

SANITIZED REPORT

**NATIONAL MONEY LAUNDERING AND
TERRORIST FINANCING RISK
ASSESSMENT OF
SRI LANKA
2014**

FINANCIAL INTELLIGENCE UNIT OF THE CENTRAL BANK OF SRI LANKA

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DISCLAIMER

The National ML/TF Risk Assessment of Sri Lanka has been conducted as a self-assessment by Sri Lankan Authorities, using the National Money Laundering and Terrorist Financing Risk Assessment Tool that has been developed and provided by the World Bank. The World Bank team's role was limited to delivery of the tool; providing guidance on technical aspects of it and review/feedback to assist with the accurate use of it. The data, statistics, and information populated into National Money Laundering and Terrorist Financing Risk Assessment Tool templates, and any other finding, interpretation, and judgment under the scope of National Money Laundering Risk Assessment process completely belong to the Sri Lankan authorities and do not reflect the views of World Bank, its Board of Executive Directors or the governments they represent. Nothing herein shall constitute or be considered to be a limitation upon or waiver of the privileges and immunities of The World Bank, all of which are specifically reserved.

LIST OF ACRONYMS

AAT	- Association of Accounting Technicians of Sri Lanka
ACCA	- Association of Chartered Certified Accountants
AMBs	- Authorized Money Brokers
AMCs	- Authorized Money Changing Companies
AML	- Anti-Money Laundering
BSD	- Bank Supervision Department
CBSL	- Central Bank of Sri Lanka
CDD	- Customer Due Diligence
CID	- Criminal Investigation Department
CIMA	- Chartered Institute of Management Accountants of the United Kingdom
CFT	- Countering the Financing of Terrorism
CMA	- Certified Management Accountants of Sri Lanka
CPD	- Continuous Professional Development
CSE	- Colombo Stock Exchange
CSEALL	- Colombo Stock Exchange All Share Index
CSTFA	- Convention of the Suppression of Terrorist Financing Act No. 25 of 2005
DNFBPs	- Designated Non-Financial Business or Professions
DOD	- Domestic Operations Department
DSNBFI	- Department of Supervision of Non-Bank Financial Institutions
ECA	- Exchange Control Act No. 24 of 1953
ECD	- Exchange Control Department
ECDD	- Enhanced Customer Due Diligence
ETA	- Electronic Transactions Act No. 19 of 2006
FATF	- Financial Action Task Force
FBA	- Finance Business Act No. 42 of 2011
FCA	- Finance Companies Act No. 78 of 1988
FI	- Financial Inclusion
FIU	- Financial Intelligence Unit
FLA	- Finance Leasing Act No. 56 of 2000

FTRA	- Financial Transactions Reporting Act No. 6 of 2006
GDP	- Gross Domestic Product
GWP	- Gross Written Premium
IAIS	- International Association of Insurance Supervisors
IBSL	- Insurance Board of Sri Lanka
ICASL	- Institute of Chartered Accountants of Sri Lanka
ICP	- Insurance Core Principles
IMFIs	- Informal Micro Finance Institutions
IMLs	- Informal Money Lenders
IMTS	- Informal Money Transfer Services
INGOs	- International Non-Governmental Organizations
IPBs	- Informal Pawn Brokers
KYC	- Know Your Customer
LB	- Licensed Banks
LCBs	- Licensed Commercial Banks
LEAs	- Law Enforcement Agencies
LFC	- Licensed Financial Companies
LSBs	- Licensed Specialized Banks
LTBO	- Local Treasury Bill Ordinance No. 8 of 1923
ML	- Money Laundering
NBPDs	- Non-Bank Primary Dealers
NEPC	- National Electronic Personal Card
NGO	- Non-Governmental Organization
NGJA	- National Gem and Jewelry Authority
NIC	- National Identity Card
NRA	- National Risk Assessment
PDD	- Public Debt Department
PDs	- Primary Dealers
PEPs	- Politically Exposed Persons
PMLA	- Prevention of Money Laundering Act No. 5 of 2006
PSD	- Payment and Settlements Department
PSSA	- Payment and Settlements System Act No. 28 of 2005

RGD	- Registrar General's Department
ROC	- Registrar of Companies
RSSO	- Registered Stock and Securities Ordinance No. 7 of 1937
RTGS	- Real Time Gross Settlement
SALAASMB	- Sri Lanka Accounting and Auditing Standards Monitoring Board
SEC	- Securities and Exchange Commission of Sri Lanka
SLCs	- Specialized Leasing Companies
SRO	- Self-Regulatory Organization
STR	- Suspicious Transaction Report
TF	- Terrorist Financing
UNSCR	- United Nations Security Council Resolutions
USD	- United State Dollars

1. RISK ASSESSEMENT OVERVIEW

Sri Lanka has promulgated three pieces of legislation i.e. Convention on the Suppression of Terrorist Financing Act No. 25 of 2005 (CSTFA), Prevention of Money Laundering Act No. 5 of 2006 (PMLA) and Financial Transactions Reporting Act No. 6 of 2006 (FTRA) in line with the global effort to fight against Money Laundering & Terrorist Financing (ML/TF). Dealing with ML/TF requires national integrity and response where all key stakeholders have to have a better understanding of ML/TF vulnerability of each sector they represent in order to implement effective measures to mitigate the ML/TF risks arising. The purpose of the National Risk Assessment (NRA) is therefore, to take the steps to identify, understand and assess the ML/TF risk in Sri Lanka. The assessment would then assist in prioritization and allocation of resources to enhance Sri Lanka's Anti Money Laundering/Countering the Financing of Terrorism (AML/CFT) regime.

The National Money Laundering and Terrorist Financing Risk Assessment Tool developed by the World Bank was adopted in NRA which is a self-assessment by Sri Lankan authorities. The Financial Intelligence Unit of Sri Lanka (FIU-Sri Lanka) took the lead role in coordinating the NRA under the ambit of the Advisory Board for the FIU-Sri Lanka. Around 80 representatives from key government and private sector stakeholders participated in the Process. The NRA process was carried out over a period of nine months from February to October 2014.

The World Bank model defines the ML Risk as a combination of national threat and national vulnerability. The national threat module focuses on understanding the proceeds of crime in the country. The national vulnerability consists of two parts; overall sectoral vulnerability and national combating ability. In the sectoral vulnerability, Banking, Securities, Insurance and all other financial institutions as well as designated non-financial businesses and professions in Sri Lanka were assessed. A number of input variables relating to these sectors were evaluated as main drivers of national combating ability. The World Bank Module contains an assessment of Financial Inclusion product risk as well.

The overall threat and vulnerability of Sri Lanka has been assessed as medium. Accordingly, the ML risk level in the country has been rated as Medium.

OVERALL MONEY LAUNDERING RISK IN THE JURISDICTION

ML THREAT	H	M	M	MH	H	H
	MH	M	M	MH	MH	H
	M	ML	M	M	MH	MH
	ML	ML	ML	M	M	M
	L	L	ML	ML	M	M
		L	ML	M	MH	H

NATIONAL VULNERABILITY

The overall money laundering risk in each sector has been assessed as follows,

Sector	ML Risk
Banking Sector	M
Securities Sector	ML
Insurance Sector	ML
Other Financial Sector	MH
Designated Non Finance Businesses and Professions	MH

The overall assessment above has been arrived based assessments done through seven modules such as ML threat analysis, national vulnerability, banking sector vulnerability, securities sector vulnerability, insurance sector vulnerability, other financial sector vulnerability and Designated Non Finance Businesses and Professions (DNFBP) sector Vulnerability. ML Risk on financial inclusion products was also assessed. All these areas will be discussed in a summarized form below.

2. DATA COLLECTION METHODOLOGY

Working groups used various methods to collect accurate and reliable data from various sources as required by the World Bank methodology. Data were gathered covering the period from 2008 to 1st quarter of 2014 through following sources.

- Databases, Annual publications and websites of the Attorney General's Department, the Commission to Investigate Allegations of Bribery or Corruption, Inland Revenue Department, Ministry of Finance, Ministry of External Affairs, Ministry of Justice, Sri Lanka Police (Criminal Investigation Department, Police Narcotic Bureau, Colombo Fraud Investigation Bureau, Terrorist Investigation Division, Colombo Crime Division, Children and Women Bureau) , Sri Lanka Customs, Department of Central Bank of Sri Lanka - CBSL (Economic Research, Bank Supervision, Exchange Control, Financial System Stability, Supervision of Non-Bank Financial Institutions, Statistics, Public Debts., Payment and Settlement, Domestic Operations), Dangerous Drugs Control Board, FIU-Sri Lanka, Securities and Exchange Commission of Sri Lanka (SEC), Insurance Board of Sri Lanka (IBSL), Department of Cooperative Development, National Gem and Jewellery Authority, Institute of Chartered Accountants, Registrar of Companies, Registrar General's Department,
- Feedback obtained through questionnaire circulated among participants of banking, Securities and Insurance sectors.
- Various research papers, surveys and Academic studies conducted
- Interviews with market participants and industry practitioners
- Reports of Transparency International and World Justice, News Paper Articles etc. and other public information

3. ML THREAT ANALYSIS

3.1 OVERALL ASSESSEMENT

A clear determination and understanding of the ML threat is important in the process of assessing the ML and TF risk. The ML / TF threat analysis considered the level and trend of predicate offences reported. However, the data with regard to unreported incidents could not be ascertained as there is no requirement for any authority to probe, unless a formal complaint has been made to the law enforcement authorities.

The overall ML threat is rated as medium as main crimes that generate the proceeds of the crimes have been rated as medium. The low level of awareness among prosecutors, financial crime investigators and other stakeholders and lack of a mechanism to record and maintain statistics have been identified as main components to be addressed in order to mitigate the ML threat.

3.2 MAIN CRIMES THAT GENERATE PROCEEDS OF THE CRIMES

The most prevalent predicate offences are drug trafficking, fraud (cheating, criminal breach of trust, criminal misappropriation), robbery, offences under Payment Devices Frauds Act No 30 of 2006 (credit and debit cards), bribery and corruption, human smuggling/trafficking, extortion and counterfeiting of currency.

Below it is summarized, the ML threat stemming from the most important proceeds generating predicate offences amongst other predicate offences though not that significant, but is likely to generate proceeds. However, the limited information on value of proceeds linked with these offences maintained by Law Enforcement Authorities (LEAs) should be borne in mind when assessing this.

When considering the offence of drug trafficking, the major narcotics that were detected include heroin and cannabis. However, there were other detections made on hashish, cocaine and opium which were insignificant, quantitatively and as far as proceeds were concerned. Hence, though quite a large number of arrests are made every year the investigations and prosecutions on ML are restricted to a few cases, since majority of them are drug users. Due to the limitation of availability of resources, trained officers and other logistical matters, ML investigations are focused where large quantities or proceeds are involved.

The definition of fraud includes cheating, criminal breach of trust and misappropriation. Majority of frauds were detected in relation to banks, real estate, legal practitioners and other financial institutions.

The offences of robbery defined in the Penal Code include robbery in the aggravated form which carries heavier penalties. The recent trend in increasing number of armed robberies in banks is prominent since it involved considerable amounts.

Human smuggling was identified as a crime in terms of Immigrants and Emigrants Act No. 20 of 1948. Any person who organizes one or more persons to leave the country in an illegal manner or any involvement preparatory to the said act commits the offence.

The Bribery Act No 26 of 2001 captures bribery or corruption confined to a public servant only. The bribery or corruption by any other person is a matter which has not been dealt with under the said Act. The function of the Commission to Investigate Allegations of Bribery or Corruption has been limited only to investigate and prosecute the offenders. Therefore, there is no record with regard to quantified amounts either maintained through the commission or any other research which can be relied upon.

The number of detected offences under the Payment Card Devices Act No 30 of 2006 has been increasing. From the inception of the said Act, it was observed that, the increased number of foreign nationals apart from the locals are involved in the said offences.

When considering the offences committed with the possession of weapons, it was observed that an increased number of armed robberies in organized crime and other offences using weapons were reported. The modern weapons that are used in street crimes and armed robberies are generally obtained through illegal means. Hence, due to the restriction imposed by the LEAs on possession of these weapons the amounts transacted to purchase those weapons are quite high. Generally the said monies come from drug trafficking or other organized crimes.

