

Financial Action Task Force
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To whom it may concern,

Response to the Financial Action Task Force's project on mitigating the unintended consequences of its Standards

We support the Financial Action Task Force's efforts to identify and mitigate the unintended consequences resulting from the incorrect implementation of its Standards. As such, we are pleased to provide you with our input on this project.

About XReg Consulting Ltd (XReg)

XReg Consulting is a boutique policy and regulatory consultancy founded by former regulators that specialises in virtual assets. We are grateful to the FATF for affording the public the opportunity to contribute to its project on mitigating the unintended consequences of the FATF Standards, and we offer a response based on our knowledge and expertise surrounding global regulation of Virtual Assets (VAs) and Virtual Asset Service Providers (VASPs).

Introduction

The FATF has requested the submission of industry and civil society perspectives, research, and documented instances of the misuse or incorrect implementation of the FATF Standards, which may result in unintended consequences such as financial exclusion and de-risking. We appreciate the FATF's longstanding efforts to provide countries with valuable guidance to promote financial inclusion, including helpful information on Customer Due Diligence and Digital ID and welcome this latest initiative to identify further areas of improvement.

Based on years of advocacy for regulators and industry participants alike, we believe that the FATF may further mitigate unintended consequences of the implementation of its Standards by encouraging countries and financial institutions (FIs) to re-define their approach to decision-making, from a singular assessment of ML/TF risks to a more comprehensive methodology that includes a Regulatory Impact Assessment (RIA). The RIA would take into account both the costs and benefits of AML/CFT action, as well as various societal priorities, and enhance accountability and transparency in the policy-making and decision-making processes.

The below assessment elaborates how the incorporation of an impact assessment of AML/CFT policy may be beneficial in promoting innovation in the areas of affordable financial services, in particular as applied to decentralised finance (DeFi) services within the VA industry, in support of the objective expressed by former FATF President Roger Wilkins AO: 'The challenge for the regulator is to be flexible and to allow innovation to occur, and to adopt standards and regulations to deal with threats and dangers but not at the expense of killing off innovation'.¹

1. Effective and Proportionate Regulations

In today's fast-paced global and digital economy, policy-making has become ever more challenging. Regulators must keep pace with complex technological developments and innovation in the interest of maintaining effective, fit-for-purpose regulations that protect consumer interests.

The G20 finance ministers and central bank governors underlined the importance of harnessing opportunities from digital technologies, in particular as they apply to financial inclusion, in their July 2020 virtual meeting. G20 high-level policy guidelines outlined the following objectives:

- Support regulatory and legal reforms that reduce unequal access to responsible digital financial services.
- Promote a competitive environment for banks and non-banks and support the development of a widely accessible, secure and responsible digital infrastructure and interoperable payment system.
- Encourage the affordability of tailored digital financial products.
- Promote responsible and inclusive policy-making through improved availability and accuracy of disaggregated data.

The importance of the FATF's role in encouraging the availability of affordable digital financial products, while supporting the implementation of effective AML/CFT safeguards cannot be overstated.

¹ Roger Wilkins AO, 'The danger of driving both illicit markets and financial exclusion' (2014) <<https://www.fatf-gafi.org/publications/fatfgeneral/documents/danger-illicit-markets-financial-exclusion.html>>.

To support FATF in achieving its objectives, while at the same time reducing the likelihood of unintended consequences such as financial exclusion, we recommend that the FATF incorporate an approach to risk-based decision-making that equally examines the impact of such decisions on societal costs and benefits. Well-developed policy-making tools that integrate these elements, such as the Regulatory Impact Assessment (RIA), should form an integral part of both the FATF policy development process and the management of ML/TF risks by countries and FIs.

An RIA is an informative instrument that can be used to support efficient decision-making and resource allocation based on facts and evidence. The Organisation for Economic Cooperation and Development (OECD) advocates its use in policy-making in the legal, administrative and cultural systems of a country, and has published instructive best practice principles for conducting an RIA.

The core objective of an RIA is to identify the policy option that yields the greatest net benefit to society as a whole. This is achieved by clearly identifying the problem and desired goals, identifying potential alternative solutions, assessing all costs and benefits (including indirect, opportunity and macroeconomic) based on available evidence and scientific expertise, and allowing for a transparent evaluation and clearly communicated decision. Finally, the real impacts of adopted regulations and decisions must be continuously evaluated and improved.

