requirements are put in place, which allow for proportionate compliance responses according to the

¹ In terms of FATF Recommendation 1.

Focus Note	Brief Description
	ML/CFT risk, this can play a positive role in promoting access to formal financial systems of countries. This can also potentially reduce the use of informal mechanisms that are outside of the authorities' scrutiny.
3. AML / CFT due diligence and related matters	Customer due diligence and related matters are described in light of relevant FATF Recommendations ² , specifically in view of financial inclusion dynamics, i.e. for the purpose of identifying themes that are relevant in the SADC region. Reference is made to the FinMark Trust country reviews ³ in this regard. While it is understood that customer due diligence that is undertaken by institutions is an important foundation on which AML/CFT compliance responses must rest, overly conservative compliance responses of institutions can result in access barriers.
4. Mobile services / technology	Key aspects of opportunities that can be derived from the introduction of mobile services and new technologies in the SADC region are highlighted. This is done in light of identified opportunities to support financial inclusion objectives. Various FATF Recommendations ⁴ are considered in order to provide the context for the analysis carried out. New technology opportunities and mobile services offer solutions that will, to a far greater extent than in the past, provide opportunities to deliver financial services to the underserved or excluded market.
5. Harmonisation of regulatory frameworks in the SADC region	AML/CFT harmonisation prospects relating to regulatory frameworks of countries in the SADC region are addressed. The underlying motivation in this regard is to put forward an analysis of various SADC regulatory requirements with a view to promoting opportunities to enhance legal certainty and regulatory predictability as well as support the strategic objective of increasing financial integration and access to financial services in the respective countries.

² Customer Due Diligence (CDD) (Recommendation 10); Record keeping requirements (Recommendation 11); Correspondent banking (Recommendation 13); Reliance on third parties (Recommendation 17); Internal controls (Recommendation 18); and Reporting requirements for suspicious transactions (Recommendation 20).

³ Published 13 May 2015.

⁴ Money or value transfer services (Recommendation 14), new technologies (Recommendation 15) and wire transfers (Recommendation 16).

2. Acknowledgements

This report has been prepared by Compliance & Risk Resources. It has been drafted taking into account the findings contained in the SADC country review reports that have been prepared for FinMark Trust⁵.

The level of cooperation and support provided by the SADC country stakeholders, who were consulted during the research phase of this project and the finalisation of the country reports, is acknowledged. The willingness of those who made themselves available to assist, often at very short notice, in all participating countries, is highly valued.

The report has been prepared by John Symington with assistance from the Compliance & Risk Resources team. Input has been obtained from a panel of experts, who provided insights and feedback relating to the design of the study. A sincere word of thanks is extended to Raadhika Sihin, Kim Dancey and Neal Estey for providing input. Dhashni Naidoo and Mojgan Derakhshani, FinMark Trust, provided feedback during the drafting process.

3. Methodology and scope

The production of focus notes for FinMark Trust has been prepared on the back of the detailed SADC country review reports prepared by the parties indicated in the acknowledgements in section 2 above.

The reports addressed the following topics:

- Legislation and Regulation in Force;
- Customer Due Diligence;
- Record Keeping;
- Correspondent Banking;
- Money Transfer Services;
- New Technologies;
- Wire Transfers;
- Reliance on Third Parties;
- Internal Controls;
- Suspicion Transaction Reporting; and
- Guidance and Feedback.

Thirteen countries participated in the study: Angola, Botswana, Democratic Republic of the Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Zambia and Zimbabwe. The review findings contained in the respective sections of the reports have been analysed and used as a platform to identify the regulatory requirements that are in place in each of the participating countries. This serves as a basis to develop recommendations relating thereto.

The Compliance & Risk Resources consulting team has made use of its knowledge and experience in respect of regulatory requirements in force in Sub-Saharan Africa and has referenced existing studies that address AML/CFT requirements and financial inclusion. It is noted that Compliance & Risk Resources was,

⁵ AML/CFT and Financial Inclusion in SADC - Consideration of Anti-Money Laundering and Combating the Financing of Terrorism Legislation in Various Southern African Development Community (SADC) countries. March 2015.

at the time this report was prepared, in association with Cenfri⁶, undertaking a project⁷ designed to engage AML/CFT stakeholders in Sub-Sahara countries in order to provide a platform from which to develop a sound understanding of national as well as sectoral AML/CFT risk assessments⁸. Accordingly, it is acknowledged that there has been an opportunity to use the knowledge gained during this engagement to inform the approach taken in developing these focus notes.

4. International standards and guidance

In view of the increasing focus on and understanding of the benefits that are derived from access to finance and financial services by communities in developing countries, both regionally and internationally, the impact of AML/CFT regulatory requirements on financial inclusion has been drawn into the spotlight. Notably, during the course of 2011, the Financial Action Task Force (FATF), following interest kindled under the G20 presidency by Mexico, agreed to have the issue of financial inclusion on its agenda and committed to examining potential challenges posed by AML/CFT requirements relating to the goal of achieving financial inclusion.

The FATF recommendations, which were revised in 2012⁹, now make the adoption of a risk-based approach mandatory. They provide space for financial inclusion to be recognised as a country policy objective and, accordingly, there is an opportunity for countries to shift the focus towards achieving AML/CFT objectives within an environment that does not compromise financial inclusion. It is encouraging that there has, in recent years, been steady progress towards recognising the importance of financial inclusion imperatives. This is particularly notable through the development of a FATF guidance paper in June 2011¹⁰, which was intended to provide support to countries in designing AML/CFT measures that meet a national financial inclusion goal without adversely impacting financial integrity objectives. This was revised in 2013, the main aims thereof being the development of a common understanding of the "FATF standards that are relevant when promoting financial inclusion and explicit the flexibility that the standards offer, in particular the risk-based approach (RBA), enabling jurisdictions to craft effective and appropriate controls."¹¹

⁶ Centre for Financial Inclusion - A non-profit think tank based in Cape Town which operates in collaboration with universities in the region to support financial sector development and financial inclusion through facilitating better regulation and market provision of financial services.