ML threat stemming out of the above offences has been rated as Medium.

The counterfeiting of currency is an offence under the Penal Code. Tax evasion has not been included as an unlawful activity within the ambit of the PMLA. Therefore, ML component will

not be considered in a situation of tax evasion. The Local Revenue Authority adopts the policy of self-compliance. Penalties are imposed on wilful evasion.

Considering the proceeds generated through the above crimes and the external threat involved, ML threat was rated as Low.

3.3 SECTOR THREAT ANALYSIS

The banking and other financial sector is identified as a main sector through which proceeds are laundered. According to the typologies, majority of the cases involving banks are fraud cases. The other type of offences that were identified, which involved banks are terrorist financing, payment card frauds, extortions, drug trafficking, exchange control violations and human smuggling. Large amounts which were collected as proceeds were either directly deposited to personal accounts or transferred to the those accounts through other means. Also, in certain cases banks safety lockers were hired to deposit undeclared money. Furthermore, the remittance sector, real estate sector and the NGO sector have been identified as other significant areas which poses a significant threat.

Casinos Business (Regulation) Act No. 17 of 2010 regulates the registration of Casinos. Casinos in Sri Lanka are not currently subject to AML/ CFT controls. Customers are not subject to sufficient Customer Due Diligence (CDD). Therefore, there is a significant level of threat in laundering illegal proceeds through casinos.

Currently, NGO's operating in the country has no mandatory requirement to be registered with NGO Secretariat, established under Voluntary Social Services Organizations (Registration) Act No. 31 of 1980 which is the monitoring authority. In the absence of such a requirement the funds coming into the country and the bank accounts through which funds are being disbursed for various projects cannot be monitored.

When considering offences related to precious stones and metals, there were no reported cases for dealers in this sector though it is a cash based sector.

Therefore, these sectors have been rated Medium threat to the ML offences.

It is observed that in certain instances the real estate sector is misused by drug traffickers, individuals involved in fraud and human smuggling, to conceal the proceeds. Despite certain control measures in place, the real estate sector is not subject to sufficient AML/CFT regulatory or supervisory regime. Conversely, it is difficult to find precise information on Lawyers and Notaries due to the lack of proper recording mechanisms.

The other significant sector would be Non-bank financial institutions. Significant factor in this sector is that the number of shell companies which have been used to lure the potential victims. These shell companies are generally established within the country in conjunction with other legitimate businesses. Therefore, while conducting the legitimate transactions, these companies are used to basically siphon off money out of the country. They don't maintain proper business premises or infrastructure to operate the said companies. Therefore, the above sector is rated as Medium High in respect of ML component.

3.4 THE LEVEL OF EXTERNAL THREAT

Sri Lanka being located in a geographically and strategically important location, the country is bound to experience the external threat from various neighbouring countries. Being situated close to the Indian subcontinent, Sri Lanka has been gradually used as a hub and as a transit point by drug traffickers and human smugglers. The direct and potential ML threat comes from some South Asian Countries. Hence, the threat in respect of the above offences is not only domestic, but an external threat as well. The TF threat has been observed during the period of war in this country. There were number of groups from western countries where huge fund raising was carried out for terrorism purposes. And even presently the threat persists.

3.5 TERRORIST FINANCING THREAT

TF has been criminalized by the CSTFA. This Act has been amended on two occasions to comply with international standards. The country was able to forfeit substantial amount of money used for TF. When TF investigations were commenced at the same time ML aspect is also investigated. Mostly, the banking sector has been abused to carry out the TF activities. Further, NGO's and few cases involving Hawala have been used to channel funding for terrorism. In transmitting funds into the country as well as transferring to other local accounts, ordinary savings accounts, bank

drafts, cheques and even the personal rapport with the Manager of the particular banking institution have been utilized. Moreover, Sri Lanka has established a legal framework to implement United Nations Security Council Resolution (UNSCR) 1267 and 1373 through the passage of United Nation Regulations 1 and 2 of 2012 in May 2012. It is observed that the threat on TF is substantially low. However, this is a continuous threat. Hence, the overall threat on TF has been rated as Medium.

3.6 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

- Level of awareness has to be increased among judges, prosecutors and stakeholders for successful convictions.
- There were certain institutions, which were not forthcoming with required information for the assessment due to internal secrecy mechanisms and/or administrative reasons. This should be addressed through amending legislature and providing facilities to exchange information related to ML/TF offences.
- NGO/NPO sector should be streamlined requiring mandatory registration with the NGO Secretariat.
- ML/TF investigations are relatively complex in nature. Therefore, when investigating the predicate offence due to the lack of knowledge on ML/TF investigative techniques and related issues, investigators tend to ignore the investigations on ML/TF resulting in low number of recordings of these crimes. Accordingly, it is required to enhance the capacity of financial crime investigators.
- LEAs are not bound to record proceeds generated from criminal activities which make it difficult to obtain data on proceeds generated. Therefore, it is required to create a mechanism to record and maintain statistics.

4. NATIONAL VULNARABILITY TO MONEY LAUNDERING

4.1 OVERALL ASSESSEMENT

The overall national vulnerability is rated as Medium. This is driven by two factors: the national combating ability and overall sector vulnerability both being rated Medium.

National combating ability has been rated medium. Input variables ‘Formalization of Economy’ and ‘Tax Disclosure’ which were rated low and medium-low respectively can be identified as two main factors which impacted on bringing down to the rating of national combating ability to medium level. DNFBP sector vulnerability being rated as medium-high and insurance sector vulnerability being rated as medium-low and other sectors being rated as medium have rated in the overall sector vulnerability to be rated as medium.

4.2 NATIONAL COMBATING ABILITY

There are total of 24 input variables that influence the country’s ability to combat money laundering. Data gathered from various sectors assisted in assessing the ML vulnerability of each variable.

The national combating ability is rated as Medium. Top three priority areas have been identified as ‘Policy and Implementation’, ‘Formalization of Economy’ and ‘Capacity of Financial Crime Investigators’. These were ranked based on their impact in reducing the vulnerability. The table below summarizes the 24 variables considered under national combating ability of the national vulnerability assessment:

Table 1: National Combating Ability of the National Vulnerability Assessment

NATIONAL LEVEL INPUTS	
Criminalization of Money Laundering	Medium-High
Policy and Implementation	Medium
STR Data Analysis	Medium-High
Criminal Penalties	Medium-High
Domestic Cooperation	Medium
International Cooperation in Criminal Matters	Medium-High
Capacity of Financial Crime Investigators	Medium
Integrity and Independence of Financial Crime Investigators	Medium-High
Capacity of Financial Crime Prosecutors	Medium-High
Integrity and Independence of Financial Crime Prosecutors	High
Capacity of Presiding Officers	High
Integrity and Independence of Presiding Officers	Medium-High
Capacity of Asset Forfeiture Investigators	Medium-High
Integrity and Independence of Asset Forfeiture Investigators	Medium-High
Asset Forfeiture Laws	High
Asset Forfeiture Orders	Medium-High
International Cooperation in Asset Forfeiture	Medium-Low
Auditing and Accounting Standards and Practices	Medium-High
Tax Disclosure	Medium-Low
Corporate and Trust Transparency	Medium
Identification Infrastructure (e.g. NIC, Passport)	Medium-High
Availability of Independent Information Sources	Medium
Financial Integrity	Medium
Formalization of Economy	Low

Note: The higher the score, the better the rating. However the rankings do not mean that the lowest rated variables have the highest impact on the vulnerability.

4.3 OVERALL SECTOR VULNERABILITY

The other component of the assessment of national vulnerability is the ‘overall sector vulnerability’. This component represents the findings from the other modules including the banking, securities, insurance, other financial institution sectors and DNFBPs. Assessment of these individual sectors are explained in detail in the relevant sections of this report.

The ‘overall sector vulnerability’ is Medium. The insurance sector has the least vulnerability. One interesting observation is that banking sector although being the biggest financial sector in Sri Lanka, has a lower vulnerability than DNFBPs and other financial institutions sector. This is mainly attributed to the high level of AML/CFT regulations and supervisions of the banking sector. Further the banking sector displays a higher level of AML/CFT awareness. DNFBPs are having the highest vulnerability attributable to lack of AML/CFT regulatory framework.

4.4 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

The assessment recommends the following:

- Policy and implementation has been ranked as the top priority. However, when analysing the situation, it is important to take into consideration that a comprehensive NRA for the country finalized by now, would help the authorities to incorporate the outcome of the NRA in decision making and legislative processes.
- Capacity of the financial crime investigators and asset forfeiture investigators needs to be improved. More training opportunities on ML investigations need to be provided. Further, steps should be taken to promote parallel investigations among LEAs.
- The capacity regarding ML/TF aspects of the financial crime prosecutors need to be improved. This will enable many cases, with an ML element to be prosecuted.
- Domestic cooperation among FIU-Sri Lanka, Sri Lanka Police, Customs, Inland Revenue, Regulators, Company Registrar and Registrar General’s Department, etc needs to be improved.
- Corporate and trust transparency needs to be improved. This can be initiated by conducting a study on Sri Lankan legislations on corporate and trust transparency and its implementation followed by a legislative review
- As Sri Lanka needs to include serious tax crimes as a predicate offence for ML, access to tax records needs to be given to the FIU-Sri Lanka and relevant LEAs.

- Training opportunities and refresher programmes for the judiciary need to be conducted.
- Awareness for the legal practitioners regarding ML/TF legislation need to be enhanced.
- Awareness among general public regarding AML/CFT to promote adherence to KYC/CDD measures and whistle blowing need to be raised.
- ML/TF risk associated with the informal economy needs to be analyzed. Conducting study / research on informal economy of Sri Lanka for this purpose is required.

5. SECTORAL VULNERABILITY ANALYSIS

5.1 BANKING SECTOR VULNERABILITY

5.1.1 INTRODUCTION

The Banking sector of Sri Lanka comprising of Licensed Commercial Banks (LCBs) and Licensed Specialized Banks (LSBs) accounted for 56.7 per cent of the financial system assets as at end 2013. The distinction between LCBs and LSBs mainly lies in the scope of activities they can undertake. LSBs include specialized savings banks and development banks which are licensed to conduct specialized banking business but not authorized to accept demand deposits and deal in foreign currency. LCBs have a broader scope. The level of banking sector assets relative to GDP was 68.5 per cent as at end 2013. This sector composition to GDP in 2012 and 2013 were 67.3 per cent and 68.5 per cent respectively and has shown an increasing trend over the years.

At the end of 2013, there were 33 licensed banks including 24 LCBs and 9 LSBs. Of the total LCBs, 12 were foreign bank branches. Out of all banks, 21 were domestic banks comprising of 12 LCBs and 9 LSBs as at end 2013. The Sri Lankan banking sector remains concentrated on a few major banks and the six largest local LCBs are identified as being systemically important. Just over half of the assets of the banking sector is accounted by two largest LCBs which are state-owned. Foreign representation of the banking sector is relatively low in market share.

Customer reach is still largely through branches and outlets, as use of alternative delivery channels such as internet banking, mobile banking etc. remain limited. The geographical dispersion of branches indicates a concentration in the Western Province. Banking density index¹ stood at 13.7 for commercial banks and 16.8 for all banks which means on an average a bank branch had to serve 5951 people as at the end of 2013.

Banking sector offers a wide range of lending and deposit products to the customers. These products can be broadly classified under corporate banking and retail banking. Banks offer lending products such as term loans, leasing facilities, trade finance etc. and deposit products such as demand deposits, savings deposits and term deposits.

¹ Banking density means Bank branches per 100,000 persons

Banks are being regulated and supervised by the Bank Supervision Department (BSD) of Central Bank of Sri Lanka (CBSL) and are subject to the AML/CFT supervision of the FIU-Sri Lanka since 2007.

5.1.2 SECTOR OVERALL ASSESSMENT

Due to the sound AML controls that are in place the vulnerability to ML of the banking sector is rated as Medium.

