Keynote speech: Mr. Emery Kobor, The Role of Anti-Money Laundering Law in Mobile Money Systems in Developing Countries, at the Mobile Money in Developing Countries Conference, 20 April 2012, Seattle, Washington

Introduction

I am delighted to be here today and for that honor, I want to thank Louis DeKoker, whom I met several years ago when we were both speaking at a conference in Kuala Lumpur. I remember that event vividly because we gave multiple presentations over several days – something like a repertory company. I recalled that experience in preparing for today's remarks. It occurred to me that to discuss how anti-money laundering (AML) regulations apply to new payment methods that are used to spur financial inclusion and boost economic development, one must, in effect, give four presentations. Not only do payments innovation, financial inclusion, economic development, and AML regulation each deserve special attention, but how each influences and is influenced by the public and private sectors is also relevant.

Consider:

- The engine of innovation is private sector ingenuity and the pursuit of profit. The public sector's role in supporting payment system innovation, at the most basic level, is to allow for the accumulation of private property; protect property rights, including intellectual property, by upholding the rule of law; facilitate access to capital; and permit competition to take place, while maintaining an open and stable economy.

- The private sector will reach out to the unbanked where it makes economic sense to do so. An under-served population is untapped profit potential. But any firm willing to invest in developing that market is going to want as big a share of the potential profits as possible, which means a firm willing to move first will seek to erect barriers to competition. The public sector and non-governmental organizations (NGOs) fostering financial inclusion will pull in the opposite direction, seeking to reduce those barriers in the belief that more competition right away means greater financial access. Failure to coordinate can ultimately impede financial inclusion.

- The pillars of economic development include macroeconomic stability; infrastructure development; and good governance, including promoting the rule of law. Unless these public policy goals are implemented effectively, the private sector, in pursuing its own self-interest, will undermine economic development. An unfriendly business environment, including endemic corruption and counterproductive monetary and fiscal policies, impedes growth and drives economic activity underground, where it erodes the tax base, worsens public sector budget constraints, and restricts government programs and policies intended to foster the basic conditions for further growth. The Council of Europe estimates the underground economy accounts for as much as two-thirds of gross domestic product in some Central and East European countries where, as they put it, "the rule of law is still fragile."[1]

[1] The Council of Europe, "The underground economy: a threat to democracy, development and the rule of law," Resolution 1847 (2011).

- Excessive or costly regulation, including potentially AML regulation, is a burden to business and a barrier to economic growth. But the rule of law and proportional regulation, particularly as it pertains to AML safeguards, deters corruption, enhances transparency, and facilitates international cooperation, which create a supportive business environment.

That is a very quick overview of how payment system innovation, financial inclusion, economic development, and financial regulation interact. Now I would like to look at each in a little more depth.

Payment System Innovation

Almost exactly ten years ago, I co-authored a paper at the Federal Reserve Bank of Chicago titled, "Why Invest in Payment Innovations?"[2] The title was not intended to be ironic. The paper was written to help financial services providers identify the appropriate strategy when investing in new payment methods. At the time, the focus was on how to leverage the Internet to extend payment options. Today, the focus is on mobile payments. But it is still a challenge for the private sector to know when to pursue customer acquisition versus customer retention, or cost-cutting versus boosting revenues.

The right private sector strategy is based in part on where a company wants to be on what I refer to as the "innovation timeline." To be the first to introduce a new payment method to the market involves taking a big risk, but opens up the possibility of big returns and locking in new customers if the strategy is successful. Taking the opposite approach and moving slowly can also be a big risk, but if fast moving competitors stumble their costly mistakes offer valuable lessons to the rest of the market. Even when the firm that acts first to establish a market is successful, other firms still have important strategic decisions to make as to how fast or how slowly they choose to follow, and how or whether they differentiate their services.

