# 9. FINANCIAL INCLUSION PRODUCTS RISK ASSESSMENT

## 9.1 Introduction

Financial inclusion is about providing access to an adequate range of safe, convenient and affordable financial services to disadvantaged and other vulnerable groups, including low income, rural and undocumented persons, who have been underserved or excluded from the formal financial sector[1].

## 9.2 Financial Inclusion Products Risk Assessment

The aim of the study is to evaluate ML/TF risks stemming from both existing and emerging/new financial inclusion products offered in Sri Lanka. This study entails the recognition of specific characteristics of the financial inclusion products, the risks and national priorities in the application of simplified AML/CFT measures and the flexibility of application of AML/CFT principles along with the financial inclusion products. The assessment will also inform policy formulation at the national level, meriting the objectives of National Financial Inclusion Strategy (NFIS). Financial Inclusion Products Survey 2021/22 was carried out covering the key financial sector organizations[2] which offer financial inclusion products in Sri Lanka. Two comprehensive questionnaires were developed mainly to focus on; 1. identifying products and product features, 2. identifying control measures used by the institutions.

Questionnaires were formulated in Microsoft forms in a user-friendly manner and sent to Compliance Officers or Chief Operating Officers of all the institutions surveyed. Survey post reconnoiter was done via focused meetings and discussions to provide proper guidance on the objective of the risk assessment. The questionnaires have been designed based on the guidelines of the WB, Financial Inclusion Product Risk Assessment Tool. The present assessment covered the formal and semi-formal sectors of the country's financial system, with a greater expansion towards semi-formal sectors comparative to the previous NRA. The NRA exercise surveyed a total of 105 institutions. The analysis is performed by deriving at responses for the variables in the module and the guidance questions.

## 9.3 Findings

### *9.3.1 Financial Inclusion Products in Sri Lanka*

Of the responses received, it was observed that 75 (71 per cent) out of 105 institutions have financial inclusion products. There were 197 products offered by these 75 institutions which were qualified as financial inclusion products as per criteria. The said 197 financial inclusion products were grouped into 10 different categories based on their characteristics. The 10 categories were:1) Regular Savings and/ or fixed deposits, 2) Micro loans, 3) Group Lending/Self-help groups products, 4) SME loans, 5) Deposit backed loan products/collateral savings, 6) Money or value transfer/ e – money services, 7) Microinsurance, 8) Finance leasing, 9) Pawning and 10) Remittances or Purchase/sale of foreign currency.

1 FATF guidance on Anti-money laundering and terrorist financing measures and Financial Inclusion
2 Banks, Finance Companies, Insurance Companies, MVTS and e-money service providers, Microfinance Companies (including NGOs), Cooperative Societies and Samurdhi Banks.