The use of such systematic evidence-based policy-making tools may help government officials and FIs alike to avoid inevitable biases in decision-making, such as framing and anchoring (conclusions or experiences frame a problem), confirmation bias (amplify supporting data and ignore or reinterpret unfavourable information), and cognitive dissonance (inconsistency between beliefs and actions).

2. The Role of RIAs within the FATF

In the context of evaluating and mitigating unintended consequences associated with implementation of the FATF Standards, we believe that some unintended consequences do not stem from the incorrect implementation of the Standards, but rather from the limiting and narrow focus of ML/TF prevention on risk mitigation.

Preventing money laundering, terrorism financing and the proliferation of weapons is not limited to the identification of the act in process, but may also take other preventative approaches. As provided for by the FATF Standards, due diligence such as the identification of beneficial ownership and the source of funds has proved an effective way of mitigating potential laundering activities. Nevertheless, in the wider societal context, measures that aim to increase a population's overall wealth and access to financing can significantly contribute to a reduction of crime and illicit activities in a more substantial and sustainable way.

One can easily imagine how a parent who is given the opportunity to establish a small local commerce via microfinancing is more likely to make more favourable decisions with regards to a child's health, well-being and education, thereby improving the child's prospects and reducing the potential for future crime. Indeed, tackling ML/TF and enhancing financial inclusion are complementary goals, as 'a world with greater financial inclusion is a world with less financial crime'.²

It therefore follows that an AML/CFT framework that encourages countries and FIs to conduct a RIA and evaluate a wider set of options, consider indirect costs and opportunity costs, and make decisions based not only on reduction of potential laundering risks but equally on possible benefits,

² Vanessa Reid, 'Financial Inclusion, Exclusion and Risk Management' (2018) <<https://www.lexology.com/library/detail.aspx?g=a0448340-a30a-4fcb-a748-1a37ef396447>>.

is likely to yield a significant reduction in both the type and severity of negative unintended consequences such as financial exclusion and de-risking.

In support of such a framework, the FATF Standards could seek to establish clear guidance on the use of RIAs in decision-making. Guidance could be provided on situations where low or medium risks of ML/TF are identified, yet there is a high probability of yielding pervasive and considerable benefits such as increased financial inclusion.

3. Simplified Due Diligence

In seeking to reduce the number of individuals and entities that are excluded from accessing global financial services, we recognise the FATF's efforts to provide guidance on situations of proven low risk that may benefit from simplified due diligence measures. Amongst others, the FATF lists certain potentially lower risk factors in its Standards, including '[f]inancial products or services that provide appropriately defined and limited services to certain types of customers, so as to increase access for financial inclusion purposes'.

We believe that simplified due diligence may equally be warranted where more significant risks are either mitigated through other regulatory controls or offset by considerable benefits. Examples of risk mitigation can be found in RegTech solutions that enable real-time monitoring and analysis of transactions. Notably, blockchain analytics services can allow the history of transactions in a particular VA to be assessed, and enable the evaluation of transaction activity and identification of suspicious or high risk behavioural patterns. Indeed, a recent report authored by Michael Morell, former acting and deputy director of the US Central Intelligence Agency (CIA), highlighted that 'blockchain analysis is a highly effective crime fighting and intelligence gathering tool' and that 'most illicit activity still takes place in the traditional banking system and not via cryptocurrency'.³ As such, while there are unique risks associated with the relative ease of transferability of VAs compared to cash or bank deposits, these may be mitigated by the unique capabilities of VA-related RegTech such as blockchain analytics.

Further, innovation in the VA industry may mitigate unintended consequences of the FATF Standards by providing more affordable and accessible financial services thanks to efficiency gains. In a 2012 study by Demircuc and Klapper of self-reported barriers to the use of formal bank accounts, 25% of non-account holders indicated that the cost of maintaining a bank account were prohibitive. In certain limited circumstances which typically involve lower ML/TF risks, relaxation or exemption of certain due diligence measures may be warranted in order to provide broader access to financial services and prevent imposing unnecessary compliance burdens on firms. A reduction of compliance and operational costs are likely to render financial products more affordable and accessible.