The innovation timeline starts when a company introduces a new payment method, ideally tapping into latent demand and a new source of profits. For taking the risk and making the investment to establish the market, a first mover will seek a high profit margin and will attempt to hold back competitors for as long as possible, often using proprietary technology and intellectual property protections. As competitors eventually enter the market, competition will gradually erode the advantage the first mover enjoyed, lowering prices and broadening market access over time.

But that scenario, in which a single company blazes a bold trail to a successful new market, is rare. More often a number of companies attempt a number of strategies and more-or-less manage to find their way to a viable market. There is always uncertainty. The mobile payments initiatives currently struggling throughout the developing world demonstrate that the need for financial inclusion and the ubiquity of cell phones do not easily translate into profitable demand for mobile payments.

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[2] Chakravorti, Sujit,and Emery Kobor (2005),"Why invest in payment innovations?" *Journal of Payment Systems Law*, 1 (4), 331-353.

Safaricom's M-Pesa mobile payment service in Kenya stands out precisely because of the rarity of its success. There have been a number of studies comparing M-Pesa with similar services elsewhere, including M-Pesa in Tanzania[3]; various mobile money providers in Ghana[4]; and in the Philippines[5]. The common deficiencies cited by these studies of service providers attempting to match M-Pesa in Kenya are ineffective marketing; inadequate distribution channels; and a failure to address country-specific demand characteristics.

Harvard Business School recently introduced a case study comparing M-Pesa in Kenya and the mobile payments company WIZZIT in South Africa.[6] The case study emphasizes that profits are earned by delivering what the customer wants, not what the service provider thinks the customer needs. More broadly, the case study illustrates that each component of a successful strategy is important, including how the company is capitalized; the marketing plan; and the distribution network. M-Pesa is successful in part because the company focused narrowly on providing a convenient and cost-effective way for Kenyans to send money domestically from urban areas to family members in rural communities. According to the case study, by contrast, WIZZIT saw its role as providing a full suite of banking services to the unbanked in South Africa without regard for market demand. The Harvard case study concludes that WIZZIT, in addition to overreaching strategically, made less than optimal decisions regarding capitalization, marketing, and distribution.

Financial Inclusion

For a mobile payments initiative to be a successful financial inclusion tool, it has to be a viable business. But government and civil society may be able to help influence the market's rate of adopting a new payment method by changing how they pay salaries and conduct transactions. Nongovernmental organizations, development banks, and bilateral development partners may be able to introduce mobile payments or other electronic payment methods as part of relief initiatives. If coordinated with private sector participants, this can promote financial inclusion.

More important than fostering the adoption of a product, however, is helping to develop a receptive market. Potential barriers to financial inclusion include market disruptions caused by armed conflict, extreme poverty, and natural disasters. Inadequate government infrastructure – including a lack of government-issued identification – as well as illiteracy, lawlessness, and well-established networks of unlicensed payment service providers also handicap financial inclusion initiatives. However, government can help ease the cost to the private sector of

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[3] Camner, Gunnar & Emil Sjöblom, Can the success of M-PESA be repeated, Valuable Bits, September 14, 2009. Available at www.valuablebits.com.

[4] Mensah, Dr. Edwin, University of North Carolina at Pembroke, Ubiquitous Technology, "Untapped Benefits: Is mobile money technology destined for oblivion in Ghana?" Microlinks, USAID. Available at: http://microlinks.kdid.org/blogs/ubiquitous-technology-untapped-benefits-mobile-money-technology-destined-oblivion-ghana.

[5] Pickens, Mark, Window on the Unbanked: Mobile Money in the Philippines, Consultative Group to Assist the Poor, December 2009.

[6] Rangan, Kasturi V. and Katharine Lee, Mobile Banking for the Unbanked, Harvard Business School, Case #9-511-049, revised January 31, 2012.

marketing a new payment initiative by promoting literacy and financial education, and providing incentives to help foster the transition to electronic payments.