**Figure 1: Sector-wise Representation of the Total Responses Received from Institutions.**

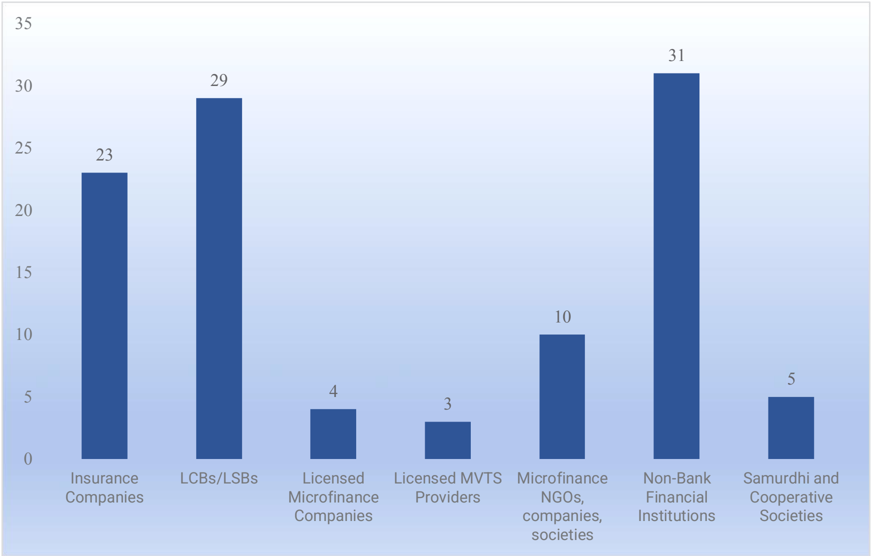
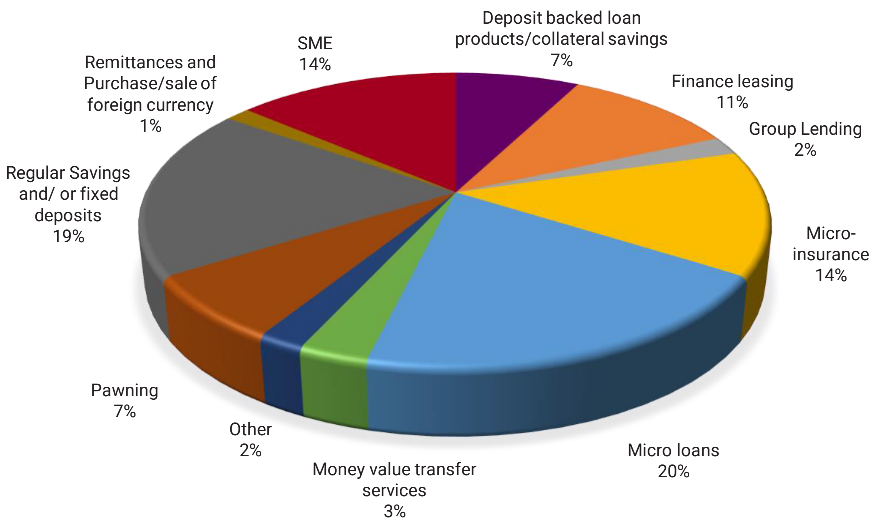



**Figure 2: Availability of Financial Inclusion Products (Product wise Categorization)**




### *9.3.2 Overall Operating Environment*

According to the WB Global Findex 2021, 89 per cent of adults in Sri Lanka have accounts at a financial institution which is more than twice the average in South Asia (excluding India) of 38 per cent and higher than the average for developing countries which is recorded as 71 per cent. Sri Lanka benefits a broad physical access to financial services boasting bank branch density of 16.4 branches per 100,000 adults, nearly double the South Asian regional average of 9.4. However, despite having a high account ownership across all segments of the population, the actual account usage falls behind with many accounts being dormant. Sri Lanka has no significant gender gap in account ownership (18 per cent). Financial literacy of Sri Lanka is 57.9 per cent (Financial Literacy Survey of Sri Lanka 2021).

#### *9.3.3 Regulatory Environment of the Financial Inclusion*

One of the key regulatory reforms introduced in the financial inclusion sector is the Microfinance Act, No. 6 of 2016. It was issued to license, regulate and supervise unregulated microfinance companies and microfinance NGOs of Sri Lanka by the Monetary Board of the CBSL. Only the financial institutions licensed by the CBSL are permitted to accept deposits from the general public in Sri Lanka. All regulated financial institutions that offer financial inclusion products are subject to the general AML/CFT requirements of the FIU. Therefore, they are required to establish an AML compliance function with competent officers on AML/CFT and to impart necessary awareness on AML/CFT to all levels of staff of the institutions. Financial Institutions (Customer Due Diligence) Rules, No. 1 of 2016 (CDD Rule), issued under Section 2(3) of the FTRA has prescribed the CDD requirements that should be applied by financial institutions including financial inclusion service providers who provide specific services as defined in the FTRA. The CDD Rules prescribe financial institutions on requirements relating to implementation of risk-based approach. Accordingly, when a financial institution is conducting transactions with a customer or a legal person, they are required to identify the risk and take measures and conduct ongoing due diligence commensurate with the risk. Product risk assessments need to be carried out before the launch of such products or new technologies. Institutions that come under CDD rules take necessary approvals from the regulator prior adopting such technological or product launch. The FIU has not issued regulations or guidelines specifically for financial inclusion products however, FIU has issued a guideline on ML and TF Risk Management for Financial Institutions, No. 1 of 2018 which stipulates the instances and possible measures of simplified CDD.  Sri Lanka initiated to develop its national level policy framework for financial inclusion in early 2018 and the NFIS of Sri Lanka for 2021-2024 was launched in early 2021.