5.1.3 GENERAL AML CONTROLS

The FIU-Sri Lanka has issued many rules, circulars, guidelines as per the section 2(3) of the FTRA to the Banking Sector to ensure compliance. The Extraordinary Gazette No.1699/10 dated March 28, 2011 was issued to the Licensed Banks (LBs) and Licensed Finance Companies (LFCs) to address the requirements on KYC/CDD. The FIU-Sri Lanka has also issued circulars from time to time addressing various aspects relating to institutional compliance. However, the strength and effectiveness of the AML laws and regulations for AML preventive measures and AML supervision are not adequate. Hence, certain gaps and deficiencies have been identified and certain corrective measures have already been proposed to rectify deficiencies.

AML/CFT supervision carried out by the FIU-Sri Lanka is comprehensive in terms of examining the AML processes and procedures of the banks. The on-site examinations carried out by the FIU-Sri Lanka are based on the prioritization of banks based on factors such as size, volume of transactions, off-site observations of non-compliances etc. These on-site examination selections were risk based even though the practice and procedures do not follow a formal risk based approach. Banks considered high risk in terms of business process and compliance function are being prioritized and examined. The findings/observations by the desk reviews and transaction monitoring are also considered as a main input in preparing the on-site examination plan for the period. Furthermore, spot examinations are carried out either by the FIU-Sri Lanka itself or through BSD, based on certain sensitive information that is received by the FIU-Sri Lanka from various reliable sources and based on triggers identified in the transaction monitoring process.

The AML supervision is also carried out by the regulator of banks, the BSD as part of their regular supervision programme/schedule for each bank as per the powers vested in the supervisor by the provisions stipulated in the Part IV of FTRA.

Sri Lanka has a legal framework that has comprehensive criminal and administrative penalties against institutions/persons including banks or its individual members of management or staff in case of non-compliance with AML Laws and Regulations. Even though the FIU-Sri Lanka is vested with sufficient powers to initiate legal actions on criminal penalties, no such non-compliances have been identified yet. Considering the threat arising from the sector and the availability of the necessary legislature in the country, it can be concluded that the enforcement of the AML obligations require further improvements. However, there were several instances of non-compliance where the FIU-Sri Lanka has imposed administrative sanctions against LBs. The banking industry in general is aware about the penalties being imposed by the FIU-Sri Lanka on non-compliance. The industry believes that the sanctions regime is proportionate and dissuasive. Therefore, proactive measures are taken by the LBs to prevent such non-compliances.

There is immense pressure on banks by their commercial partners such as correspondent banks to meet their AML standards at the time of establishing the business relationship as well as continuing the course of business relationship. Furthermore, there is pressure being exerted by the international rating agencies as well as foreign investors to meet the AML standards.

Banks have proper information systems to collect record and monitor the transactions. Most of the major banks have specific AML monitoring applications. The others also have well established manual systems for record keeping and data reporting.

The identification infrastructure in the country is very strong and the general public has faith and greater reliance on the same. There had not been many cases reported of fake identification documents in the country in the recent past. After the thirty years of civil war in the country, re-registration of the displaced communities was done and proper identification documents were issued to them by the government. These issuing agencies are government institutions which are independent and reliable. Hence, credibility of the identification documents issued by these institutions remains very strong in the country.

The corporate trust and transparency legislation has deficiencies and it remains a challenge for the banks in understanding the procedures they should follow in identifying the ultimate beneficial owner of an institution. This is more difficult when the corporate or trust is of foreign origin.

5.1.4 PRODUCT/SERVICE VULNERABILITY

Banking sector offers a wide range of products and services. The products are assessed based on their volume, average transaction size, cash intensiveness of the product, investment/deposit feature, the availability and frequency of domestic and international money transfer feature, availability of any specific AML/CFT controls on the products, the availability of anonymous transactions etc.

The credit products have a medium high level of vulnerability to ML/TF risk. Credit cards, letters of credit, corporate lending and overdraft facilities are classified as credit products. The volume and average transaction size are significant and can be quite high in case of corporate credit. Client profile is mixed with ordinary customers, residents, foreign nationals, high net worth individuals, PEPs etc. and therefore the client profile can be rated medium risk. Specific controls are available for most of these products. Furthermore, money transfer feature is available in the product. It can either be domestic or international transfer and the frequency in international transfer is also medium high.

Electronic fund transfers also have a medium high level of vulnerability. The volume and the average transaction size are high and the money transfers can either be high or low value and also include both international and domestic fund transfers. The product involves some non-face to face transactions whereby customers can simply write to the bank asking to transfer certain amounts to a different account or bank. The small value transactions are mostly done through Sri Lanka Inter Bank Payment System (SLIPS).

The volume of trade finance transactions is generally medium but the average transaction size can be very high. There is a lot of international trading activities involved, hence higher number of international money transfers occur and the frequency of these transfers are also medium high. The client profile is mixed mainly comprising of corporates and the cash activity involved is also medium. In view of the fact that banks will only deal with the documents supporting the trade transaction rather than the goods themselves, there are opportunities to exploit the trade cycle for criminal purposes. Considering these factors, trade finance has been rated to have a medium level vulnerability.

The Deposit products have the highest percentage in volume compared with the rest of the products and the average transaction size is also significantly high. It is composed of mixed

clientele, since it caters to the mass market of individual customers, sole proprietorships, large corporates, associations and clubs. Some are more risky than others and are from various jurisdictions. The product mainly includes fixed deposits which comprises of about 60 per cent from the total deposits in the banking sector and savings accounts which comprises about 30 per cent of the deposit base. Deposit products have a medium level of vulnerability.

Microcredit is the extension of very small loans (microloans) to impoverished borrowers who typically lack collateral, steady employment and a verifiable credit history. The volume and transaction size are very low. Client profile is in very low risk category. Money transfer feature is not at all significant and the product is more cash based. Micro deposits are also similar to savings accounts and the volume and transaction size are low and this product is mainly accessed by low income earners. Considering all these factors it can be assessed that the product is very low risk to ML.

5.1.5 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

In order to reduce the vulnerability emanating from the banking sector, the following recommendations are made in order of their priority;

- Every bank has to adopt an ML/TF Risk assessment within the bank. Accordingly, all banks should identify, assess and understand their ML/TF risk and apply measures to commensurate with associated risk. Enhanced measures must be in place to address higher risk while simplified measures must be in place to address lower risks. Customer risk profiling and identification of product specific risk would be major areas of concern in this assessment.
- Improve knowledge of bank employees with regard to understanding of ML issues and obligations (duties and responsibilities) on their part, in curbing ML. In this connection, it is required to take into account, the quality of the training materials, frequency and level of training and type of staff to be trained.
- Improve the quality of AML supervision. This should include but not be limited to having sound AML regulatory framework, method of supervision, frequency thereof, and qualified AML supervisors. There should be punitive measures for non-compliance to ensure non-repetition of malpractices. After each supervision visit, feedback should be given to responsible officers of the banks concerned to take further action if necessary. A review of

the regulations should be done to address any existing gaps. This will facilitate improvement of the efficiency and quality of supervision.

Bank Supervisors should follow the risk based approach on their supervision. Allocation of supervisory resources and implementation of specific process to supervise the individual banks need to be based on ML/TF risks involved. Furthermore, supervisors need to have a clear understanding of ML/TF risks identified in the NRA process. They must have access to relevant information on risks associated with customers, products and services of banks. There should be procedures to review and update risk profiles of banks on regular basis as well as in the occurrence of significant events in the market. Frequency and intensity of the supervisory process need to be based on the bank's AML/CFT risk profile and bank's risk assessment policies.

- Measures should be taken to amend the prevailing AML laws and regulations to be in compliance with the international requirements. The deficiencies and gaps identified during the assessment could be taken as guidance to do these amendments. This process will eventually facilitate a sound enforcement of the AML obligations.
- Banks should make arrangements to improve the existing AML monitoring system, introduce a mechanism by which they are in a position to perform effective customer screening and unusual transaction identification etc. This system should be a dedicated system for AML monitoring and it should improve the efficiency and effectiveness of the compliance function of the bank. FIU supervision has to be expanded to examine the AML IT systems available.
- Specific guidelines on the identification of the ultimate beneficial owner should be issued since the knowledge and awareness of bank staff in this area is low. These guidelines may address the practical concerns and issues in the identification process.

5.2 SECURITIES SECTOR VULNERABILITY

5.2.1 INTRODUCTION

The securities sector of Sri Lanka is regulated by the Securities and Exchange Commission of Sri Lanka (SEC). The Colombo Stock Exchange (CSE) is the only licensed stock exchange operating in the country. As at end of March 2014, there were 15 Member Firms and 15 Trading Members (commonly referred to as ‘Broker Firms’) operating in the CSE. In addition 16 Custodian Banks providing custody services to clients were operating on the CSE.

As at end of March 2014, the CSE had listed on it 293 companies covering 20 sectors with a market capitalization of approximately Rs. 2500 billion (USD 19 billion). The CSE witnessed a remarkable growth after the end of the 30 year war, with the benchmark All Share Index (CSEALL) peaking at 7,800 points in February 2011. Given the bourse’s unprecedented growth levels, Bloomberg named it as one of the best-performing stock markets in the world for the years 2009 and 2010.

The CSE’s Market Capitalization was 32.4 per cent of the Gross Domestic Product (GDP) according to the latest available figures (2013). It is evident that the CSE’s market capitalization to GDP is still low compared with those of most other emerging markets in the region.

There are 3 product types available to investors on the CSE, namely equity, corporate debt and units of closed end funds. An analysis of the total volume of trading in all types of securities shows the predominance of the turnover generated from equities, which is 99 per cent of the total turnover. Further, 65 per cent of the investor turnover is generated by the institutional investors and the retail investors’ contribution is 35 per cent.

It appears that the turnover generated by the CSE has shown a downward trend during the last two years (2012, 2013). This decline was mainly due to a correction that took place in the market after the phenomenal rise during the period of 2009 - 2011. Taking into account the decrease in the trading volume, especially the annual turnover, as well as strengthening of the regulatory functions by the SEC and CSE, the possibility of activities relating to ML can be viewed as low.

5.2.2 SECTOR OVERALL ASSESSEMENT

As the securities sector of Sri Lanka does not have many products on offer such as derivatives, unlike in other developed markets, the vulnerability of the sector is mainly related to the efficiency of the AML general controls.

As highlighted, the CSE's product range is predominantly equity. The overall capital market vulnerability to ML risk is rated Medium for quality of general AML controls of both Institutional Broker Firms and Retail Broker Firms. This has mainly resulted in due to the quality of AML operations which is slightly impacted by the inadequate staff compliance. Since the enforcement of AML/CFT laws and quality of AML/CFT supervision are insufficient, staff compliance is also suboptimal in relation to both Retail and Institutional Broker Firms. Senior management's commitment for AML compliance is not satisfactory in relation to Retail Broker Firms whilst Institutional Broker Firms have shown more intent.

Most of the Retail Broker Firms have individual clients and are exposed to non-face to face delivery channels. Further, it is observed that there are some cash placements on a limited scale. This leaves room for a certain degree of vulnerability since the firms are only having general AML controls. It is also notable that the most of the foreign investments in the capital market are coming from the countries with medium or low ML risk that could result in low jurisdictional risk.

Although most of the Broker Firms have AML policies in place, they do not comprehensively address some of important AML areas such as risk profiling of clients and Enhanced Customer Due Diligence (ECDD) for potential high risk clients.

Overall, Retail Broker Firms are exposed to a slightly higher level of ML vulnerability than the Institutional Broker Firms. This is particularly due to the fact that AML compliance function, staff knowledge, identification of ultimate beneficiaries of corporations and trusts, corporate governance and staff integrity of Retail Broker Firms need further improvement.

5.2.3 QUALITY OF AML GENERAL CONTROLS

The AML laws and regulations applicable to the securities sector are adequate and the market participants are aware of the AML obligations. Although supervisory inspections are conducted in a spaced-apart yet regular manner and legal provisions being in place, there is a risk of the regulators not identifying certain AML/CFT related issues. This is due to the reason that no

specific supervisory inspections are conducted by SEC/FIU on a regular basis exclusively on AML/CFT.

Opening of foreign accounts requires far more documentation and several levels of scrutiny; hence there is significant pressure on the Broker Firms, to meet international AML standards, which has resulted in the Broker Firms being sensitive to international and national AML related reputational risks. Therefore, Institutional Broker Firms are more sensitive to market pressure to meet AML standards than the Retail Broker Firms.