Economic Development

Financial inclusion is one facet of economic development, and financial inclusion itself has many facets. Giving the poor an alternative to cash that allows them to hold what money they have with a service provider for safekeeping has the effect of mobilizing capital. In Kibera, a slum in Nairobi that is home to hundreds of thousands of people who, remarkably, have electricity but very little else, I saw a surprising number of M-Pesa agents. For the residents of Kibera, using M-Pesa can reduce crime and help facilitate the accumulation of savings. My observations are consistent with the results of a recent study of the effects of M-Pesa in Kenya, which concluded that M-Pesa is helping to expand local economies, enhance security, help people to accumulate capital, and make transactions easier.[7]

There is a limit, however, to what can be accomplished without financial transparency, effective governance, and the rule of law. Serious development challenges remain in Africa, where, according to the World Bank, almost half the population lives on $1.25 a day, and governance and transparency remain weak.[8] In Kenya, for example, where we have seen mobile payments have a successful impact on financial inclusion, much more needs to be done. There is an understanding in Kenya of the importance of good governance and transparency to economic development. The country's development plan, Kenya Vision 2030, states: "One of the most urgent steps towards creating a competitive financial environment in Kenya is introducing legal and institutional reforms that will enhance transparency in all transactions, build trust and make enforcement of justice more efficient."[9] However, Kenya's slow progress on financial transparency, combating corruption, and affirming the rule of law may jeopardize the gains M-Pesa has achieved.

Corruption is most prevalent and damaging where it compounds other forms of institutional inefficiency, such as political instability, bureaucratic red tape, and weak legislative and judicial systems. Research by the International Monetary Fund shows corruption reduces economic growth primarily by discouraging private investment.[10] Poor monetary and fiscal policies also hurt economic growth in many ways, including by driving consumers and entrepreneurs to use cash and transact in the underground economy. Zimbabwe gave up on monetary policy in 2009, adopting the U.S. dollar instead. But the memory of crushing inflation is keeping people away from banks and alternatives to cash, putting a brake on economic growth.[11] Argentina, Greece, Italy, Nigeria, Russia, and Tanzania are attempting to reduce the use of cash through regulation in order to mitigate capital flight, financial crime, and tax evasion. However, in countries with

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[7]Plyler, Megan G., Sherri Haas, and GeethaNagarajan, Community-Level Economic Effects of M-PESA in Kenya: Initial Findings, IRIS Center, University of Maryland, June 2010.
[8]Boch, Herbert, Africa Regional Brief, The World Bank. Available at: http://go.worldbank.org/3IGKDWFTG1
[9]Kenya Vision 2030, The Popular Version, Government of the Republic of Kenya, 2007, p15.
[10] Mauro, Paolo, "Corruption: Causes, Consequences, and Agenda for Further Research," International Monetary Fund, Finance & Development / March 1998, Volume 35, No. 1.
[11]McGroarty, Patrick and Farai Mutsaka, Hanging On to Dollars In Zimbabwe, *The Wall Street Journal*, March, 26, 2012. Pg. C1.

inadequate regulation, supervision, and enforcement, electronic transactions are more efficient for both licit and illicit transactions.

Regulation and Supervision

The ease with which money moves around the world today make it seem that every major financial crime now is an international crime. The U.S. Department of the Treasury was reconfigured in 2004 to better deal with the challenges of money laundering and terrorist financing, which have become increasingly more complicated. The creation of the Office of Terrorism and Financial Intelligence (TFI), where I work, signaled a new era for finance ministries globally. TFI includes an intelligence component and has enforcement, policy, and regulatory authorities. TFI works to establish, support, and enforce best practices against money laundering and terrorist financing domestically, bilaterally, and through multilateral bodies, including the Financial Action Task Force (FATF).

Established by the G-7 Economic Summit in 1989, the FATF is acknowledged by the G-20, International Monetary Fund, World Bank, and United Nations to be the global standard-setter for anti-money laundering and counter terrorist financing policies and procedures (AML/CFT). The FATF includes 36[12] members, representing most major financial centers in all parts of the globe. In addition to setting AML/CFT standards, the FATF promotes and assesses compliance, and, when necessary, coordinates diplomatic pressure and countermeasures through its member governments. Through a combination of technical expertise and political and economic strength, the FATF has been unique among international bodies in its ability to take strong, effective multilateral action to prompt positive change in strengthening jurisdictional AML/CFT regimes worldwide.