##### *9.3.3.1 Delayed Verification under Customer Due Diligence Rules*

CDD rules have provided for delayed verification in instances where the risk level of the customer is low and verification is not possible at the point of entering into the business relationship, the Financial Institution may, allow its customer and beneficial owner to furnish the relevant documents subsequent to entering into the business relationship and subsequently complete the verification[3] as soon as it is reasonably practicable but not later than fourteen working days from the date of opening of the account, the delay shall be essential so as not to interrupt the Financial Institution's normal conduct of business and no suspicion of money laundering or terrorist financing risk shall be involved[4].

##### *9.3.3.2 Key Legislations and Rules that Govern Identification of Customers*

The FIU issued several regulations circulars and guidelines under the Section 3(2) of the FTRA in relation to the requirements of risk assessment, STR reporting, non face-to-face identification technologies, etc., further explaining AML/CFT responsibilities. All institutions under the FTRA are required to report suspicious transactions to the FIU. According to the rules and regulations in Sri Lanka, identification (passport, NIC, driving license, etc.), address verification, telephone/fax numbers, etc., must be obtained from potential customers to enable banks and other institutions to fulfill their KYC requirements.

3 Rule 31 of Financial Institutions (Customer Due Diligence) Rules, No. 1 of 2016 (CDD Rule)
4 Rule 32 of Financial Institutions (Customer Due Diligence) Rules, No. 1 of 2016 (CDD Rule)

Thus, as it stands at present, irrespective of the customer's ML/TF risk, the KYC requirements as stipulated in the rules are identical. Therefore, low-income groups i.e., low-income people, farmers, those involved in cottage industries, etc., who are generally low risk, are unable to furnish the above requirements and hence, get excluded from participating in the Financial Inclusion products.

#### *9.3.4 Risk Rating of Object Specific Products*

For 8 categories of products which are Micro Loans, SME Loans, Group lending/Self help groups, Regular savings/Fixed deposits, Microinsurance, Deposit backed loan products, Finance leasing, and Pawning, initial and final risk assessment arrived as Low risk. For MVTS and Remittances and sale/purchase of foreign currency, initial product risk assessment was medium and final risk assessment after considering risk mitigants, arrived at Low risk.

#### *9.3.5 Risk Assessment of Specific Product Categories*

##### *9.3.5.1 Microcredit*

The ML/TF risk for microcredit is Low, not only due to the size of the loan and the prescribed threshold amounts, but also due to clearly defined product features and existence of risk mitigants for the product. Anonymous use of the product is not possible since the institutions carry out customer identification prior to on-boarding. Loan products are availed of mainly by natural persons who are citizens residing in the country. The credit cooperatives, Samurdhi banks, MFIs and microfinance NGOs only lend to their members within the communities they serve. The value and number of loan transactions are limited, and the majority of products have threshold limits for value and frequency of transactions. There are no cross-border transactions. Non face-to-face account opening and transactions are allowed in some banking, finance leasing and MVTS micro credit products. Such microcredit facilities are disbursed and collected via established online platforms under monitoring of transactions, security (usernames, passwords and One Time Passwords, etc.) and the loans are disbursed after careful loan appraisals. Notably, there is no history or record of financial crimes. At instances where legal persons are entitled to use microcredit facilities, customer identification procedures are followed, and strict credit appraisal procedures are in place for granting loans. Agent banking is allowed, however, there is frequent interaction and close relationship between the service providers and agents as well as the clients.