With regard to good corporate governance, Institutional Broker Firms are more committed than the Retail Broker Firms. Both Retail and Institutional Broker Firms are aware of the sanctions regime in force in relation to AML/CFT and financial sanctions in existence. Considering the sanctions for non-compliance, the Broker Firm's understanding and the level of compliance, it can be concluded that the penalties are at a satisfactory level.

The level of enforcement on AML/CFT requirements for the securities sector appears to be low. The low incidence of convictions related to lack of integrity, reflects that appropriate persons are employed by Broker Firms. Compared to the Retail Broker Firms, the Institutional Broker Firms have better internal controls to ensure high level of staff integrity.

The staff awareness on AML/CFT is at satisfactory level. The compliance functions on AML/CFT of both Retail and Institutional Broker Firms are insufficient. The internal controls and internal/external audits on AML/CFT have more scope for improvement.

There appears to be a deficiency relating to the on-going CDD with regard to the existing clients as well as employees of Broker Firms. Further, Broker Firms do not possess dedicated systems which enable them to profile/screen their clients specifically from an AML/CFT point of view. The changes of circumstances are not monitored at regular intervals, resulting in a reactive approach relating to record keeping, and creating conditions for AML risk to appear or escalate.

The identification infrastructure used for KYC/CDD is adequate. But other than the identity verification, availability of independent sources for information verification is insufficient.

Identification of beneficial ownership of corporate or trust remains a challenge for both Broker Firms and Custodian Banks. Particularly, the Broker Firm and Custodian Banks find it difficult to identify ultimate beneficiary of corporate or trust especially if they are incorporated in a foreign jurisdiction.

5.2.4 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

- AML supervision on the securities sector needs to be strengthened through the adoption of a risk based approach. It is necessary to review the current AML/CFT supervision of the securities sector by FIU and SEC. The SEC needs to provide feedback on AML/CFT supervision to the FIU on a regular basis.
- The FIU may consider issuing supervisory guidelines on AML/CFT to the sector regulators from time to time.
- All industry participants should endeavor to maintain the standards of quality when recruiting staff. Policy on employee due diligence should be promoted to carry out at regular intervals for clients as well as employees.
- The market participants must take pro-active measures to make aware their staff on penalties for AML/CFT non-compliance.
- The level of enforcement should be enhanced together with the supervision functions to be carried out by the SEC and FIU-Sri Lanka. It is imperative that the regulators follow up each and every matter that is reported to them and ensure that the matter thus reported is concluded or escalated to the next level.
- Compliance function of Broker Firms needs to be strengthened further, empowering them to carry out AML/CFT functions effectively. FIU may consider providing the relevant training material and guidelines in order to standardize the AML/CFT training procedure. The Continuous Professional Development Programme (CPD) for Investment Advisors should include an AML/CFT module.

5.3 INSURANCE SECTOR VULNERABILITY

5.3.1 INTRODUCTION

The Insurance Industry in Sri Lanka is governed by the Insurance Board of Sri Lanka (IBSL) established under the Regulation of Insurance Industry Act No. 43 of 2000. There were 21 companies operating as insurers under the Act as at the end of the year 2013. Out of the 21 companies, 12 companies are registered as composite insurers, carrying on both long term insurance business and general insurance business, 3 companies are registered to carry on long term insurance business and 6 companies are registered to carry on general insurance business.

Total assets held by insurance companies were only 3.5 per cent of the total assets of financial sector in 2013. Total Gross Written Premium (GWP) generated by companies amounted to Rs. 94.4 billion (USD 726 million) and industry grew by 8.39 per cent in 2013 compared with the previous year. Long term insurance business recorded a premium income of Rs. 41.3 billion (USD 317 million) and grew by 10.22 per cent while general insurance premium accounted for Rs. 53.1 billion (USD 385 million) of all premiums recorded, with a growth of 7.01 per cent in 2013 compared with 2012.

5.3.2 SECTOR OVERALL ASSESSMENT

The overall vulnerability of the insurance sector for ML risk is Medium Low. In determining the vulnerability, non-life (General) insurance products were given the highest weight as it holds the highest GWP compared to other products. Life insurance products were given the next highest weight and all other products such as linked long term insurance, annuities, contracts for the granting of disability and multiple indemnity, accident and sickness benefits, permanent health products, capital redemption policies and pension policies, were given a same weight considering their low contribution towards the total GWP.

5.3.3 QUALITY OF AML GENERAL CONTROLS

Under the powers given by the FTRA, the FIU-Sri Lanka has issued ‘KYC / CDD Rules for insurance industry’ in 2008 and has also issued circulars from time to time to address various aspects relating to institutional compliance. The FTRA also gives powers to the FIU-Sri Lanka to impose administrative sanctions relating to non-compliance with the AML obligations.

The IBSL has issued the ‘Determination 12’ for insurance companies and accordingly, all insurance companies are required to confirm their compliance with all provisions in the FTRA, Rules issued by the FIU-Sri Lanka and guidelines on AML programme issued by IBSL. The compliance certification should be certified by the Principal Officer, Chief Executive Officer and the Compliance Officer of the insurer on a quarterly basis for the compliance of the said Determination 12.

Further, IBSL is a member of the Insurance Association of Insurance Supervisors (IAIS) and IAIS has developed the Insurance Core Principles (ICPs) of which ICP 22 is in relation to AML/CFT.

Entry to the insurance industry in Sri Lanka is highly controlled where a person who wishes to carry on insurance business in Sri Lanka is required to obtain a license from IBSL prior to carrying on business. The Regulation of Insurance Industry Act No. 43 of 2000 and rules have set out criteria for registration of insurers. IBSL is empowered to issue directions, warnings and suspend or cancel the license in the event of violations of the provisions of the Regulation of Insurance Industry Act No. 43 of 2000 and any rules, determinations or circulars made there under.

The AML supervision by the FIU-Sri Lanka is based on the examination guidelines set by the team and the Examination Manual. The FIU-Sri Lanka conducts regular off-site reviews on insurance companies through threshold reporting (over one million cash transaction reports and electronic fund transfers). Meetings (one-to-one/all representatives of the sector) are also arranged to discuss major issues identified at reporting and other general issues.

Inspections by IBSL mainly focus on verification of AML/CFT policy document and programmes of the company, approval by the Board of Directors and effective implementation of the same. Further, compliance with the mandatory reporting to FIU-Sri Lanka, implementation of KYC/CDD rules and duties of the compliance officer will also be examined. On-site monitoring is conducted jointly by the Supervision Division and Legal Division of IBSL. Off-site inspection is covered via confirmation of compliance certificate of insurance companies. All insurance companies are required to file Risk Assessment Survey annually which covers AML/CFT risk as well.

Insurance companies maintain both automated as well as manual controls for AML transaction monitoring and STR reporting. The importance of raising STRs is continuously communicated to the insurance companies through awareness and training programmes by FIU-Sri Lanka.

5.3.4 PRODUCT SPECIFIC INPUTS

The GWP of the Non-Life (General) Insurance represents the highest portion of the sector. Out of total policies, highest number of policies is reported under general insurance category. Despite the large volume, vulnerability for ML of General insurance products is low due to the minimal cash intensiveness. The percentage of maintaining high risk customers, non-resident customers and trusts are also at a very minimal level. Only few companies maintain international transactions.

The GWP of Life Insurance represents the second highest portion of the sector. However, only few numbers of policies are maintained under the life insurance category. Cash receipts of life insurance products indicate a low level of cash intensiveness. Number of transactions with PEPs, non-resident customers and trusts are at an insignificant level. Therefore, the vulnerability for ML is also low in Life Insurance products.

ML vulnerabilities of other insurance products, namely linked long term insurance, Annuities, Contracts for the granting of disability and multiple indemnity, accident and sickness benefits, Permanent health products, Capital redemption policies and Pension policies, are very Low considering low share of GWP, low cash intensiveness and lower level of transactions with high risk customers.

5.3.5 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

The existing controls on insurance sector provide a common framework for all products with regard to compliance on ML, which seems not justifiable according to the assessment. Therefore, simplification of existing rules on products other than life insurance would indicate a more realistic approach on compliance and also would facilitate towards risk based supervision. This would be an essential action since the approach of new FATF recommendations is towards risk based.

As identified during the assessment, the number of on-site supervisions by the FIU-Sri Lanka and IBSL need to be increased in order to maintain a low level of vulnerability of the sector. Further, the importance of raising STRs also needs to be emphasized in training and awareness programmes as it would further identify the areas where the insurance sector could be misused by money launderers.

5.4 OTHER FINANCIAL INSTITUTIONS' VULNARABILITY

5.4.1 INTRODUCTION

Other Financial Sector's vulnerability module covers the financial entities in two main sectors; the regulated sector and informal sector. Regulated sector comprises of Licensed Finance Companies (LFCs), Specialized Leasing Companies (SLCs), Authorized Money Changers (AMCs), Non-Bank Primary Dealers (NBPDs), Authorized Money Brokers (AMBs), E-money Services Providers and Co-operative Societies while informal sector comprises Informal Money Transfer Services (IMTSs), Informal Money Lenders (IMLs), Informal Pawn Brokers (IPBs) and Informal Microfinance Institutions (IMFIs).

5.4.2 SECTOR OVERALL ASSESSMENT

The transactions of other financial institutions are inherently cash intensive except NBPDs and AMBs which use electronic fund transfers for their high value transactions. There are some possibilities for involvement of high risk persons such as PEPs, non-resident customers, private banking customers and trusts in these institutions as per the nature of their operations. Laws, directions, regulations, rules and guidelines have been issued to some of regulated entities with regard to AML/CFT by FIU-Sri Lanka in addition to the legislative enactments issued by the respective supervisory authorities. They are regularly monitored through on-site and off-site supervisions conducted by those authorities and FIU-Sri Lanka as well.

The IMTSs have recorded the highest vulnerability in ML/TF framework by indicating high structural risk and low control measures in the assessment. However, the regulated institutions are less vulnerable to ML/TF risks compared to the informal sector institutions. All of the regulated institutions other than SLCs in Sri Lanka remain medium in vulnerability. SLCs have shown medium high of vulnerability due to high level of foreign borrowings and high cash intensiveness. The overall vulnerability of the other financial institutions sector has been assessed as Medium.

5.4.3 LICENSED FINANCE COMPANIES (LFCS)

There were 48 LFCs registered under the CBSL in terms of the Financial Company Act No. 78 of 1988 (FCA) and Financial Business Act (FBA) No 42 of 2011 as at end of 2013. All those LFCs are subjected to regulation and supervision by the DSNBFI of CBSL under the power vested in FBA.

The market share of LFCs is higher than that of ‘other financial institutions’ in the regulated sector. Cash intensive transactions of the LFCs are comparatively high. The share of international transactions in LFCs is very low compared with the share of domestic transactions. Majority of the customers of the LFCs are individuals and small scale enterprises in the country.

Other than the regulations issued by DSNBFI, LFCs are also subjected to AML/CFT regulations issued the FIU-Sri Lanka. They are also subjected to regular monitoring in the form of on-site and off-site supervision by the DSNBFI. At the same time, awareness programs on AML/CFT framework are being conducted by both the FIU-Sri Lanka and DSNBFI for the general public and employees of LFCs. STRs reported by the LFCs to the FIU-Sri Lanka remain low. Based on these factors, ML/FT vulnerability of the LFCs has been rated as Medium.

5.4.4 SPECIALIZED LEASING COMPANIES (SLCS)

The companies which are authorized to engage only in leasing activities are considered in this category. Ten (10) SLCs are currently operating in Sri Lanka. Finance Leasing Act No. 56 of 2000 (FLA) provides necessary legal framework for the regulation and monitoring of finance leasing businesses.

Customers of the SLCs are individuals as well as small business enterprises. High cash transactions and foreign borrowings of SLCs have been major factors for the high vulnerability on ML/TF.

DSNBFI monitors and supervises the SLCs in terms of rules, directions and guidelines issued by the CBSL. FIU-Sri Lanka is yet to issue KYC/CDD rules covering SLC sector. Based on these factors, the risks in vulnerability of SLCs have been rated as medium high. As per the on-going financial sector consolidation process undertaken by the CBSL, steps are being taken to merge all of the SLCs with LFCs.