⁷ Financial Sector Deepening Africa (FSDA). Current research being undertaken entitled "Risk-Based Approaches to Regulation of AML/CFT".

⁸ This is designed to address key aspects of international guidance and examples of how jurisdictions have approached the adoption of a RBA by outlining the elements thereof as relevant to countries in the Sub-Sahara Africa region and assisting participating countries with a product scan to define parameters of risk at a sectoral level to get to grips, in a practical way, with what low and high money laundering (ML) and terrorist financing (TF) risk could entail. The project directly addresses financial inclusion related considerations, noting that the application of the RBA will not be limited to financial inclusion impacts.

⁹ FATF. International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation - The FATF Recommendations. 2012.

¹⁰ FATF, APG and World Bank. FATF Guidance - Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. June 2011.

¹¹ FATF, APG and World Bank. FATF Guidance - Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. February 2013.

Other FATF guidance, relating to AML/CFT and the risk-based approach, has also touched on AML/CFT and financial inclusion. For example, the following question is raised: “Does the manner in which AML/CFT measures are applied prevent the legitimate use of the formal financial system, and what measures are taken to promote financial inclusion?”¹². This refers to the issue of whether financial institutions and designated non-financial businesses and professions (DNFBP) adequately apply AML/CFT preventive measures commensurate with their risks and report suspicious transactions. Further, there have been a number of publications by international organisations that have shed light on this topic, for example published by AFI¹³ and CGAP¹⁴, which illustrates the growing momentum that has been gained and the international understanding of the impact of AML/CFT requirements on financial inclusion.

5. Focus Note 2 - Risk-based approaches

5.1. Introduction

The adoption of a risk-based approach to the regulation of ML/TF is no longer optional - This is now required in terms of international standards¹⁵. Key aspects thereof are considered in this focus note with a view to identifying regulatory harmonisation opportunities as set out in Focus Note 5 (entitled “Harmonisation of regulatory frameworks in the SADC region”).

Where financial inclusion friendly AML/CFT requirements are put in place, which allow for proportionate compliance responses according to the ML/CFT risk, this can play a positive role in promoting access to formal financial systems of the respective countries, and at the same time potentially reduce the use of informal mechanisms that are outside of the authorities’ scrutiny. This theme is explored in the commentary that follows.

5.2. Focus Note 2 executive summary

The risk-based approaches that are applied by countries and institutions are now shaped by the specifications set out in FATF Recommendation 1 and related interpretive note, which provide a platform for countries to develop regulatory and supervisory frameworks that allow flexibility to achieve financial integrity objectives while at the same time providing the room to address financial inclusion objectives.

The specification of standards and guidance relating to risk-based approaches has, perhaps to greater extent than in the past, brought the achievement of AML/CFT objectives into view. It is reasoned that there would be merit in unpacking this matter in that countries would, as a matter of course, be steered towards focusing on the effectiveness of AML/CFT requirements and the achievement of objectives, and, as a consequence, institutions would also be more AML/CFT output focused.

¹² FATF. Methodology for assessing technical compliance with the FATF recommendations and the effectiveness of AML/CFT systems. February 2013.

¹³ Alliance for Financial Inclusion - A global network of financial policymakers from developing and emerging countries working together to increase access to appropriate financial services for the poor.

¹⁴ Consultative Group to Assist the Poor - An organisation which has the objective of advancing financial inclusion to improve the lives of the poor.

¹⁵ In terms of FATF Recommendation 1.

There has been progress towards developing an international understanding of how a national risk assessment should be undertaken, as illustrated in FATF guidance published in 2013¹⁶, which provides guidance on the conduct of risk assessment at a national level. The outputs of the aforementioned will, over a period of time, provide valuable insights towards informing the development of regulatory frameworks going forward. Over half of the countries that participated in the study have AML/CFT laws that specifically allow for risk-based approaches. These allow for proportionate responses by institutions, which generally fall into the following categories: proven low ML/TF risk, lower ML/TF risk and higher ML/TF risk. Examples of risk-based approaches that may be allowed, in terms of regulatory requirements, are highlighted under the following heading in this focus note: Low Risk Exemption - General; Low Risk Exemption - Occasional Transactions; Low Risk Exemption - Wire Transfers; Simplified Due Diligence - Rules-Based; and Simplified Due Diligence - Principles-Based.

A country's regulatory framework could be structured so as to allow for appropriate country level support for financial inclusion, which could, in broad terms, include "low risk" exemptions as well as rules and principles-based simplified due diligence requirements that allow for proportionate risk responses, i.e. in a manner that provides for regulatory clarity on a level playing field, while at the same time allowing for adequate flexibility.

The FATF recommendations and guidance relating thereto is not prescriptive about the manner in which ML/TF risk assessments should be undertaken. However, the indications are that countries that are undertaking national risk assessments in the SADC region appear to be geared towards identifying, assessing and understanding the risks in the formal financial system of a country. They are not, at this juncture, scoped to deal with the risks that are inherent in the informal economy. Accordingly, the question of whether a country's risk assessment should also incorporate an assessment of the informal sector is relevant. This would shed light on the ML/TF risks relating to financial exclusion.