##### *9.3.5.2 Small and Medium Enterprises Loans*

The ML/TF risk for SME loans is Low, mainly due to clearly defined product features, prescribed threshold amounts, and existence of risk mitigants for the product. Anonymous use of the product is not possible since customer identification or KYC procedures are carried out prior to customer on-boarding. Loan products are used only by citizens. These products are lent to their members within the communities they serve. Few products have threshold limits and the upper limit amounts to Rs. 500,000 which shows a low value facility. Therefore, the value of transactions is limited, and the number of loan transactions is also limited. For products which inward remittances are allowed, there is no possibility of having transactions from high-risk jurisdictions. Transactions are generally face-to-face and often conducted onsite (in or near clients' place of residence) by authorized loan officers. Some SME product facilities are allowed non face-to-face and in such instances, loan disbursements and repayments are carried out via established online platforms under monitoring of transactions. There is no history or record of financial crimes. Legal persons are entitled to avail themselves of the SME facilities, and customer identification procedures are followed. Agent banking is allowed, however, there is frequent interaction and close relationship between the service providers and agents as well as the clients.

*9.3.5.3 Regular Savings and/ or fixed deposits*

Despite the expansion of the functionalities of the regular savings and/ or fixed deposits, the ML/TF risk for regular savings and/ or fixed deposits remains to be Low. This is primarily due to the existence of risk mitigants, such as product is not typically available to individuals/entities other than the Bank's existing customers (not for walk-in customers), product typically creates a long-term obligation to the bank and the product significantly used by and/or marketed not towards customer types categorized as higher risk in regulatory or industry guidance. This product typically does not involve a high volume of transactions over a short period of time. The fact that deposit taking is allowed only for institutions which are licensed and supervised by the CBSL greatly contributes to the sustained low ML/TF risk. All the service providers of regular savings and fixed deposits are required to be compliant with the FTRA and CDD rules issued by the FIU for financial institutions. There are no thresholds on the number of transactions hence the number of transactions is unlimited. However, the average daily transactions must be monitored. Compliance is verified through supervision. This product is not offered to non-residents. Cross-border transactions are possible, however, due to strict compliance with the rules and regulations, there is no possibility of having transactions to and from high-risk jurisdictions. Further, transfers to microdeposit accounts by a third party are possible through electronic channels but the KYC aspect for the remitter is undertaken by remittance agents.

*9.3.5.4 Microinsurance*

The ML/TF risk for microinsurance is generally Low due to clearly defined product features suited to the target market, and existing risk mitigants. It is not offered to non-residents, and anonymous use of the product is not possible. Microinsurance products do not allow transactions across borders. Anonymity cannot be possible because the products are offered to pre-identified customers. All insurance companies have to comply with IRCSL issued rules and regulations. The FIU had issued special CDD rules for the insurance sector in 2009, which were later repealed and replaced by the Insurers CDD Rules issued by the FIU in 2019. Accordingly, IRCSL has also issued AML/CFT regulations/guideline for their regulating insurance companies. Other financial institutions that offer insurance products need to adhere to CDD rules issued for FIs. Therefore, almost all insurance service providers have to comply with tightened AML/CFT rules. The value and the number of the transactions (per provider) are limited, and cross-border transactions are not allowed. Basic KYC, including face-to-face account opening, is required, although the process/documentation is simplified to accommodate the targeted low-income clients. Moreover, the product is generally offered to residents only. Of the surveyed products, 44.4 per cent has a threshold for value of transactions. Given the specific premiums and low frequency of payments, the transaction frequency is limited. It is generally offered to residents and citizens only. The usage of microinsurance products to perpetrate ML/TF activities is not known and there are not any reported cases that relate these products to financial crimes or activities. Given that there are strict procedures prior to the rolling out of these products and that the product caters to the low-income sector, possibility to commit fraudulent activities using the product is very low.