The FATF recently revised its Recommendations. Originally there were 40 AML Recommendations. After 9-11, the FATF adopted nine special recommendations to address terrorist financing. As part of the revision this year, some Recommendations were combined or dropped, some added, resulting once again in 40 Recommendations, with no special recommendations. The FATF 40 Recommendations now cover money laundering, terrorist financing, and the financing of proliferation of weapons of mass destruction (WMD).

The Recommendations are clustered into seven categories, with the first two Recommendations making up the first cluster. The new Recommendation #1 calls on countries to undertake a national risk assessment to understand the money laundering and terrorist financing risks in the country. A guidance paper is being prepared to help countries conduct their first risk assessment. Recommendation #2 calls for national risk-based AML/CFT policies, responsive to the risk assessment.

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[12] FATF members include Argentina; Australia; Austria; Belgium; Brazil; Canada; Denmark; European Commission; Finland; France; Germany; Greece; Gulf Cooperation Council; Hong Kong, China; Iceland; India; Ireland; Italy; Japan; Luxembourg; Mexico; Kingdom of the Netherlands; New Zealand; Norway; People's Republic of China; Portugal; Republic of Korea; Russian Federation; Singapore; South Africa; Spain; Sweden; Switzerland; Turkey; United Kingdom; and the United States.

Recommendations 3 and 4 address criminalizing money laundering and facilitating the forfeiture of illicit assets. The next group, Recommendations 5-8, address the financing of terrorism and WMD proliferation, including the implementation of relevant sanctions in United Nations Security Council resolutions.

The preventative measures, Recommendations 9-23, are the standards most closely associated with the FATF and most directly tied to discussions of regulatory costs, economic growth and financial inclusion. These Recommendations include the customer identification and recordkeeping obligations, as well as requirements for filing suspicious transaction reports and conducting enhanced due diligence when opening an account for a foreign political figure or their family members.

Recommendations 24 and 25 concern the registration of legal entities and opening an account for a legal entity at a financial institution, and the requirement in both processes to understand who owns or controls the entity—so-called beneficial ownership. Recommendations 26-35 address supervision of financial institutions, the role and responsibilities of law enforcement, and the role of financial intelligence units.

The final cluster, Recommendations 36-40, addresses international cooperation, including requirements to implement four international conventions.[13] These Recommendations include criteria regarding cross-border cooperation for civil and criminal investigations, the freezing and confiscation of assets, extradition, and cooperation among supervisory authorities.

The FATF is working on a new methodology for the mutual evaluation process to assess compliance with the Recommendations. Previously, the assessment process was detailed, technical, and lengthy, and produced detailed, technical, and lengthy reports. The goal of the new methodology is to emphasize effective implementation of the standards rather than technical compliance, and in so-doing, hopefully, the next round of mutual evaluation reports will be less technical and much shorter.

Exactly what criteria the FATF will use to measure effective implementation is the subject of ongoing lengthy discussions. It is hoped that effective compliance with the FATF Recommendations will help to provide the financial transparency necessary to deter corruption, assist law enforcement, and maintain the rule of law not only at home, but globally through international cooperation. Poor laws and inadequate enforcement provide little capacity to support neighbors seeking help in conducting criminal investigations, identifying stolen assets, or deterring terrorist financing. A country that demonstrates an unwillingness to address significant gaps in its AML/CFT regime opens its borders to a cross-flow of illicit assets, weakening the anti-corruption and AML/CFT efforts of other countries.