5.4.5 AUTHORIZED MONEY CHANGERS (AMCs)

Exchange Control Department (ECD) of CBSL is responsible for monitoring of the AMCs in Sri Lanka. 68 agencies have been permitted to engage in money changing business at present. Money changing business include sale and purchase of foreign currency against Sri Lankan rupees, encashment of traveller’s cheques, and exchange of the foreign currency for any other foreign currency.

AMCs deal with large amount of physical cash. These transactions are mainly with walk-in and one-off customers. On the other hand, duration to complete a transaction is very minimal and there are possibilities to convert one transaction into multiple small transactions. Both domestic and foreign customers are doing transactions with AMCs where proportion of foreign customer involvement is relatively high. Majority of the local customers' transactions are relating to conversion of worker remittances. All the transactions involved in the money changing business are cash intensive.

The ECD of the CBSL is responsible for regulating and monitoring AMCs. Several circulars have been issued by the ECD in order to monitor operations of AMCs. All the money changers are required to obtain new licenses annually. AMCs have to adhere to the KYC requirements stipulated in terms of the license issued by the ECD. The FIU issued separate rules relating to reporting of STRs by AMCs. The FIU-Sri Lanka has issued a circular relating to implementation of UNSCR 1267 to AMCs as well. The ECD is also responsible for supervision of AMCs based on the AML/CFT aspects. Based on these factors, the vulnerability of the sector has been rated as Medium.

5.4.6 NON-BANK PRIMARY DEALERS (NBPDS)

PDs are appointed by the CBSL under the Local Treasury Bill ordinance No. 8 of 1923 (LTBO) and the Registered Stock and Securities Ordinance No. 7 of 1937(RSSO). Main objectives of establishing PDs are to participate effectively in primary auctions conducted by the CBSL, to provide secondary market liquidity, to build distribution channels of treasury bills, and to provide market information on T-bills. Primary dealing is a part of operations of some licensed banks while 7 non-bank institutions also actively participate in primary dealing at present. Supervisory authority for primary dealers is Public Debt Department (PDD) of the CBSL.

Since majority of transactions are conducted through the Real Time Gross Settlement (RTGS) system, proportion of cash involvement is negligible. On the other hand, the international transactions involved in T-Bill market are relatively low. Therefore, the sector records a low level of vulnerability to the ML under the 'structural indicators'. But the control measures undertaken on the AML/CFT aspect are inadequate. Therefore, vulnerability was rated as Medium.

5.4.7 AUTHORIZED MONEY BROKERS (AMBS)

There are 9 AMBs registered under the CBSL, subject to renewal of licenses annually. They are all monitored by the Domestic Operations Department (DOD) of CBSL. The main function of an

AMB is to facilitate interbank transactions among the LCBs in Sri Lanka. AMBs' income is derived from the commissions charged by them for the services.

Since all the transactions of this sector are settled through the electronic fund transfers, the sector is not cash based. Although the entities are not involved in the international transactions at present, there are some possibilities to bring international customers to the banks. All the transactions facilitated by money brokering institutions are interbank transactions. There is no involvement of the natural persons in the money brokering business. Money brokers' main function is to facilitate the coordination among LCBs for day to day borrowings and lending. Therefore, the sector is not vulnerable to ML/TF depending on the nature of the business.

5.4.8 E-MONEY SERVICE PROVIDERS

In view of facilitating the development of electronic payment mechanism in Sri Lanka, the mobile payments guidelines no. 1 and 2 of 2011 for mobile payment services have been issued in terms of the Payments and Settlements Systems Acts No. 28 of 2005 (PSSA). Currently, there are several e-money service providers in Sri Lanka. Licensed e-money service providers need to adhere to all applicable laws and regulations issued under the PSSA , FTRA, ECA and Electronic Transactions Act No. 19 of 2006 (ETA).

Transactions carried out in this sector are highly cash intensive. Mobile payment services are exclusively for domestic transactions. Since the e-money service sector is still at a developing stage in Sri Lanka, the value of a transaction is limited to a maximum of LKR 25,000.00 (USD 190). Most of the customers are individuals and are in low income categories. The possibility of involvement of high risk customers such as PEPs, non-resident customers, private banking customers etc is low.

E-money service providers are regulated and supervised by the Payment and Settlement Department (PSD) of the CBSL. The Mobile Payments Guidelines issued by the PSD covers AML/CFT aspects as well. The PSD does not conduct on-site surveillance on the business relating to payment cards and/or mobile/payment systems of any licensed services provider. The accounts related to the e-money service providers are maintained with custodian bank. These custodian banks are subject to frequent supervision by the BSD. As per the guidelines issued to e-service providers, STRs are reported to the FIU-Sri Lanka, through their custodian banks. All the transactions of this sector are entirely cash intensive and handled by the local customers. Majority of the transactions are small in value. The sector vulnerability has been rated as Medium.

5.4.9 CO-OPERATIVE SOCIETIES

Co-operative societies are administrated by the Ministry of Co-operative and Internal Trade. Operations of these societies are regulated by the Co-operative Societies Law No. 05 of 1972. According to the Law, all of the co-operative societies need to be registered under the Registrar of Co-operative Societies. Co-operative societies are involved in distribution of consumer goods, supply of essential inputs, promotion and marketing activities in the field of agriculture, fisheries and industry, as well as mobilization and allocation of savings in the rural areas through the co-operative rural banks.

9,751 small co-operative societies are currently in operation in the country. Cheques are used for high value payments and other transactions carried out through the co-operative societies are in cash. No international transactions are involved. The majority of the customers are public servants such as teachers, clerks etc. who are also members of these societies. The loans are provided to various purposes and usually recovered through the salaries of the member.

The administrative guidelines which are not covered the AML/CFT aspects have been issued to the societies by Department of Co-operative Development. Supervision on the co-operative societies are undertaken to check the compliance with regulations and audit guidelines.

Based on the structural risk indicators, vulnerability to ML of this sector is identified as low. But due to the lack of control measures in this sector, overall vulnerability has been rated as Medium.

5.4.10 INFORMAL MONEY TRANSFER SERVICES (REMITTANCE AGENTS)

IMTSs are primarily used by the migrant workers in overseas to send money to the families in their home countries. IMTSs include Hawala and Hundi. Both Hawala and Hundi systems are used as fast, safe and cost effective way to transfer money domestically and internationally without using formal financial institutions.

The goods sent by overseas workers to home country through returning migrants or visiting migrants accounted for 10 per cent of total amount of remittances. Duration of the transaction depends on the factors such as type of transfer, point of origin and sending institutions. IMTS sector operates predominately through Hawala, Hundi and Cash Courier. The availability of the accurate information on IMTS is limited due to confidentiality of the agents and lack of documentation.

Cash intensive nature of transactions and possibility to process a large number of transactions at relatively a low cost within a shorter period of time have been advantageous for the money launderers to use IMTS. The cross border transactions involved in this sector is high. On the other hand, undocumented migrants who are working abroad without VISA or illegally could increasingly use these informal services to remit money to their families.

Accordingly, the IMTS in Sri Lanka is more vulnerable to ML/TF. Since the process of informal money transfer services is undocumented, illegal flows of money is difficult to track. Further, those who are involved with drug trafficking, terrorism, smuggling, welfare fraud, insider trading, custom and tax evasion and gambling can transfer their illegal money to other parties through remittances services. Therefore, the ML/TF vulnerability in the IMTS sector has been rated as High.

5.4.11 INFORMAL MONEY LENDERS (IMLs)

Lending and borrowing activities of this sector take place among friends, relatives, traders and landlords. Although the entry to informal money lending market in Sri Lanka is not restricted, money lenders who are currently in the market have a tendency to resist new entrants in particular at the initial stage. IMLs usually charge high interest rates on their loans than market rates applicable to formal sector lending. Documentation, registration or supervision is non-existent because of non-availability of regulations.

Informal Money lending activities are more likely to expose to the ML risks since high usage of cash transactions and involvement of high risk customers. Lending is entirely based on the trust of recovery. Values of the loans are often very small and short term since most of the loans are not backed by tangible assets. There are some risks relating to recovery of loans. Informal Money lending activity has been identified as high in number of transactions and therefore significant within the informal financial sector. However, as the activities of this sector are taking place behind closed doors, it is very difficult to figure out exactly the number of persons and institutions engaged in informal money lending activities. Therefore, informal money lending business sector has been rated as Medium High.

5.4.12 INFORMAL PAWN BROKERS

Gold jewellery has been the main items exchanging in informal pawning industry in Sri Lanka. Transactions with the informal pawn brokers can be conducted anonymously. Informal pawn

brokers do not collect KYC information as the loan given to borrower is covered by the items pawned in transactions. Usually informal pawn brokering business is carried out on cash basis. Involvement of the higher risk persons in informal pawning sector is low. Most of the customers are from low income group communities. Therefore, the informal pawning industry in Sri Lanka is entirely restricted to local customers. The majority of the informal pawn broker institutions are very small entities.

There is no any supervisory institution involved in monitoring the informal pawning agents. Lack of such a legal framework to cover these pawning institutions has been a major obstacle for the implementation of AML/CFT control measures. Accordingly, the sector vulnerability remains Medium High.

5.4.13 INFORMAL MICRO-FINANCE INSTITUTIONS (IMFIs)

IMFIs play a vibrant role in rural areas in Sri Lanka. These institutions mainly provide lending facilities for the people for various purposes such as business, agriculture, welfare, purchase of machinery and tools, emergency loans, housing, education and consumption. There are about 14,000 branches/outlets involved in IMFI industry directly or indirectly. The interest rate charged by the IMFIs is higher than that of regulated financial institutions. Also, some IMFIs provide savings services to their clients. Most of the sources of funds of IMFIs come from loans obtained from the commercial banks in Sri Lanka. However, the possibilities of International Non-Governmental Organizations (INGOs) funding cannot be underestimated.

Usually, if the loan value is higher than Rs. 50,000.00 (USD 385), Cheques are drawn, while most of transactions with amounts less than Rs. 50,000.00 take place in cash. There are no foreign customers' involvements in informal microfinance. Most of the customers are from low income families in the rural areas in Sri Lanka. Mostly, loans are given after the verifications of the purpose of loans. Probability of conducting transactions with high risk customers is relatively low.

Required control measures relating to AML/CFT are also not available for the IMFIs. Awareness under the ML/TF in this industry is not in satisfactory level. Market entry has been controlled to a certain extent by the industry players.

Therefore, possibilities of ML in this sector cannot be considered as non-existent. As such, the overall vulnerability of the IMFIs sector is assessed as Medium.

5.4.14 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

- Inadequacy of STR reporting by the LFCs

The major reason for this is the unavailability of proper mechanisms to identify and report STRs to FIU-Sri Lanka by LFCs. In this connection, measures are required to enhance the awareness of compliance officers on STR reporting and strengthening of AML/CFT supervision.

- Lack of proper mechanism of STR reporting by AMCs

It has been found that reporting of STRs by the AMCs is inadequate. Therefore, necessary arrangements are required to be made to encourage the AMCs to report STR to the FIU-Sri Lanka. Identification of problems of the STR reporting system and enhancement of capabilities/skills of compliance officers of money changing institutions, would be considered as priority areas for improvement of the reporting of STR.

- Strengthening of supervision of e-money services providers on AML/CFT aspect

As the supervisory institution, PSD of CBSL should initiate the conduct of on-site supervision under the AML/CFT aspect in order to reduce the risks involved in this sector.

- Non-availability of AML/CFT monitoring mechanism for the informal money transfer institutions.

It is suggested to bring IMTIs under a regulatory framework in order to mitigate risks.

5.5 DESIGNATED NON-FINANCIAL BUSINESSES AND PROFESSIONS

5.5.1 INTRODUCTION

DNFBPs which operate in the country, i.e Casinos, Real Estate Agents, Dealers in Precious Stones and Precious Metals, Lawyers and Notary Public, Accountants and Trust & Company Service Providers have been considered for the assessment.

As per subsection (3) of Section 2 of the FTRA, the Director of FIU has power to issue Rules on KYC / CDD requirements to be adopted by the DNFBPs. However, the FIU has not issued such

Rules covering the DNFBPs sector yet. Therefore, they are currently not subjected to AML/CFT supervision.