*9.3.5.5 Pawning*

When compared with other loans, the value of transactions for this product is high, as generally a threshold is not provided. However, ML/TF risk is Low because the amount is based on weight of the gold article a customer possesses. Pawning loans are usually short-term, involving small amounts which are generally carried out by those from the low-income bracket, especially for urgent cash requirements. The customers typically carry out loans below Rs. 2 million. These products do not allow anonymity of the customers. These institutions which provide pawning services are supervised by the relevant regulatory authority. The ML/TF risk is also low due to the requirement of face-to-face transactions at the point of both pawning and settlement/redeeming stages. Although KYC is required, the process/documentation is simplified to fit the targeted low-income and small borrowers. Borrowers are natural persons. One identified risk in pawning is the issue of ownership of the personal property offered as collateral. These include instances where personal properties obtained through robbery or theft were pawned. Under the FTRA and CDD rules, financial institutions and DNFBPs are required to comply with explicit KYC procedures consistent with the requirements. The institutions following the practice of conducting the necessary due diligence to determine ownership of the item to be pawned and blacklisting those who pawn items which are found to be sourced from illegal activities is considered an effective risk mitigant.

*9.3.5.6 Remittance Services and Purchase/Sale of Foreign Currency*

The ML/TF risks for remittance services are generally Low because thresholds have been placed on the amount of remittance and on the number of transactions. Due to the limits on the amount and number of transactions, in general, the amount of these remittances is relatively low. Some remittances also have regularity (i.e., once a month) with recipients already known to the institution. These remittance services are offered by financial institutions which are strictly adhered to AML/CFT requirements and supervision. The transaction monitoring and STR reporting is mandatory, indicating their ability to determine risks associated with transactions. Enhanced CDD needs to be conducted on remittances involving large amounts, especially, on cross-border transactions. Cross-border transactions with high-risk jurisdictions are very unlikely and closely scrutinized under the applicable laws and regulations. For enhanced measures for cross-border transactions, institutions take Visa information / dual citizenship copy/ source of income details, confirmation from correspondence agent and monitor transactions through separate monitoring rules available to cross border transactions and large remittances.

*9.3.5.7 Money or Value Transfer Services/E-Money*

The ML/TF risk for e-money and MVTS is Low because of low value threshold, transaction monitoring and existence of risk mitigants. These service providers are required to ensure compliance with AML/CFT requirements. They provide training for individual retailers who are agents of the MVTS providers, and they have implemented the AML/CFT requirements of the CDD including maintaining a directory of agents and providing training. For non face-to-face account opening, the threshold of transactions per month is as low as Rs. 10,000. Also, whenever a customer cashes in and out in the e-money system, required CDD procedures are performed. The number of STRs filed by the sector is relatively low, as against the other financial sectors. Nonetheless, potential exposure to financial crimes and abuse of the product for scam purposes remains a concern that regulators continue to address with commensurate consumer protection rules, guidance, and awareness. Although cross-border transactions have the probability to expose the sector to ML/TF risks, the risk of ML/TF is reduced, given a lower aggregate threshold amount per month and the current average transaction amount is very low. Considering the possibility for terrorist groups and drug traffickers to channel funds for their activities using e-money and remittance transfers, the service providers scrutinize and analyze all transactions and make the necessary reports in compliance with the requirements of the CDD rule on wire transfers. Moreover, service providers have information on high-risk jurisdictions, UNSCR sanction screening and have blocked transactions to these high-risk jurisdictions and designated individuals and entities.

*9.3.5.8 Deposit Backed Loans/ Collateral Savings*

The ML/TF risk for deposit backed loans continues to be Low. The value thresholds and the existing risk mitigants for the product significantly contribute to such low risk. These products are issued to existing customers who are risk rated, hence, anonymous usage of product is not allowed. Deposit taking is allowed only for institutions regulated under the CBSL. Fund withdrawals and transferring are significantly limited. These saving accounts are mainly offered only to individuals in Sri Lanka or to existing customers who are already known to the institution. All the transactions are complied with AML/CFT regulations and transaction monitoring.