Accommodating a risk-based approach to AML/CFT compliance is an ongoing process within the FATF. Flexibility is built into many of the Recommendations, and there are guidance and best practices papers, either written or underway, that illustrate how to apply a risk-based approach. But a review of the FATF mutual evaluations done between 2005 and 2011 indicates

[13] The Vienna Convention, 1988; the Palermo Convention, 2000; the United Nations Convention against Corruption, 2003; and the Terrorist Financing Convention, 1999.

that few countries have attempted to apply a risk-based approach to the FATF Recommendations. Most countries take a uniform approach, with the same obligations applied across all financial institutions. This tactic obviously hampers financial inclusion efforts involving small-scale, low-risk financial services providers.

One reason why the risk-based approach has not yet been widely embraced is because it is not well understood. Most countries have not attempted a systematic risk assessment, and where governance is weak, there will be few civil or criminal enforcement actions or suspicious transaction reports filed by financial institutions to help policy makers understand the underlying threats. However, a risk assessment does not have to be retrospective, especially regarding new payment initiatives fostering financial inclusion. Establishing usage limits such as a balance, deposit, or withdrawal cap and transaction limits, with effective ongoing transaction monitoring, is one way of limiting risk by design.

I often hear that the FATF customer identification and recordkeeping obligations can be too burdensome for developing countries, especially those exploring financial inclusion initiatives using mobile payments or other new payment methods. But in fact, customer identification and transaction recordkeeping are essential to the private sector to inform marketing decisions, help prevent fraud, and protect consumers. An important benefit M-Pesa has enjoyed in Kenya is the availability of government-issued identification for citizens over the age of 18.

Accommodating nontraditional financial service providers within the regulated financial system is difficult for many countries. Although there may be limitations due to culture or infrastructure, the public and private sectors do share a mutual interest in developing feasible preventative measures to deter illicit finance. The traditional financial services paradigm divides financial services into account-based and transaction-based services, with banks on one side and money or value transfer services on the other. The idea of an account-based financial service offered by a business that is not regulated as a bank is a new frontier, which the FATF is also struggling with. The only way to cross that frontier is to apply a risk-based approach that caps account and transaction value or deposit and withdrawal value and frequency, allowing for a more flexible regulatory approach because the risk has been reduced.

A different challenge for many countries is limited resources for supervision, examination, and enforcement. If a country has only a small cadre of trained bank examiners and the central bank can barely account for the depository institutions in the country, it is daunting and potentially dangerous to open the financial system to additional service providers without adequate oversight. Defining the parameters of what is acceptable for businesses operating as financial services providers can help to mitigate the potential risk and help countries become comfortable with allowing nontraditional service providers into the market.

The tools to foster economic development are not at odds with AML/CFT policies and procedures, and in fact are mutually reinforcing. The challenge for developing countries is to ensure that financial inclusion efforts include appropriate risk-based AML/CFT safeguards, rather than assuming these efforts can be sequenced. It is misguided to start implementing new financial services now and follow with regulation and supervision at some point in the future. A better approach is to apply appropriate safeguards, given the potential risks. A mobile payments initiative offered through a mobile network operator that provides the unbanked a limited purpose account arguably could present a lower money laundering and terrorist financing risk than the status quo, if the status quo means a large unbanked population, transacting in cash, using unlicensed money transmitters.

Conclusion

In an increasingly interconnected world, our interests are inextricably bound to the interests of those beyond our borders. A few years ago, when Gordon Brown was still Chancellor of the Exchequer before becoming Prime Minister, he said: "There is a paradox about globalization: the very opportunities it offers - the free movement of money, people, goods and information - are harnessed by terrorists and organized criminals."[14] Brown's observation is a good reminder that as we seek to channel the benefits of technological and geopolitical change to increase access to economic opportunity, we must also be working to limit opportunities for corruption, financial crime, and terrorism. The FATF Recommendations are above all intended to establish a common defense against financial crime, and encouraging financial inclusion supports that effort.

[14] Brown, Gordon (Chancellor of the Exchequer), Securing Our Future, Speech delivered at the Royal United Services Institute, London, February 13, 2006. Available at: http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/chancellorexchequer/speech_chex_130206.cfm