4. Unintended Consequences: De-Risking

Although de-risking may be necessary as a last resort where risks are unacceptably high or cannot be mitigated, it can restrict innovation, growth, and financial inclusion. With a similar effect to financial exclusion, de-risking can also drive activity towards unregulated alternative financial products, increasing the overall ML/TF risks due to the decreased visibility into financial activity.

De-risking is of particular concern to products, activities, sectors or geographic regions generally labelled or perceived as high risk, such as innovative financial solutions. Much like the mobile banking sector, DeFi seeks to offer individuals with mobile and other digital wallets lower-cost

³ Michael Morell, Josh Kirshner and Thomas Schoenberger, 'An Analysis of Bitcoin's Use in Illicit Finance' (2021) <https://cryptoforinnovation.org/resources/Analysis_of_Bitcoin_in_Illicit_Finance.pdf>.

trading, borrowing and lending services that leverage decentralised ledgers and smart contracts. In some cases, such services cannot be directly controlled by any individual or group, and are truly decentralised. Other regulated FinTech services offer similar advantages, but in a more centralised and controlled manner. Regardless of the technology underpinning the services, innovations in the development, offer and evolution of financial services would greatly benefit from a decision-making process that balances both AML/CFT effort and financial inclusion.

Regrettably, DeFi services, along similar innovations and third parties that interact with them, may be de-risked by 'ring-fenced' regulated FIs or VASPs due to the perceived higher risks associated with peer-to-peer transactions. As a result, individuals or third party services interacting with DeFi platforms may be charged higher fees or altogether denied access to regulated financial services.

In order to mitigate the danger of de-risking, we believe the FATF should more frequently and clearly cite concerns of de-risking in its Standards and Guidance. Although firms may be tempted to de-risk due to difficulties in assessing the risks of new immature technologies, the FATF should encourage the use of a systematic impact assessment tool such as an RIA in strategic and operational decision-making.

We believe that with respect to new and innovative areas such as DeFi, the FATF should incorporate greater flexibility in its risk assessments, which accounts for any difficulties in measuring risks, and encourages such further flexibility in the risk-based approach adopted by countries and firms. Instead of assuming risks to be high in cases of uncertainty, the use of an RIA may allow for the consideration of empirical evidence and the cost/benefit of various alternatives. Finally, the FATF should emphasize that risks can only be minimised and not eliminated, and they may be outweighed by the benefits of providing financial services.

5. Unintended Consequences: Financial Exclusion

De-risking has a direct effect in exacerbating financial exclusion. For example, while financial services such as decentralised microfinancing platforms could reduce financial exclusion for individuals who have access to a mobile phone but not traditional banking services, such DeFi business models may be restricted or charged premium fees by VASPs or other regulated entities due to their perceived high risk.

In order to comply with the FATF standards, decentralised business models often rely on several external services (e.g. blockchain analytics, identity verification) and internal compliance support and resources. These compliance costs are likely to be passed onto consumers, reducing the affordability of such services. Further, where VASPs are obliged to implement the same AML/CFT requirements as FIs, the same groups of individuals unable to afford or access services provided by FIs are also likely to be excluded from accessing VASP services.

Currently, risk assessment measures and frameworks designed for traditional FIs and payment systems are often applied to new financial services, despite them not being appropriate for the industry's specific risks and characteristics. For example, risk assessments may flag activities such as frequent or large transactions as abnormal or suspicious, despite these being common in the VA industry. Equally, transactions involving private wallets might be considered higher-risk, yet could often simply be a customer's withdrawal to their own wallet for self-custody. We believe that a key cause of financial exclusion in the VA and other industries is the application of narrow risk assessments that do not put in context sector or product-specific risks.

In 2020, the FATF published an informative report on red flag indicators of ML/TF involving VAs, which recognised that the methods and indicators of ML/TF differ where VAs are used rather than

traditional assets. While this report is helpful in identifying the key indicators giving rise to suspicions, we feel that it leaves open the possibility for overly strict interpretations of risk factors, which may lead to financial exclusion due to inaccurately high assessments of risk. Many of the red flag indicators may arise in the context of legitimate VA activity, and we feel the FATF could be more explicit in pointing this out so that risk assessments are not abnormally high purely due to the use of VAs. For example, private wallets and decentralised exchanges are highly popular amongst DeFi users, and do not necessarily warrant suspicion or the application of enhanced due diligence.