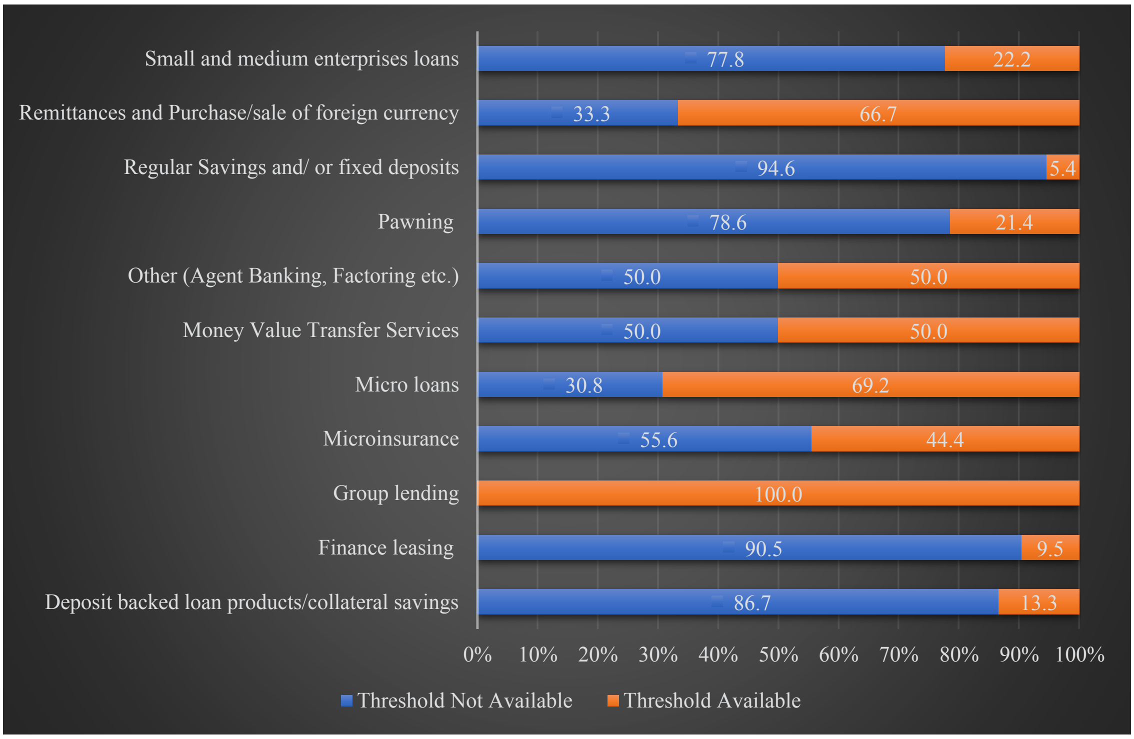
*9.3.5.9 Finance Leasing*

The ML/TF risk for finance leasing remains to be Low, primarily because of the existence of risk mitigants such as threshold limits, loan to value ratios imposed by the regulator i.e., CBSL and the regulation and supervision by CBSL. The product typically creates a long-term obligation to the company. This product typically does not involve a high volume of transactions over a short period of time. The approval and actual opening of accounts were done only at the head office or a branch. The leasing product disbursements are subject to stringent appraisals of the customer. The fact that finance leasing products are offered only by financial and leasing companies which are licensed and supervised by the CBSL, greatly contributes to the sustained low ML/TF risk. These accounts cannot be opened without KYC compliance. All the service providers are required to be compliant with the FTRA and CDD rules. The average daily transactions are monitored and sanction screening is carried out. Compliance is verified through supervision. This product is not offered to non-residents.

*9.3.5.10 Group Lending Products*

The ML/TF risk for Group Lending Products is Low, due to the small size of the loan, and existence of risk mitigants for the product. Anonymous use of the product is not possible since the institutions are carrying out customer identification and these products are issued in village level individuals who are known to each other. Loan products are used only by natural persons who are citizens residing in the country. Recommendation of the Grama Niladhari or the monk of the temple, etc., is required. The value and number of loan transactions are limited, and the majority of products have threshold limits for value and frequency of transactions. There are no cross-border transactions. Transactions are generally face-to-face and often conducted onsite (in or near clients' place of residence by authorized loan officers or agents). Agent banking is allowed, however, there is a close relationship between the service providers agents and customers.