5.5.2 SECTOR OVERALL ASSESSEMENT

The general vulnerability to ML/TF was initially estimated for each and every sector based on the below mentioned structural risk indicators.

1. Size of the businesses and professions
2. Volume or Turnover
3. High cash intensive product/services
4. Frequency or percentage of international transactions for clients
5. Percentage of customers who have higher risk (e.g. PEPs, non-resident customers, private banking customers, trusts, bearer share holders, etc)
6. Indicators of potential ML activities (for example, the number of ML/TF cases involving the sector, the number of STRs reported on the industry)

Following control measures were examined to determine the final vulnerability to ML/TF for each and every sector.

1. AML/CFT Regulations/ Guidelines/Enforcement mechanism in place
2. Existence of regulatory authority or Self-Regulatory Authorities (SROs) and AML/CFT on-site inspection/compliance monitoring
3. Resources committed to AML/CFT by supervisory authority/SRO (budget, number of staff)
4. Professional ethics standards
5. Monitoring of transactions and adequacy of STR reporting

Finally the individual vulnerability levels were combined giving weights for every sector. Accordingly, the level of vulnerability of the DNFBP sector was estimated at Medium High.

5.5.3 CASINOS

In recent time there is much controversy and debate on the setting up of new casinos and introducing regulations relating to the casino industry in Sri Lanka. The reason behind this is the enactment of The Casino Business (Regulation) Act No 17 of 2010. The Act focuses on providing

explanations to “prohibition” on the carrying of the business of Casino without a valid license, terms and conditions of the license, regulations etc.

As per the sources of Department of Inland Revenue, there are 5 casinos which pay the relevant taxes to the authorities. There is no mechanism to estimate the turnover of the industry as there is no reporting requirement to any authority. Most of the instances customers enter into the casinos with cash in hand although payments are routed through electronic modes in certain instances. Majority of the customers of casinos are foreigners. There are no cases of ML investigations reported in relation to the casinos for the last five years as per the CID data sources.

Accordingly, level of vulnerability before the controls stands at Medium. However, largely due to the fact that FIU has not issued Rules covering Casinos relating to ML/TF, overall level of vulnerability stands at Medium High.

5.5.4 REAL ESTATE AGENTS

There is no clearly identifiable regulator for Real Estate Agents as many finance companies, private/public companies, partnerships, individuals etc. act as real estate agents who play an intermediary role between buyers and sellers. Therefore, estimating the turnover related to real estate business by segregating their income on real estate business has become difficult. However, the activities relating to transfers of ownership are clearly registered in 45 Land Registries situated in different parts of Sri Lanka. That process is monitored by the Registrar General’s Department (RGD) as the supervisor of land registries. The volume of transactions was significant when estimated from data collected on the number of deeds registered in the different land registries.

The turnover of the Real Estate Agents was concluded as very significant. Cash, cheques and bank drafts are collectively used as the transaction modes between buyers and sellers in the industry. Frequency of international transactions is very minimal as there are restrictions in transferring ownership to foreigners. The percentage of high risk customers involved in transactions is also at a low level compared with the total number of transactions taking place. Although there was ML investigations relating to real estate industry none of them were against Real Estate Agents.

Accordingly, level of vulnerability before the controls stands at Medium. However, largely due to the fact that FIU has not issued Rules covering real estate agents relating to ML/TF, overall level of vulnerability stands at Medium High.

5.5.5 DEALERS IN PRECIOUS STONES AND PRECIOUS METALS

Dealers in Precious Stones and Precious Metals in Sri Lanka are regulated under the National Gem and Jewellery Authority Act No. 50 of 1993. Further, Sri Lanka Gems and Jewellery Association was established in 2002 to function as a trade association representing the interests of all industry sub-sectors from mining to manufacturing, wholesale and retail.

During 2013, 6,565 and 4,429 licenses have been issued for gem mining and gem dealing respectively by the National Gem and Jewelry Authority (NGJA) as the supervisor. This total of 10,994 is considered as the total dealers in the country. The export value of gem, jewellery and diamonds as per the 2013 annual report published by the Central Bank of Sri Lanka is Rs. 55 billion (USD 445.5 million) and it represents 4.3 per cent of exports and equivalent to 7,015 export invoices as reported to NGJA. In addition, most of the transactions within the country are cash based as per the experience of NGJA. Further, most of the customers are foreigners as per the information on customer visits to different shops in the country. There are no cases of ML investigations reported in relation to the dealers for the last five years as per the CID data sources.

Accordingly, vulnerability level before the controls stands at Medium. However, largely due to the fact that FIU has not issued Rules covering Dealers in Precious Stones and Precious Metals relating to ML/TF, overall level of vulnerability stands at Medium High.

5.5.6 LAWYERS AND NOTARY PUBLIC

Legal professionals, solicitors, and barristers in Sri Lanka are regulated by the Supreme Court, which determine eligibility for admission to the legal profession and issues rules on their conduct. On the other hand, the Bar Association of Sri Lanka acts as the SRO for the profession. It is difficult to find some important information relevant to lawyers in Sri Lanka due to lack of proper recording systems. However, considering all the available information, the total number of lawyers could be estimated to be around 12,000. Further, estimate of turnover of lawyers is very difficult as their fees vary based on the level of experience, reputation of each lawyer and the type of services offered by him/her.

On the other hand, notaries are governed by the Notaries Ordinance. Notary public who wishes to practice in Sri Lanka must obtain a warrant from the RGD authorizing them to conduct the relevant activities. According to the data sources of RGD there are 364 notaries who are not lawyers and

9,988 lawyers who are practicing as notary public by the end of 2013. Accordingly, total numbers of practicing notary public were 10,352 in the country by the end of 2013. The turnover of the notary public is also difficult to estimate because their charges depend on the level of experience and reputation of each notary public as in the case of lawyers.

The percentage of catering to foreign and high risk customers is very low compared with the number of customers handled by both professionals. There are cases of ML investigations reported in relation to the legal profession and notary public for the last five years as per the CID data sources.

Accordingly, vulnerability level before the controls stands at Medium. However, largely due to the fact that FIU has not issued Rules covering legal profession and notary public relating to ML/TF, overall Level of vulnerability also stands at Medium.

5.5.7 ACCOUNTANTS

In Sri Lanka, there are several bodies offering accounting qualification and acting as SROs. On the academic side the Universities offer the B.Sc. accounting qualification. Apart from that there are bodies such as the Institute of Chartered Accountants of Sri Lanka (ICASL), Chartered Institute of Management Accountants of the United Kingdom (CIMA), Association of Chartered Certified Accountants (ACCA), Association of Accounting Technicians of Sri Lanka (AAT), and Certified Management Accountants of Sri Lanka (CMA) offer professional qualifications. Further, there are government accountants serving in the public sector in addition to the members of the professional bodies stated above. Hence it is not practically possible to quantify the number of accountants. Size of the business of professional accountants also cannot be estimated due to unavailability of relevant information. The members of the professional bodies are governed by the Acts, regulations or by laws and ethics of each professional body. The Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) is the mandated organization by the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, for monitoring the quality of the private sector financial reporting and auditing from a regulatory perspective. Accordingly, the Act has restricted, conducting external audits of business entities only to the members of ICASL. The professional service fees of accountants would vary depending on the level of experience, reputation etc. which are difficult to estimate. Further, number of international transactions is very minimal as most of the clients are local residents. Accountants and auditors provide their service more often to low risk customers as they are required to do so in terms of the Code of ethics of

individual SROs. There is a case of ML investigations reported in relation to accountants and auditors for the last five years as per the CID data sources.

Accordingly, vulnerability level before the controls stands at Low. However, as there are certain control measures in place by different SROs despite FIU has not issued Rules covering accountants relating to ML/TF, overall level of vulnerability stands at Medium Low.

5.5.8 TRUST AND COMPANY SERVICE PROVIDERS

Trust and company service providers are required to act according to the provisions of the Companies Act, No. 07 of 2007 whereas Registrar of Companies (ROC) is the regulator. An individual to act as a trust or company service provider he/she should be registered with ROC satisfying the registrar that service provider is qualified, according to the Extraordinary Gazette 471/6 dated 14th September 1987 under the Companies Act No. 17 of 1982.

Based on the data sources of ROC, two types of service providers are registered in the country totalling 10,162 of which 1,621 are Auditors and 8, 541 are Secretaries. The turnover of the service providers is also difficult to estimate. As per the ROC, percentage of foreign clients catered is low compared with the total number of customers. There are ML investigations reported in relation to companies and business structures for the last five years as per the CID data sources.

Accordingly, vulnerability level before the controls stands at Low. However, as there are certain control measures in place by the ROC, despite FIU has not issued Rules covering Trust and company Service Providers relating to ML/TF, overall level of vulnerability stands at Medium Low.

5.5.9 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

The major deficiencies and gaps identified are as follows.

- As a result of FIU not issuing rules and/or guidelines covering the DNFBPs sector, control level of ML/TF in respect of the sector is low.
- Further, on-site inspection and compliance monitoring carried out by the supervisory authorities related to AML/CFT are insufficient.
- Resources committed to AML/CFT by the supervisory authorities are also at a minimum level.

Accordingly, followings are proposed to rectify the issues.

- FIU should issue CDD Rules covering DNFBPs as stipulated in subsection (3) of Section 2 of the FTRA. However, when issuing CDD Rules on the above sector FIU should consider the content of FATF Recommendation 22 and 23 and the findings of the NRA process.
- Supervisory authorities should include AML/CFT supervision as a key area in their supervisory schedules, code of ethics etc. Further, they should take sufficient actions against any violations of CDD Rules.
- Supervisory authorities should allocate sufficient resources for effective AML/CFT supervision.

6. FINANCIAL INCLUSION PRODUCTS RISK ASSESSMENT

6.1 INTRODUCTION

Financial inclusion (FI) is the process of ensuring access to financial services by low income and underserved groups on a timely manner at an affordable cost. In other words, financial inclusion is the process of facilitating to certain unbanked sectors and segments of the population to operate actively within formal financial system. FI should be accompanied with financial literacy and financial discipline to make it more sustainable.

The aim of the risk assessment is to evaluate ML/TF risks stemming from both existing and emerging/new FI products offered in Sri Lanka. The FI product risk assessment would be helpful for regulators as well as market players to redesign the product features and introduce (ML/FT) mitigation measures depending on the results of the risk assessment. Financial institutions should be permitted to conduct simplified CDD measures for products with low ML/TF risks. Hence, a proper identification of ML/TF risk associated with the FI products is complementary to ensure the safety, integrity and soundness of the financial system and the protection of depositors. Therefore, this study entails the recognition of specific characteristics of the financial inclusion products, the risks and national priorities in the application of AML/CFT measures and the flexibility of application of AML/CFT principles on the FI products.

6.2 FINANCIAL INCLUSION PRODUCT SURVEY

Financial Inclusion Products Survey 2014 was carried out by covering the key financial sector organizations in Sri Lanka. This was a postal survey and questionnaires were sent to Compliance Officers of all Licensed Banks (34), Licensed Finance Companies (48), Insurance Companies (21) and Stock Brokers (29).

Of the responses received, it was observed that only few institutions have FI products and majority of the financial institutions do not offer FI products. According to the survey, FI products not being in line with the business model was cited as the major reason for non-availability of FI products.

The survey also highlighted the fact that some institutions have not clearly understood the objective of FI products. Some financial institutions have indicated that FI products were not offered by them due to procedures adopted to comply with KYC requirements. It is therefore, observed that the existing AML/CFT legislation has discouraged financial institutions to introduce FI products.

According to the survey followings have been identified as FI products.

1. Deposit products - normal savings and fixed deposit accounts
2. Loan products - personal loans, housing loans, student loans, vehicle loans, loans to fund children's education abroad etc.
3. Remittances received through exchange houses.
4. Group-based savings and credit accounts
5. Micro-credit schemes
6. Insurance schemes

Sri Lanka does not have a specific regulatory framework for the providers of FI products. The financial institutions licensed by the CBSL, which are permitted to accept deposits from the general public, would be subject to the AML/CFT regulation of the FIU-Sri Lanka. Therefore, they are required to establish an AML compliance function with the competent officers and to impart necessary awareness on the same at all levels of staff of the institutions. However, the FIU-Sri Lanka has not issued regulations or guidelines for FI product specific risk assessment, reporting and monitoring systems.