Financial inclusion could be further incentivized by the FATF by clarifying the nature of bespoke regulatory impact assessments which are appropriate for alternative finance industry, and encouraging their adoption in place of frameworks appropriate for traditional financial services. Any analysis of risks should best account for the different customer behaviours of immature industries, combined with factual evidence of likely ML/TF risk, and assessed against financial inclusion opportunities.

Conclusion

We believe that extensions or modifications to the FATF Standards and Guidance should follow the OECD best practices in governance by including a Regulatory Impact Analysis (RIA). Use of an RIA would support effective and proportionate policy-making that balances different policy goals and avoids decision-making biases. Notably, RIAs conducted by the FATF, its member countries and FIs to inform decision-making should incorporate equal analysis of potential benefits, as well as costs and risks.

We feel that where benefits such as financial inclusion and innovation may outweigh ML/TF risks, or where risks are assessed as low or can be mitigated, simplified due diligence could be appropriate and de-risking should be avoided. Reductions in the regulatory burden thanks to simplified due diligence measures may serve to make products more affordable and reduce financial exclusion.

While the systematic use of an RIA to inform decision-making is important in enhancing financial inclusion, it is not sufficient. We believe that for firms to leverage technological benefits, continue innovating and deliver more accessible financial services, they should be encouraged to adopt a flexible, outcomes-based approach to compliance with the FATF Standards, which allows innovators the discretion to achieve compliance on their terms.

Finally, we believe that the benefits of accessible financial services as well as the risks of driving activity into unregulated channels must be carefully measured against ML/TF risks, and we encourage the FATF to conduct and publish comprehensive RIAs to inform its own internal decisions and to increase transparency in policy-making.

We would like to thank you for the opportunity to provide input into this project and would be happy to expand upon any of our comments or answer any questions the FATF may have.

Resources

FATF Recommendations

<http://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-recommendations.html>

FATF Guidance - National Money Laundering and Terrorist Financing Risk Assessment

https://www.fatf-gafi.org/media/fatf/content/images/National_ML_TF_Risk_Assessment.pdf

FATF Guidance - Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion

<http://www.fatf-gafi.org/media/fatf/content/images/Updated-2017-FATF-2013-Guidance.pdf>

FATF Methodology for Assessing Technical Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems

<http://www.fatf-gafi.org/media/fatf/documents/methodology/FATF%20Methodology%2022%20Feb%202013.pdf>

Guidance Note - Use of Alternative Data to Enhance Credit Reporting to Enable Access to Digital Financial Services by Individuals and SMEs operating in the Informal Economy

Global Partnership for Financial Inclusion (GPFI)

https://www.gpfi.org/sites/gpfi/files/documents/Use_of_Alternative_Data_to_Enhance_Credit_Reporting_to_Enable_Access_to_Digital_Financial_Services_ICCR.pdf

OECD Promoting inclusive growth through better regulation

https://read.oecd-ilibrary.org/governance/promoting-inclusive-growth-through-better-regulation_5jm3tqwqp1vj-en#page1

OECD Regulatory Impact Analysis

<https://www.oecd.org/regreform/regulatory-policy/ria.htm>

Access to Finance and Human Rights

Dr.B.Pradeep Kumar

https://mpra.ub.uni-muenchen.de/80336/1/MPRA_paper_80336.pdf

An Analysis of Bitcoin's Use in Illicit Finance

Michael Morell, Josh Kirshner and Thomas Schoenberger

https://cryptoforinnovation.org/resources/Analysis_of_Bitcoin_in_Illicit_Finance.pdf

Financial Inclusion, Exclusion and Risk Management

Vanessa Reid

<https://www.lexology.com/library/detail.aspx?g=a0448340-a30a-4fcb-a748-1a37ef396447>

The danger of driving both illicit markets and financial exclusion

Roger Wilkins AO

<https://www.fatf-gafi.org/publications/fatfgeneral/documents/danger-illicit-markets-financial-exclusion.html>