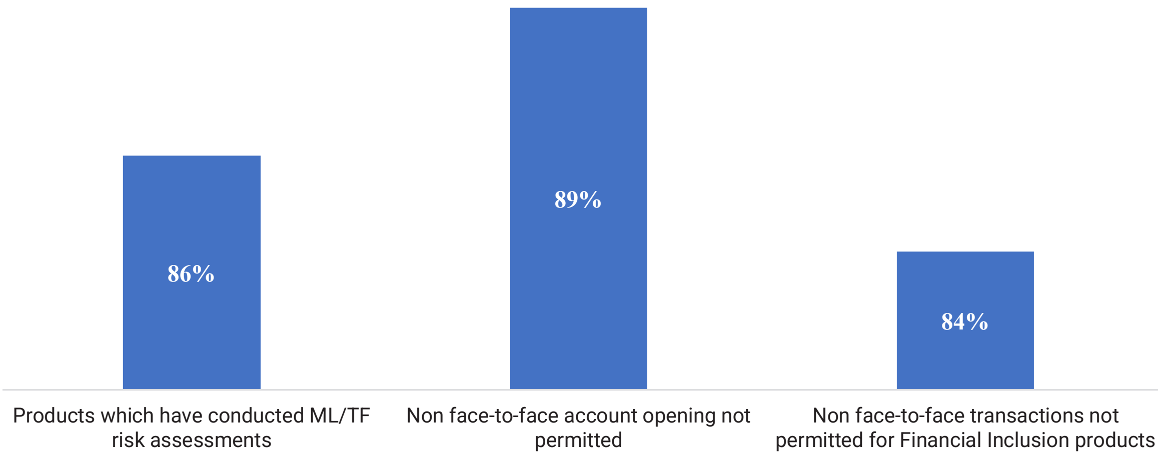
**Figure 3: Product wise Availability of Threshold for Value of Transactions of Financial Inclusion Products**




## 9.4 Summary of Control Measures taken by the Institutions

Among the surveyed products, 88.6 per cent institutions had developed policies and procedures for AML/CFT. Further, 86 per cent of the institutions carry out risk assessment with regard to ML/TF risk of the customer. The measures in order to mitigate the misuse of these products from ML/TF and related frauds by minimizing customer risk, the institutions have implemented periodical audits, requirement of customer being a member of a particular society or the institution, providing training to staff, ongoing monitoring of customers, requirement of proof of low-income status of customer and recommendation of the customer by Grama Niladhari or an acceptable authority.

**Figure 4: Availability of Non Face-to-Face Account Opening and Transactions and Institutions that have Conducted Money Laundering/Terrorist Financing Risk Assessment for Financial Inclusion Products (as a percentage of all financial inclusion products)**



## 9.5 New Products Planned to be Launched

Of respondents, 26 per cent have responded that they have planned to introduce new financial inclusion products in the future. Out of them, 63 per cent of products would not permit for non face-to-face account opening. Of the future products, 70 per cent would not allow for cross-border transactions. Such products would not allow sending money to high-risk jurisdictions. Of the products, 75 per cent would not be offered to, and used by, non-resident and/or non-citizen customers.

## 9.6 The Challenges that Institutions Encounter when Providing Financial Inclusion Services

Findings of the survey highlight that 41.7 per cent of respondents claiming stringent KYC requirements as a major challenge for providing financial inclusion products. Among the difficulties in relation to stringent KYC regulations, obtaining proof of income of customers, the requirement to periodically review the KYC of the Account Holder/Customer, ascertaining the source of income / origin of funds, lack of knowledge on regulatory requirements of the agents were highlighted. Lack of digital identification documents was another key challenge highlighted by 31.3 per cent respondents. Among other challenges which the respondents highlighted were, high mobility of customers without any forwarding addresses, clients' exposure to external shocks which undermines loan recoveries in the absence of a reasonable collateral and the lack of awareness in low-income segments.

**Figure 5: Financial Inclusion Product Risk Assessment**