The FinMark Trust review of the AML/CFT regulatory frameworks in various SADC countries has revealed that progress has been made towards adopting risk-based approaches, i.e. in respect of implementing regulatory frameworks that allow simplified due diligence in respect lower ML/TF risks and provide exemptions relating to low ML/TF risks. The question of whether these developments have optimised opportunities to encourage financial inclusion should be considered. For instance, it can be argued that the increased flexibility allowed by the revised 2012 FATF Recommendations has not been fully embraced in the regulatory frameworks of some countries, and is perhaps not being used to its full potential to achieve AML/CFT objectives. This matter is covered in Focus Note 5 (entitled: "Harmonisation of regulatory frameworks in the SADC region"), which includes an analysis of the participating SADC country risk-based approaches to AML/CFT, with a view to identifying regulatory harmonisation opportunities.

5.3. FATF Recommendations

In terms of FATF Recommendation 1: "Countries should identify, assess, and understand the money laundering and terrorist financing risks for the country, and should take action, including designating an authority or mechanism to coordinate actions to assess risks, and apply resources, aimed at ensuring the risks are mitigated effectively. Based on that assessment, countries should apply a risk-based approach (RBA) to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified".¹⁷

¹⁶ FATF Guidance. National Money Laundering and Terrorist Financing Risk Assessment. February 2013.

¹⁷ FATF Recommendation 1 - Assessing risks and applying a risk-based approach.

This provides the foundation for the efficient allocation of resources for AML/CFT purposes and the implementation of risk-based measures. Where countries identify higher risks, they should ensure that their AML/CFT regime adequately addresses such risks. On the other hand, where countries identify lower risks, they may decide to allow simplified measures under certain conditions.

Recommendation 1 also specifies that: "Countries should require financial institutions and designated non-financial businesses and professions (DNFBPs) to identify, assess and take effective action to mitigate their money laundering and terrorist financing risks."

The risks that are faced by countries and institutions are addressed in the interpretive notes¹⁸, which provide a platform for countries to develop regulatory and supervisory frameworks that allow flexibility to achieve financial integrity objectives, while at the same time providing room to address financial inclusion objectives. It is noted that, a national risk assessment¹⁹ serves as an important source of reference in the design of these frameworks. This would involve a detailed identification of ML/TF-related threats and vulnerabilities, as well as crime and the proceeds of crime, i.e. providing a basis to inform the regulatory responses of countries. This should be sensitive to financial inclusion objectives in jurisdictions where a high proportion of the population is financially excluded or informally served. FATF guidance recognises opportunities in this regard:²⁰ "In addition to the objective of promoting access to formal financial services thus reducing the use of financial mechanisms that are outside of the authorities' scrutiny, FATF has a strong interest in articulating guidance that supports financial inclusion."

Each country is at liberty to establish regulatory and supervisory frameworks that are suitable for its circumstances, i.e. in achieving AML/CFT objectives. Such frameworks should be established in a manner that allows institutions to apply a proportionate response in light of the level of ML/TF risk in question.

5.4. AML/CFT risk management objectives

Risk assessment and the mitigation of ML/TF risk should be seen as being part of a process and, as is the case in any process, there will be inputs and outputs, i.e. at both the national and institutional levels. For example, at a macro level, inputs would include obtaining detailed information relating to crime, proceeds of crime, suspicious transaction reports, ML/TF typologies and methods, prosecutions, convictions and other matters, while outputs of a country's AML/CFT regulatory framework and the supervision thereof can be seen in terms of whether national AML/CFT objectives have been achieved. On the other hand, at an institutional level, inputs will include those things that are done or obtained by financial institutions to mitigate against being used for ML/TF purposes (due diligence, reporting of suspicions, record keeping, training and operational matters and monitoring). The output of the aforementioned will be seen in terms of compliance with regulatory requirements and the extent to which institutions/DNFBPs have been used for ML/TF purposes, i.e. this will include an assessment of the ML/TF residual risk.

¹⁸ Interpretive Note to FATF Recommendation 1 - Assessing risks and applying a risk-based approach.

¹⁹ Required in terms of FATF Recommendation 1.

²⁰ FATF, APG and World Bank. FATF Guidance - Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. February 2013. Page 7.

It is acknowledged that the FATF Recommendations do not explicitly guide countries towards addressing the AML/CFT challenge in this manner. However, there is value in tackling the questions that arise from this line of debate.

In order to effectively address the aforementioned, such outputs or objectives would need to be considered. For instance, obtaining documentation to verify the identity of customers would provide assurance that business with unknown persons will not be undertaken and that business will be undertaken with persons who are who they say they are. These objectives, together with other relevant objectives, would feed into a macro view of AML/CFT outcomes/objectives which could ultimately be seen in terms of whether the financial system of a country (both formal and informal) has been abused for ML/TF purposes. The level of assurance provided in respect of the aforementioned achievement of objectives, at both micro and macro levels, would be a function of the ML/TF mitigation structures and processes at both national and institutional levels. For example, the integrity of national identity systems will be relevant to institutions that must undertake customer due diligence and the identification/verification process and controls put in place by such institutions will need to take this into account.

Unintended consequences that can arise as a result of the introduction of AML/CFT requirements would, to some extent, as a logical outcome of the above approach, be addressed. This will include the likes of overly conservative responses from rigid rules-based laws, or from flexible regulatory approaches where there is a high level of uncertainty relating to how institutions/DNFBPs should comply with the requirements.