Most of the classified products do not have limits on the value of transactions. This indicates that, financial institutions are not aware of the potential risk of ML/TF associated with high value transactions. Some institutions have set upper ceilings for transaction amounts of their FI products. For example, most of Micro Finance Loan Schemes had imposed a limit of Rs. 50,000.00 (USD 384) per transaction.

Further, unlimited frequency of transactions could certainly increase ML/TF risk. Most of the products offered by financial institutions have limits on the number of transactions. This limitation is mentioned in their product feature documents and account opening mandates. For example, in one product, customer is given the option to limit his transactions to a maximum of four per month to eligible to earn interest on the balance of deposit.

There are no reported cases relating to any suspicious financial crimes perpetrated using FI products. The volume of transactions of FI products is very low due to customers' low income level. ML/TF risks should be differentiated from consumer fraud risks and FIs should be able to implement controlling measures accordingly.

Reported products do not allow customers to send and receive money across borders. Therefore, they may not have additional risks visible from cross border transfers. Most of financial

institutions allow customers to send and receive money across borders through the licensed banking channels or reputed money transferring systems. This denotes that effective controls and required monitoring mechanisms are in place.

When financial institutions receive funds across borders, they have to adhere to rules and regulations imposed by the ECD of the CBSL. As a result it, the risk of funds received from high risk jurisdictions is very low.

FI products are not offered to and not used by non-resident and/or non-citizen customers. If they want to open an account in Sri Lanka they have to adhere to KYC requirements and exchange control procedures. Most of immigrant workers employed in the country have not used formal financial system to transfer funds. Accordingly, FI products may be introduced to suit financial services required by this segment of the population. The risk associated with such products would be very low due to the limited number of immigrants working in Sri Lanka.

FI products are not usually designed for legal persons. Reported products are mainly targeted for low income persons and individuals who operate small scale businesses. Further, these products are not used by banking correspondents and agents as well.

When considering the Sri Lankan bank density, accessibility is not the major cause for financial exclusion. In this context, existing networks such as the postal, telecommunication, schools and private chains of super markets spread throughout the country can be used to mobilise deposits and to disburse loans through FI products.

Financial institutions in Sri Lanka need to explore the possibility of introducing more FI products suitable to the unbanked population in order to cater to demand of these services by them. These products could be designed for the poor by waiving off stringent requirements such as minimum balance and withdrawal charges. Further, documentation should be kept simple and to a minimum and brochures may be distributed indicating the features of the products in a manner that can be understood by the reader easily.

Financial literacy is important for promoting access to finance. Hence, awareness programmes are required to be conducted for deserved people whose financial literacy is poor. Topics such as improvements in savings and saving habits, budgeting, financial management of households, availability of financial products/services at formal financial institutions, risk in dealing with unauthorized financial institutions and prohibited schemes etc. have to be discussed at these programmes.

Affordable financial services must include, not only need-based credit, but also other major demands of the poor such as insurance services, payment and remittance facilities and financial advisory services.

6.3 PROPOSED ACTIONS TO RECTIFY THE DEFICIENCIES IDENTIFIED

- Government of Sri Lanka in association with other key institutions such as CBSL is required to formulate a policy framework to improve FI in the country. In this connection, it is necessary to define Financial Inclusion and FI products appropriate to Sri Lankan context.
- CBSL should catalyse and lead the awareness on FI products among banks and other institutions in order for them to promote FI products and improve financial literacy among low income groups.
- FIU-Sri Lanka should carry out periodical reviews on available FI products available in the market in order to assess their risks and vulnerabilities in controlling possible ML/TF risk.
- Financial institutions should be encouraged to introduce simplified KYC/CDD requirements for FI products.
- Sri Lankans who do not possess, any form of identification documents should be issued with national ID cards as a priority task of the government.
- The possibility should be explored to issue National Electronic Personal Card (NEPC) embedded with sophisticated personal information to every Sri Lankan when he/she reaches the age of 18.

ANNEX I

INSITUIONS PARTICIPATED IN THE NRA

This report is prepared by the NRA Working Group represented by officials from following institutions that are coordinated by the FIU-Sri Lanka.

1. Attorney General's Department
2. Ministry of Justice
3. Ministry of Finance and Planning
4. Ministry of External Affairs
5. Department of Inland Revenue
6. Sri Lanka Police
7. Sri Lanka Customs
8. Registrar of Companies
9. Department of Immigration and Emigration
10. Export & Import Control Department
11. Bribery and Corruption Commission
12. National Dangerous Drug Control Board
13. Gem & Jewelry Authority
14. Institute of Chartered Accountants
15. NGO Secretariat
16. Department of Registrar General
17. Securities and Exchange Commission
18. Colombo Stock Exchange
19. Insurance Board of Sri Lanka
20. CBSL
 - Bank Supervision Department
 - Non-Bank Supervision Department
 - Exchange Control Department
 - Regional Development Department
 - Financial System Stability Department
 - Economic Research Department
21. Bankers' Association
22. Insurance Association of Sri Lanka
23. Colombo Stock Brokers Association

ANNEX II

NATIONAL RISK ASSESSMENT – PROPOSED ACTION PLAN

PROCEEDS OF CRIME

Sources of ML Risk	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
Inadequate capacity of financial crime investigators	Improve capacity of financial crime investigators	Sri Lanka Police	FIU	<ul style="list-style-type: none"> • Provisions for regular training program for financial crimes • Provide new technology for investigators in line with International investigation techniques and supply of physical resources • Provide incentives depending on the financial asset recovery • Establish a special unit for Frozen Asset Management
Low level of awareness among prosecutors	Improve the capacity of prosecutors	Attorney General's Department	FIU	<ul style="list-style-type: none"> • Designate a specialized team to handle files and prosecutions in relation to ML • Conduct regular training programs for prosecutors
Low level of awareness among stakeholders (Bribery Commission, Inland Revenue)	Improve the capacity of the stakeholders	FIU	respective authorities	<ul style="list-style-type: none"> • Provisions for training programs • Encourage to initiate legal proceedings on ML along with the predicate offences • Improve the quality of investigations by providing facilities in line with international standards
No mechanism to record and maintain statistics	Create and maintain a centralized database for statistics in regard to proceeds of crime	FIU	Sri Lanka police	<ul style="list-style-type: none"> • Provide financial resources • Create a standard format to record, proceeds of crime • Provide access to the centralized database with certain restrictions

Non-availability of information in the NGO/NPO Sector	Streamline the NPO/NGO sector	NGO Secretariat	FIU	<ul style="list-style-type: none"> • Amend the present Act and provide for mandatory registration • re-registration of NGO with a categorization of International, National and District level • Prepare mechanisms to record financial assistance and resource persons
low level of awareness among judges	Improve the capacity building for judges	Judicial Service Commission	Ministry of Justice, AG's Dept.	<ul style="list-style-type: none"> • Provisions for training programs

NATIONAL VULNERABILITY

Sources of ML Risk	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
Current AML/CFT legislations and AML/CFT mechanisms do not reflect outcomes of the NRA	Incorporate the outcome of the NRA to any further decision making and legislative processes	FIU	Ministry of Finance, Legal Draftsman's dept., Attorney General's Dept.	Identify legislations to be amended (Acts, rules, directives, Regulations etc.)
				Issue new rules by the FIU
	Keeping the NRA up-to-date	FIU advisory board	FIU	Amend Acts
				Form a steering committee under the FIU advisory board for matters relating to ML/TF risks.
Insufficient capacity of financial crime investigators and asset forfeiture investigators	Improve capacity and the staff strength on financial crime investigations and asset forfeiture investigations	Sri Lanka Police		Provision for more training programs to Sri Lanka Police
				promote parallel investigations among law enforcement agencies
				An internal mechanism to refer suspected cases to the Financial Investigation Unit of the CID by other police units
		Bribery Commission Sri Lanka Customs		Provision for more training programs to relevant officers regarding financial crime and asset forfeiture investigations
			Assign trained financial crime investigators and asset forfeiture investigators to specialized law enforcement / investigatory agencies	

Insufficient Capacity of ML/TF Prosecutors	Increase the number of prosecutors of the AG's Dept. on ML/TF prosecutions and improve capacity building	AG's dept.		Provision for more training programs to AG's dept. officials
	Improve awareness among High Court judges	Judicial Services Commission	Ministry of Justice, AG's Dept.	Provision for training opportunities and refresher programs for the judiciary
	conduct awareness programs for the practitioners of law on ML/TF legislation	Bar Association of Sri Lanka	AG's Dept.	awareness/training programs to be conducted by FIU
	Raise awareness among general public regarding ML/TF to promote adherence to KYC/CDD measures and whistle blowing	FIU	Communication Dept. (CBSL)	Raising awareness through mass media
			Provincial Offices (CBSL)	Conduct public awareness programs
			Communication Dept. (CBSL)	Public outreach at exhibitions held / participated by CBSL
Insufficient level of domestic cooperation	Domestic cooperation needs to be improved	FIU	Advisory board of the FIU	inter-agency working level committees to be created
	Create a database and a secured network for criminal data which can be accessed by relevant law enforcement / investigatory agencies	Sri Lanka Police Sri Lanka Customs FIU		Make policy decisions regarding such a network

Lower level of corporate and trust transparency	Corporate and trust transparency needs to be improved	Registrar General Dept.		conduct a study on Sri Lankan legislations on corporate and trust transparency and its implementations
				Amending relevant legislations accordingly
Shortcomings of the current NIC	Introducing electronic NIC	Registrar of persons		Introducing electronic NIC
Tax crimes are not a predicate offence	Insert tax crimes as a predicate offence	Ministry of Finance	Legal Draftsman's dept., Attorney General's Dept.	Amend FTRA & PMLA
Tax records are not accessible by FIU and Law Enforcement Agencies	access to tax records for the FIU and LEAs needs to be improved	Dept. of Inland Revenue	Ministry of Finance, Sri Lanka Police, FIU	amending current legislations
Low level of formalization of the economy	ML/TF risk associated with the informal economy needs to be analyzed	FIU	CBSL Economic Research Dept.	Conduct a study / research on informal economy of Sri Lanka Analyze the associated ML/TF risk

BANKING SECTOR

sources of ML Risk	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
Banking Sector does not have a formal ML Risk Assessment	Issue rules on the adoption of A ML Risk Assessment	FIU	BSD/ Respective Banks	<ul style="list-style-type: none"> • Issue guidelines on the adoption of ML risk assessment • Review the current methodology of risk assessment • Identify, assess and understand the ML/TF risks of each bank. • Get the feedback from the banks on the adoption
AML supervision is inadequate	Supervision needs to be strengthened through the adoption of a risk based approach.	BSD	FIU	<ul style="list-style-type: none"> • Review current banking sector AML supervision by FIU and BSD • Adoption of Risk Based Supervision by FIU and BSD based on the guidelines issued by the Basel committee on Banking Supervision on ML/TF in 2014 • BSD officers involved in supervision needs to be given training on AML • Regular on-site examinations by the FIU • Information Exchange between FIU and BSD on BSD's AML supervision findings and concerns
Staff knowledge on AML/CFT is inadequate	The banks should take appropriate measures to train and improve the staff knowledge and understanding of ML issues and their obligations on their part in curbing ML and the AML enforcement measures.	FIU	BSD	<ul style="list-style-type: none"> • Assess the knowledge of the bank staff to identify the training requirement • AML training programs/workshops/ seminars to banks • Regular assessment of AML knowledge of the staff

				<ul style="list-style-type: none"> • Conducting internal staff training programs by the Compliance officer periodically • Establish a mechanism by banks to assess the knowledge and understanding of their staff on the absorption of the training given.
Deficiencies and gaps exist in the prevailing AML legislation	Amend the prevailing AML legislation.	Ministry of Finance	Legal Draftsman's dept., Attorney General's Dept.	<ul style="list-style-type: none"> • Review the existing legislation to identify the gaps and deficiencies • Draft necessary guidelines to amend the legislation • Enact the legislation and follow up with the response by stakeholders
Level of enforcement of AML/CFT obligations needs improvement	The level of enforcement should be enhanced together with the supervision functions to be carried out by the regulators. It is imperative that the regulators follow up each and every matter that is identified and reported to them and ensure that the matter thus reported is concluded or escalated to the next level.	FIU	BSD	<ul style="list-style-type: none"> • Adopt Risk Based supervision • BSD should Communicate the findings/concerns on AML after every on-site examination to the FIU as per the legal requirement. • Impose sanctions after regular On-site inspections by the FIU
AML monitoring systems of banks needs improvement	Improve the existing AML monitoring systems in banks to improve the efficiency and effectiveness of the compliance function of the respective bank.	Respective Banks		<ul style="list-style-type: none"> • Banks should identify the deficiencies in the existing AML monitoring system • Take prompt action to make necessary arrangements to improve the existing system to address the deficiencies identified and to incorporate new requirements that may arise. • Evaluate the output given by the system to ensure its compliance to the requirement.