It is noted that detailed consideration of this theme is beyond the scope of this document, however, there would be value in flagging this topic for further consideration. Although the FATF Recommendations do not directly address AML/CFT from an output or achievement of objectives perspective, it is reasoned that there would be merit in unpacking this matter in that countries would, as a matter of course, be steered towards focusing on the effectiveness of AML/CFT requirements, as opposed to seeing AML/CFT in terms of compliance rules. Where this is the case, they will be encouraged to dynamically focus on what will achieve the established outputs of an AML/CFT risk process. Notably, if objectives are not being achieved, however measured, ongoing feedback and changes needed relating to the regulatory framework to the risk process will play a role in the continuous development thereof.

Importantly, what is measured in any process will have a significant impact on how stakeholders thereto will react. Supervisors and institutions may be well versed in assessing the adequacy and effectiveness of AML/CFT variables in respect of the pillars on which AML/CFT responses are built within institutions, i.e. customer due diligence, reporting of suspicions and unusual transactions, record keeping, training or other operational matters, and risk monitoring. However, an assessment of the achievement of high level AML/CFT objectives, as well as financial inclusion goals, enabled by appropriate regulatory/supervisory dynamics, would provide valuable insights from both the financial integrity and economic development perspectives. This will, to some extent, be addressed as an integral part of the national risk assessments that are being carried out by countries.

5.5. ML/TF risk considerations

The implementation of a full risk-based approach to the regulation of AML/CFT is, in many respects, not simple and there are multidimensional and interrelated challenges. It is recognised that risk assessment at national and institutional levels involves the consideration of a combination of factors that, taken together, will be used to assess ML/TF risk using an appropriate risk assessment methodology. For

example, regulatory guidance²¹ provided in South Africa recognises that a systematic approach to determine different risk classes is needed, which involves criteria to characterise clients and products. Importantly, it is understood that a “one size fits all” approach to risk management is not appropriate and the following factors may be relevant in the assessment process: product type, business activity, client attributes, source of income or funds, jurisdiction of clients, transaction value, type of client and politically exposed persons (this is not a complete listing and is included for illustration purposes).

Risk management disciplines in institutions have, in general, developed to the point where risk frameworks and processes embrace the concepts of risk appetite and risk tolerance. It is perhaps fair to say that this increasingly applies in an AML/CFT context in financial institutions. Notably, supervisors generally expect institutions to determine their ML/TF risk appetite and to specify risk tolerances, which should be subject to appropriate governance within institutions. The question of whether these matters should also be understood and addressed at country level should be considered. This could perhaps form part of a national risk assessment process. For instance, should a country level risk appetite be determined and should regulators/supervisors be expected to specify risk tolerances at country level? It is, however, reasoned that this could represent somewhat of a challenge in that where this is not done in a manner that facilitates practical engagement therewith by institutions, there could be unintended consequences, which could have an impact on financial inclusion where an overly cautious approach is adopted by institutions.

There has been progress towards developing an international understanding of how a national risk assessment should be undertaken, as illustrated in FATF guidance published in 2013²², which provides guidance on the conduct of risk assessment at the national level. This relates to key requirements set out in FATF Recommendation 1 and paragraphs 3-6 of the interpretive note to Recommendation 1. The guidance recognises that ML/TF risk assessments may be undertaken at different levels and with differing purposes and scope, including supranational assessments (of a group of countries), national (country level) assessments and sub-national assessments (of a particular sector, region, or operational function within a country), although the obligation for assessing and understanding ML/TF risk rests with the country itself. The different risk assessments should relate to each other and different approaches can be followed. For example, a top down approach may mean that the supranational risk assessment takes place first and informs aspects of the national assessments at country level. This will provide a benchmark for certain judgments made in subsequent risk assessments at the country level. Alternatively, a bottom up approach may be undertaken where the supranational assessment is informed by the results of country-level or sub-national assessments. The outputs of these approaches will, over a period of time, provide valuable insights towards identifying opportunities for the harmonisation and calibration of SADC laws.

Given that a risk assessment is now required in all countries, and that the risk-based approach requires each country to respond proportionally and effectively to their ML/TF risks, it is logical that, over time, a sound understanding thereof will be developed. It is acknowledged that these risks will not be the same in all SADC countries and, accordingly, the AML/CFT control measures needed to address those risks may vary from country to country. This will, to an extent, determine how regulatory frameworks should develop going forward.

²¹ Guidance Note 3A published by the South African Financial Intelligence Centre.

²² FATF Guidance. National Money Laundering and Terrorist Financing Risk Assessment. February 2013.

5.6. Proportionate AML/CFT responses

All of the countries that participated in the study have introduced regulatory requirements that allow for various aspects of proportionate AML/CFT responses, and it is noted that over half of the participating countries have AML/CTF laws that specifically allow for risk-based approaches. The question of whether these requirements optimise opportunities to implement country relevant regulatory frameworks should be considered. Notably, the regulatory requirements that enable risk-based approaches vary from country to country. While this is not, in itself, cause for concern, there is merit in highlighting features thereof. In this regard, the categories of regulatory/compliance responses that are proportionate to the ML/TF risks in question can be identified. These are, with reference to the FATF interpretive note to Recommendation 1, illustrated in the table set out below:

Figure 2: Proportionate AML/CFT responses

ML/TF Risk	AML/CFT Responses
Proven low ML/TF risk	<p>Countries may decide not to apply some of the FATF Recommendations requiring financial institutions or DNFBPs to take certain actions, provided:</p> <ul style="list-style-type: none"> • There is a proven low risk of money laundering and terrorist financing (in limited and justified circumstances) relating to a particular type of financial institution or activity, or DNFBP; or • A financial activity (other than the transferring of money or value) is carried out by a natural or legal person on an occasional or very limited basis (having regard to quantitative and absolute criteria), such that there is low risk of money laundering and terrorist financing.
Lower ML/TF risk	<p>Countries may decide to allow simplified measures for some of the FATF Recommendations requiring financial institutions or DNFBPs to take certain actions, provided that a lower risk has been identified, and this is consistent with the country's assessment of its money laundering and terrorist financing risks.</p> <p>Independent of any decision to specify certain lower risk categories in line with the previous paragraph, countries may also allow financial institutions and DNFBPs to apply simplified customer due diligence measures, provided that financial institutions and DNFBPs take appropriate steps to identify, assess, understand, manage and mitigate their money laundering and terrorist financing risks and there is supervision and monitoring of such risks.</p>
Higher ML/TF risk	<p>Where countries identify higher risks, they should ensure that their AML/CFT regime addresses these risks.</p> <p>Financial institutions and DNFBPs should take enhanced measures to manage and mitigate the risks in question.</p> <p>Various FATF Recommendations include specifications that address higher risks; i.e. in respect of politically exposed persons (Recommendation 12), correspondent banking (Recommendation 13), value or money transfer services (Recommendation 14), new technologies (Recommendation 15), wire transfers (Recommendation 16) and transactions with businesses and persons from high risk countries (Recommendation 19).</p>

The above table contains a high level description of the risk responses that are appropriate in respect of “low”, “lower” and “higher” ML/TF risks. It is not a comprehensive analysis of the specifications contained in Recommendation 1, and the interpretive note relating thereto, but outlines key aspects to serve as a point of departure in determining how a country could structure its regulatory framework in this regard, which could be framed using a “rules” or “principles” regulatory context.

For example, in South Africa, the core AML/CFT regulatory requirements²³ are primarily rules driven, although elements of a risk-based approach have been introduced - to a large extent by way of guidance published by the South Africa Financial Intelligence Centre. Notably, regulatory exemptions and simplified due diligence specifications are put in place using thresholds and other criteria in a rules-based format, i.e. in respect of low risk or lower risk ML/TF circumstances. However, certain aspects of the guidance that has been published by the Financial Intelligence Centre has introduced a principles approach to addressing ML/TF risk, which attempts to allow a level of flexibility in conducting customer due diligence.

On the other hand, countries may follow a more principles-based approach in drafting AML/CFT laws required – core and subordinate legislation. This approach will generally not be prescriptive and allows for a high level of flexibility. Regulatory requirements would be framed at a principle level and there would typically be a focus on regulatory outcomes that are required, which allows institutions to adapt their compliance responses when circumstances change. For example, Malawi Regulation 3(5)²⁴ permits a financial institution to apply simplified customer identification requirements for “low risk categories of customers, beneficial owners, beneficiaries or business relationships”.

A rules approach is, to a large extent, an approach that allows a jurisdiction to take responsibility for identifying and assessing the risks in question and for providing institutions with a framework within which to comply with the requirements / criteria that are set by the authorities. This will typically provide for a uniform application of customer due diligence requirements, but can be inflexible and may not address the needs of all stakeholders, specifically in respect of low income customers where the requirements do not meet the changing needs of the market. Alternatively, a principles approach typically provides for a higher level of flexibility, but can encourage variable compliance responses by institutions. Regulatory frameworks may have elements of both the rules-based and principles-based approaches. This is the approach that is preferred by the writers of this report, i.e. to allow for flexibility, but at the same time include regulatory specification that will avoid high levels of uncertainty.

A country’s regulatory requirements should be periodically reviewed in light of its effectiveness relating to AML/CFT standards, and its impact on financial inclusion.

5.7. Examples of proportional responses

The table that is set out below has been prepared in order to illustrate practical approaches that have been applied in various SADC countries. This has been included in order to indicate how the aforementioned can be categorised, with a view to facilitating comparison of the approaches applied.

²³ Financial Intelligence Centre Act 38 of 2001 and regulations and exemptions relating thereto.

²⁴ Money Laundering and Proceeds of Serious Crime and Terrorist Financing Act.

Figure 3: Practical Examples

Approach	Examples
<p>Low Risk Exemption - General</p> <p>Due diligence exemptions where there is a proven low risk of ML/TF (in limited and justified circumstances) relating to a particular type of financial institution or activity, or DNFBP.</p>	<ul style="list-style-type: none"> Namibia exemption in respect of a client that is a public company the securities of which are listed on an exchange that meets specified criteria.²⁵ South African exemption for a prepaid instrument that meets strict criteria and conditions of usage.²⁶
<p>Low Risk Exemption - Occasional Transactions</p> <p>Due diligence exemptions for financial activities (other than the transferring of money or value) carried out by a natural or legal person on an occasional or very limited basis (having regard to quantitative and absolute criteria), such that there is low risk of ML/TF. Carrying out occasional transactions above the applicable designated threshold (USD/EUR 15 000).</p>	<ul style="list-style-type: none"> Angola's requirement²⁷ that all reporting entities must identify and verify the identity of their clients and, where applicable, of their representatives, and of the beneficial owners, through the presentation of a valid support document whenever conducting an occasional transaction of an amount equal to or higher than the local currency equivalent of USD15 000, notwithstanding the transaction is conducted through a single operation or various operations that seem to be interrelated. This will not apply when there is a suspicion that the operations, irrespective of their amount, are related to the crime of money laundering or terrorism financing, or where there are doubts as to the authenticity or conformity of client identification data.
<p>Low Risk Exemption - Wire Transfers</p> <p>Due diligence exemptions for financial activities (other than the transferring of money or value) carried out by a natural or legal person on an occasional or very limited basis (having regard to quantitative and absolute criteria), such that there is low risk of ML/TF. Carrying out occasional transactions that are wire transfers in the circumstances covered by the Interpretive Note to Recommendation 16.</p>	<ul style="list-style-type: none"> Zimbabwe's requirements²⁸ include a <i>de minimis</i> threshold of USD1 000 (or such lesser or greater amount as may be prescribed). When undertaking wire transfers equal to or exceeding this amount, financial institutions, must undertake specified due diligence relating to the originator. It is noted that there is some doubt as to what due diligence must be undertaken in respect of wire transfers below USD1 000, which illustrates the importance of regulatory clarity.