INSURANCE SECTOR

Sources of ML Risk	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
Low vulnerability of ML for non-life insurance products	Simplify existing rules on non-life insurance products	FIU	IBSL	<ul style="list-style-type: none"> • Draft the simplified Rules for non-life insurance products • Review of the draft Rules by FIU • Review of the draft Rules by IBSL • Review of the draft Rules by the Legal Consultants of the FIU • draft Rules to Legal Draftsmen Department for gazetting
Low on-site inspections	Increase the AML inspections by the FIU and IBSL	FIU	IBSL	<ul style="list-style-type: none"> • Review of onsite inspection methodology used by FIU and IBSL • Arriving at a common onsite methodology • Designing a Risk Scoring system for supervision of insurance companies • Drawing up an annual combined onsite inspection plan based on the risk scoring system • Implement the plan and review the plan annually
Low STR's on insurance sector	Highlight the importance of raising STRs	FIU	Insurance Companies	<ul style="list-style-type: none"> • Develop an awareness program by the FIU to train Compliance Officers of Insurance Companies • Conducting training programs to train Compliance officers by the FIU (Train the Trainer program) on annual basis • Compliance Officers to submit Annual Declaration to the FIU & IBSL confirming the training programs conducted

SECURITIES SECTOR

sources of ML Risk	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
AML supervision is inadequate	The AML supervision on the Securities sector needs to be strengthened through the adoption of a risk based approach. - Long Term	SEC	FIU	<ul style="list-style-type: none"> • Review current securities sector AML supervision by FIU and SEC • Adoption of Risk Based Supervision by FIU and SEC (2) • SEC officers involved in supervision needs to be given training on AML • Regular on-site examinations by the FIU • Information Exchange between FIU and SEC on SEC AML supervision
Sector regulators' AML supervision is not following RBA	Consider issuing supervisory guidelines on AML/CFT to the sector regulators -	FIU	SEC	<ul style="list-style-type: none"> • Review current securities sector AML supervision by SEC • Issue supervisory guidelines on AML • Get feedback/ outcomes of the AML supervision by SEC
Staff screening during recruitment and ongoing employee due diligence is inadequate	All industry participants should endeavor to maintain the standards of quality when recruiting staff. Policy on employee due diligence should be promoted to carry out at regular intervals for clients as well as Employees. These actions should be cost effective as well.	SEC		<ul style="list-style-type: none"> • Issue circulars/guidelines on staff screening by sector regulators • Include staff screening and reference checks where necessary
Level of enforcement of AML/CFT obligations needs improvement	The level of enforcement should be enhanced together with the supervision functions to be carried out by the regulators. It is imperative that the regulators follow up each and every	FIU	SEC	<ul style="list-style-type: none"> • Adopt Risk Based supervision • Impose sanctions after regular On-site inspections by the FIU

	matter that is reported to them and ensure that the matter thus reported is concluded or escalated to the next level.			
Staff knowledge on AML/CFT is inadequate	The market participants must take pro-active measures to train their staff as to the specific penalties since, although the staff is aware that there are existing penalties, they may not be aware of the specific penalty for specific offences	FIU	SEC/ Stock Brokers	<ul style="list-style-type: none"> • Include AML module in CPD program for the securities sector • AML training programs/workshops/seminars to securities sector institutions. • Regular assessment of AML knowledge of the staff • Conduct of internal staff training programs by the Compliance officer
AML Compliance functions of institutions are weak (3)	In order to standardize the AML/CFT training procedure the FIU may consider providing the training material. Compliance function of Broker Firms need to be strengthened further, empowering them to carry out AML/CFT functions effectively	Stock Brokers	SEC/ FIU	<ul style="list-style-type: none"> • Review AML policy regularly • Streamline account opening process in line with RBA • Application of RBA for customer due diligence accordingly • Streamline internal and external audits on AML • Improvements to internal controls/ procedures on reporting STRs
Too tight regulations on foreign account opening		SEC	CSE	<ul style="list-style-type: none"> • Review the current account opening process • Streamline the account opening process by avoiding repetitive KYC checks • Communicate it to industry participants

OTHER FINANCIAL SECTOR

sources of ML Risk	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
STR reporting of Licensed Finance Companies is inadequate	Introduce an effective mechanism of identifying and reporting STRs to the FIU by Licensed Finance Companies	Respective LFC	FIU / SNBFI	<ul style="list-style-type: none"> • Enhance the awareness on STR reporting for compliance officers of finance Companies • Strengthening the supervision mechanism covering AML/ CFT framework • Implementation of integrated supervisory mechanism by DSNBFI and FIU • Provide supervisory staff for FIU and DSNBFI
STR reporting of Authorized Money Changers is inefficient	Encourage Authorized Money Changers to report STRs to the FIU efficiently.	Authorized Money Changers	Exchange Control Department (CBSL) FIU	<ul style="list-style-type: none"> • Identify the problems of STR reporting systems of the money changers. • Revision of regulations by making mandatory to appoint a capable Compliance Officer for each Money Changer • Further training to the Compliance Officers of the Authorized Money Changers (eg: computer literacy). • Improve the Foreign Currency Monitoring System by applying new technologies to enhance the efficiency of reporting • Provide special permission to the senior supervisory staff of Exchange Control Dept. to enter into the Money Changers in the Airport premises for inspections • Take necessary measures to revise the existing penalty of Rs. 2,000.00 (introduced in 1953) for violation of money changing rules as suitable for current situation

Supervision of e-money services providers on AML/CFT aspect is not adequate	Introduce on-site supervision on e-money service providers' transactions	Payments and Settlements Dept. (CBSL)	FIU	<ul style="list-style-type: none"> • Issue AML/ CFT guidelines to the e money service providers • Implement on site supervisions on e-money services providers
Non-availability of regulations to monitor the informal money transfer institutions under the AML/CFT framework	Regulate the informal money transfer institutions such as Hawala, Hundi	FIU	Payments and Settlements Dept.(CBSL)	<ul style="list-style-type: none"> • Preparation of an act for issuing of a license • Introduce a supervisory mechanism after the registration of those institutions • Initiate a supervisory mechanism for the registered institutions

DESIGNATED NON FINANCE BUSINESSES AND PROFESSIONS

Sources of ML Risk	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
Absence of Rules and Regulation related to the DNFBP Sector	Formulation of regulatory framework and legislation covering the sector	FIU	All DNFBPs SROs Regulators	<ul style="list-style-type: none"> • Prepare Rules related to DNFBPs by the FIU with the help of the legal consultants • Submission of Rules to the relevant stakeholders for their comments • Submission to the Legal Draftsman after incorporating the comments • Submission to the Attorney General's Department for their review • Gazette the Rules on DNFBPs through the Government Printer after obtaining the necessary approvals
Lack of awareness on AML & CFT	Enhance Awareness on ML & TF in Sector to avoid any potential misuse	FIU	All DNFBPs SROs Regulators	<ul style="list-style-type: none"> • Asses the areas where training is required to focus more attention with limited resources • Accordingly set the training objectives to bridge the gaps identified • Create an effective and comprehensive training program considering the nature of the participants • Implementation of the training program with quality resource persons • Evaluate and revise the program based on the feedback received from the participants
Absence of on-site supervision related to AML & CFT	Introduction of AML & CFT on-site supervision to the existing work schedules	FIU	SROs Regulators	<ul style="list-style-type: none"> • Formulate schedules and policies on supervision within the entities • Create supervision units related to AML & CFT or allocate more individuals to existing units • Provide sufficient and continuous training to the supervisors • Report the deficiencies identified to the relevant stakeholders to take remedial action

Insufficient resource allocation to AML & CFT from the policy makers	Emphasis AML & CTF as a national priority	Ministry of Finance	SROs CBSL	<ul style="list-style-type: none"> • Explain the policy makers importance of AML & CFT in the long term • Prepare necessary documentation to support the same as evidence • Increase the allocated amounts to AML & CFT through the budgetary provisions
Non-availability of information required for the assessment	Formulation of a proper recording systems for the sector	All DNFBPs SROs Regulators FIU		<ul style="list-style-type: none"> • Emphasis the SROs and Regulators the importance of data for analysis in the future • Carry out necessary action to facilitate DNFBPs to collect and record such information through SROs/Regulators • Prepare mechanisms to report key information periodically to the stakeholders

FINANCIAL INCLUSION

Concerns Relating to ML/TF	Key Action	Primary Agency	Secondary Agency	Detailed Action Plan
Need for high-level commitment to the Financial Inclusion Products				
Non availability of a definition for Financial Inclusion	Government of Sri Lanka should put in place a Policy Frame work with a Definition for Financial Inclusion.	CBSL and Ministry of Economic Development	Ministry of Finance and Divinaguma Department	Identify requirements and area Submit the Cabinet Paper for Definition Publish Gazette notification for Financial Inclusion
Awareness of Financial Inclusion and FI Products				
Lack of Awareness of FI	Improved awareness on FI products among banks and other institutions.	CBSL SEC and IBSL	Banks, Finance Companies, Stock Brokers, Insurance Companies	Organize Institutional Awareness Programs Publish Financial Inclusion Products details
	Improve financial literacy	CBSL, SEC and IBSL	Divinaguma Department, Ministry of Education, Institute of Bankers, Financial Institutes	Organize Awareness Programs for public, include in the school curriculum
Regulatory measures for Financial Inclusion				
Non availability of regulatory measures for FI	Issue new rules and regulations to encourage Financial Inclusion Product	CBSL, IBSL, SEC		Issue Regulations for introducing FI Products New KYC/CDD rules for FI Products

Non availability of regulatory measures for FI products and services	Developing a comprehensive monitoring framework to track the progress of the financial inclusion and deepening efforts related to AML/CFT measures on a nationwide basis.	CBSL SEC and IBSL		Implementing On site off site monitoring mechanism
Tightened KYC/CDD measures	Reduce the KYC requirements on the Divinaguma Beneficiaries to enable them to participate in FI products especially on basic savings products.	CBSL, SEC, IBSL	Banks, Finance Companies, Stock Brokers, Insurance Companies	Introduce New FI products for community base banking system (<i>Prajama Banks</i>)
Limited access to financial institutions and Products by low income people	A special basic savings account with simplified KYC requirements for FI products with a specific transaction threshold per month.	CBSL SEC and IBSL	Banks, Finance Companies, Stock Brokers, Insurance Companies	Introduce New simplified KYC/CDD rules for FI products
Financial Inclusion Products risks and vulnerabilities assessment				
Non availability of a system to assess FI product risks and vulnerabilities	Carry out periodical reviews on available FI products in the market	CBSL IBSL, SEC		FIU should carry out periodical reviews on available FI products in the market to assess their risks and vulnerabilities to control possible identified ML/TF risk.
	Introduce FI products Risk Management System - World Bank FIRAT tool published in a public web site	CBSL		FIU should sanction a tried and tested mechanism as a Financial Inclusion Product Risk Assessment Tool (FIRAT) to identify current/future FI products, assess their risk, evolve mitigates to control possible identified ML/TF risk. Must obtain the consent of World Bank to publish FIRAT tool in a public website.

Lack of proper identification system of low income groups	Introduce new biometric unique identification document for all Sri Lankans or improve the existing NIC.	Relevant Ministry	Department of Registration of Persons	Smart National Identity Card (SNID)
Payment of Social Benefits	Every citizen should be issued with a National Electronic Bank Account (NEBA) automatically at the time of receiving their SNID card by a high quality, national, full-service bank.	Relevant Ministry	Divinaguma Department	