²⁵ Paragraph 2.5 of Exemption Order No. 75: General Exemptions.

²⁶ Gazette 33309 on the 25 June 2010.

²⁷ Article 5(1) of Law n° 34/11.

²⁸ Section 27 of the Zimbabwean Money Laundering and Proceeds of Crime Act 4 of 2013.

Approach	Examples
<p>Simplified Due Diligence - Rules-Based Structured rules-based regulatory requirements that allow simplified due diligence measures to be applied in respect of lower ML/TF risks.</p>	<ul style="list-style-type: none"> • Simplified due diligence requirements that are specified in terms of Exemption 17 in South Africa, i.e. where there is country level support for the ML/TF risks that are taken by institutions in terms of the nature and extent of the simplified due diligence required. • A more detailed description of Exemption 17 is included in the commentary that follows in this section of the report – i.e. in recognition of the value that this carve out has had on encouraging financial inclusion.
<p>Simplified Due Diligence - Principles-Based Principles-based regulatory requirements that allow simplified due diligence measures to be applied in respect of lower ML/TF risks.</p>	<ul style="list-style-type: none"> • Malawi Regulation 3(5)²⁹ permits a financial institution to apply simplified customer identification requirements for “low risk categories of customers, beneficial owners, beneficiaries or business relationships”. • It is noted that, for this regulatory approach to be effective, regulatory clarity/guidance is needed.

South Africa is, in some respects, seen as setting the benchmark in the SADC region with respect to providing for a special dispensation for financial inclusion in terms of the Financial Intelligence Centre Act, 2001.³⁰ Notably, South Africa put Exemption 17 in place in response to an identified need to support economic transformation in the country. This applies to business relationships and single transactions that fall within set transaction limits/criteria. Clients may only withdraw, transfer or make payments of an amount not exceeding R5 000 per day, and the cumulative transactions during any particular month may not exceed R25 000, and the transfer of funds outside of South Africa is not permitted. Further, the balance maintained in that account may not at any time exceed R25 000 and clients may also not simultaneously hold two or more such accounts with the same accountable institution, i.e. which meet the specified criteria and are similar in nature.³¹

The diagram set out below illustrates the Exemption 17 requirements³².

²⁹ Money Laundering and Proceeds of Serious Crime and Terrorist Financing Act.

³⁰ Act 38 of 2001 - In South Africa exemptions are Gazetted.

³¹ PCC No. 21 clarified the scope and application of Exemption 17.

³² FinMark Trust. AML/CFT and Financial Inclusion in SADC – South Africa Country Report. March 2015.

Figure 4: Exemption 17

<p>APPLIES TO</p> <ul style="list-style-type: none"> • A person who carries out the 'business of a bank' as defined in the Banks Act, 1990 (Act 94 of 1990) • A mutual bank as defined in the Mutual Banks Act, 1993 (Act 124 of 1993) • The Postbank referred to in section 51 of the Postal Services Act, 1998 (act 124 of 1998) • The Ithala Development Finance Corporation Limited • A person who carries out the business of a money remitter <p>(but only in respect of transactions in terms of which both the sending and receipt of the funds in question take place in the Republic)</p> <div style="border: 1px solid black; border-radius: 50%; padding: 10px; text-align: center; margin: 10px auto; width: 80%;"> <p>Places a limit on where the transaction can take place – domestic only</p> </div>	<p>TRANSACTION LIMITS</p> <p>Every business relationship or single transaction which:</p> <ul style="list-style-type: none"> • Enables the client to withdraw, transfer or make payments of an amount not exceeding R5 000 per day and not exceeding R25 000 in a monthly cycle • Does not enable the client to effect a transfer of funds to any destination outside the Republic, except for a transfer as a result of a point-of-sale payment or a cash withdrawal in a country in the Rand Common Monetary Area <p>CONDITIONAL ON</p> <ul style="list-style-type: none"> • The balance in such an account may never exceed R25 000 • The same person does not simultaneously hold two or more accounts which are similar in nature with the same institution <p>TIERED APPROACH</p> <ul style="list-style-type: none"> • No debit is allowed if the transaction limits have been exceeded until full KYC in terms of section 22 of the Act has been performed
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South Africa recognised the need for the encouragement of financial inclusion as an important factor in the journey towards economic transformation. Policy objectives were translated into banking industry strategic imperatives through the Financial Sector Charter. Specifically, the growth of the Mzansi account business, on the back of the Exemption 17 carve-out, has strongly prompted financial inclusion within the country.

Where countries identify proven low risk circumstances, exemptions may be appropriate, i.e. this allows consumers to make use of the financial services in question on the basis of a risk assessment that is undertaken by the appropriate regulatory authorities, as opposed to the organisations that provide financial services, thereby avoiding overly conservative responses relating to the low risks in question. For example, in 2010 South Africa issued a "low risk" exemption for a prepaid instrument that meets strict criteria and conditions of usage³³. It is noted that the South African prepaid card effectively allows for anonymous accounts, which allows for the usage thereof without any due diligence. However, risks are mitigated by not allowing cash-outs and limiting the card usage (to an extent that is acceptable to the regulatory authorities). However, while this might reduce regulatory due diligence barriers in the intended context, this approach would have limited application in relation to the broader market. For example, not allowing cash-out makes the exemption inappropriate for those living in a cash economy.

Other countries have developed tiered due diligence structures that recognise that higher levels of due diligence are required in respect of higher ML/TF risks. For instance, Nigeria has implemented a 3 tier due diligence structure and Mexico has a 4 tier approach. These rely on the specification of thresholds and other criteria that are designed to limit ML/TF risks, which provides institutions with a framework within

³³ Gazette 33309 on the 25 June 2010.

which to comply with the respective due diligence requirements that are determined at country level. This means that there will, by design, be a level playing across all financial institutions that the framework applies to (in applying a structured rules-based tiered approach to due diligence).

Where a regulatory framework also allows institutions to apply simplified due diligence for lower ML/TF risks, they would then be able to apply these outside of the rules-based exemption, which would then allow them to determine the level of due diligence that is appropriate. However, where there is a high level of uncertainty relating to the amount of ML/TF risk that that can be tolerated and the consequences relating thereto, institutions may tend to favour conservative and restrictive compliance responses to limit their risk in this regard. Accordingly, it will be important for countries to consider how risk can be addressed at country level and action taken to assist institutions with the development of compliance programmes that are financial inclusion friendly – without limiting flexibility. Appropriate country level support for a risk-based approach can include regulations that avoid overly conservative due diligence processes in institutions that can adversely impact on financial inclusion imperatives.

The adoption of a risk-based approach to the regulation of AML/CFT has the potential to positively impact on the financial inclusion initiatives of financial institutions. However, this need not be the case in all instances, particularly where the regulatory/supervisory framework introduces a high level of regulatory uncertainty for institutions or where it is inflexible and relies on a one size fits all approach, which can have unintended consequences. Importantly, country circumstances and the profiles of threats and vulnerabilities will be relevant in considering the features of access friendly products. These may, in various respects, be complex in nature and have interdependencies and variables that may not be constant across different populations and geographies, and could change over time. Accordingly, it is advisable to monitor the impact that the risk-based approach has on financial inclusion on an ongoing basis.

5.8. ML/TF risk and country AML/CFT responses

As indicated in the commentary above, a country's regulatory framework could be structured so as to allow for appropriate country level support. It could include "low risk" exemptions and provide rules- and principles-based simplified due diligence requirements that allow proportionate risk responses, i.e. in a manner that provides for regulatory clarity on a level playing field, while at the same time allowing for adequate flexibility.

South African regulators indicated that the existing AML/CFT regulatory requirements will be changed/updated to fully embrace FATF Recommendation 1 specifications, i.e. to comprehensively address the adoption of risk-based approaches at national and institutional levels. Draft requirements have been published in this regard. It is noted that the aforementioned could involve the withdrawal of all current exemptions. This may not, in itself, represent a challenge in respect of financial inclusion, provided that the anticipated changes to the South African regulatory framework, in the light of the national risk assessment that will be carried out in South Africa, provides national level support for institutions to apply simplified measures that would be equally effective as the likes of the current Exemption 17 (in the achievement of financial inclusion objectives). However, eliminating exemptions will, in all likelihood, have a negative impact on financial inclusion in the absence of clear guidance/specification in terms of the risk-based approach in question. Where institutions/DNFBPs are left to determine thresholds on their own, this could lead to much more conservative due diligence approaches that could materially affect financial inclusion outcomes. This will be the case where there is an increased level of uncertainty as to how to comply with the regulatory requirements and what the implications of non-compliance will be. Clear guidance that is developed by both regulatory and business

stakeholders will alleviate risks in this regard. It is reasoned that where guidance is developed by regulators/supervisors in conjunction with institutions, this is far more likely to address the wider business realities in a manner that will keep pace with changing circumstances.

In any event, bearing in mind the consequences of financial exclusion, an impact analysis should be undertaken at country level prior to the implementation of new regulatory requirements.

Institutions will take on ML/TF risk whenever they do business. By virtue of its very nature, when risk is taken on, this will mean that an institution will not, in every instance, get its risk rating entirely accurate. Accordingly, levels of uncertainty relating to ML/TF risk will have an impact on the compliance responses of organisations. Further, supervisory practices will play an important role in influencing an institution's compliance approach. As a consequence, it is important that regulators / supervisors consider the implications of risk in discharging their regulatory / supervisory responsibilities. It is suggested that regulators / supervisors should be open to working with institutions in developing risk-based approaches.

Countries and institutions will also not be able to identify or anticipate all ML/TF risks, and criminals are often one step ahead of regulatory developments. Accordingly, there will be a constant need to keep pace with developments that are needed to achieve regulatory objectives. Although AML / CFT should not be a purely "hind-sight game", there should be an ongoing feedback loop in countries and in institutions.

In the past, MNOs in some countries have indicated that the regulatory environment has favored banks. However, this has, in certain countries, to an extent, been reversed and it has been argued that MNOs are advantaged in terms of due diligence requirements that are in place. In principle, the regulatory requirements should be framed, implemented and supervised in a manner that allows a level playing field. Where this is not the case, AML/CFT objectives and business imperatives can be compromised.

5.9. ML/TF risk assessment in respect of the informal sector

The FATF recommendations, and guidance relating thereto, is not prescriptive about the manner in which ML/TF risk assessments should be undertaken. However, the indications are that countries that are undertaking national risk assessments in the SADC region appear to be geared towards identifying, assessing and understanding the risks in the formal financial system of a country and are not, at this juncture, scoped to address the risks that are inherent in the informal economy, which may be significant in some jurisdictions. For instance, those countries that have adult populations that are largely financially excluded or informally served may, in particular, have unknown ML/TF risks if a full national risk assessment is not conducted. In view of the level of financial exclusion in countries that have cash-based economies, an assessment of both the formal and informal sectors to arrive at an overall country risk assessment would represent some practical challenges, but could yield valuable insights. There would be limited data on which to carry out a comprehensive assessment of the informal sector, however, the question of whether it makes sense to only assess the formal sector in understanding the overall AML/CFT risk picture of a country should be addressed.

Countries will be in a position to consider some aspects of ML/TF risks in respect of exposures that will relate to the informal market such as hawala³⁴, black market currency exchange, loan sharks and informal

³⁴ "Hawala and other similar service providers (HOSSPs) arrange for transfer and receipt of funds or equivalent value and settle through trade, cash, and net settlement over a long period of time. What makes them distinct from other money transmitters is their use of non-bank settlement methods." Refer <http://www.fatf-gafi.org/documents/documents/role-hawalas-in-ml-tf.html>

remittances. This will be a starting point from which to understand the risks in question, and may go some way towards providing an overall country risk assessment.

In any event, where the strategic AML/CFT focus in a jurisdiction is placed purely on the formal financial system, a potentially substantial component of the jurisdiction's economic activity will not be addressed from a planning and resource allocation perspective. This may result in the development of regulatory frameworks that are not optimised to address the overall ML/TF risk posed therein.

5.10. AML/CFT risk-based approach recommendations

AML/CFT outputs/objectives – Refer to section 5.4 above

Although the FATF Recommendations do not directly address AML/CFT from an output or achievement of objectives perspective, it is reasoned that there would be merit in unpacking this matter so that countries would, as a matter of course, be steered towards focusing on AML/CFT effectiveness (over and above technical compliance with the FATF Recommendations).

Risk appetite and tolerance – Refer to section 5.5 above

The question of whether risk appetite and tolerance should also be understood and addressed at country level should be considered. This could perhaps form part of a national risk assessment process and can inform AML/CFT approaches in relation to access to finance.

Monitoring of the impact of laws on financial inclusion – Refer to section 5.6 above

An assessment of the impact of laws on financial inclusion is complex in nature and has interdependencies and variables that may not be constant across different populations and geographies, and could change over time. Accordingly, it is advisable to monitor the impact that the risk-based approach has on financial inclusion on an ongoing basis.

Regulatory frameworks – Refer to sections 5.7 and 5.8 above

A country's regulatory framework should be structured so as to allow for appropriate country level support, which could, in board terms, include "low risk" exemptions as well as rules and principles-based simplified due diligence requirements that allow for proportionate risk responses, i.e. in a manner that provides for regulatory clarity on a level playing field, while at the same time allowing for adequate flexibility. It is advisable to undertake an impact analysis when developing new laws.

ML/TF risk assessment in respect of the informal sector – Refer to section 5.9 above

Where the strategic AML/CFT focus in a jurisdiction is placed purely on the formal financial system, a substantial component of the jurisdiction's economic activity may not be addressed from a planning and resource allocation perspective. This may result in the development of regulatory frameworks that are not optimised to address the overall ML/TF risk posed therein.

5.11. Focus Note 2 conclusion

AML/CFT risk-based approaches provide opportunities to develop financial inclusion friendly AML/CFT frameworks in respect of lower ML/TF risks (allowing simplified due diligence, which could be rules-based

or principles-based) and low ML/TF risks (providing for exemptions - general, occasional transactions, and wire transfers).

It is suggested that there should be an increasing focus on the achievement of AML/CFT objectives, which will, to an extent, be encouraged through the developing appreciation of the contribution made by ML/TF risk assessment and the role that this plays in AML/CFT.

6. End-note

The achievement of AML/CFT objectives through the AML/CFT regulatory requirements and the supervision thereof in a manner that does not unduly compromise financial inclusion is a thread that runs through all aspects of this report.

Two overarching opportunities have been identified over the course of the study in this regard, i.e. which could be addressed in further projects:

- Development of a SADC relevant understanding of the application of FATF Recommendations, perhaps with a view to aligning this with relevant specifications contained in the FIP; and
- Undertaking of a SADC supra-national ML/TF risk assessment, perhaps with a view to informing the regulatory approaches that are adopted in SADC countries.

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Abbreviations/glossary

The following abbreviations are used:

AML – Anti-Money Laundering

CFT – Counter Terrorist Financing

CDD – Customer Due Diligence

DNFBP – Designated Non-Financial Businesses and Professions

EDD – Enhanced Due Diligence

ESAAMLG – Eastern and Southern Africa Anti-Money Laundering Group

FATF – Financial Action Task Force

FIP – SADC Protocol of Finance and Investment

ICRG – International Cooperation Review Group

MAP – Making Access to Financial Services Possible

ML – Money Laundering

MNO – Mobile Network Operator

OTT – Occasional Transaction Threshold

TF – Terrorist Financing