

6. OTHER FINANCIAL INSTITUTIONS VULNERABILITY ASSESSMENT

6.1 Introduction

The module covers the vulnerability of FIs operating in Sri Lanka in 2 broader categories, i.e., regulated FIs and unregulated/informal/under-regulated FIs. The regulated category consists of LFCs, SLCs, MVTS Providers, EMS Providers, LMFCs, RDs, CSs and Samurdhi Banks while unregulated/informal/under-regulated category consists of Informal Money Transfer Systems (Hundi/Hawala), Informal Pawn Brokers (IPBs), IMLs and Micro Finance Institutions (MFIs).

Total asset of the other financial institutions as at the end of 2022 was as follows.

Table 1: Total Assets of Financial System

Financial Institution Type	Rs. billion/ USD million
Licensed Finance Companies (Rs. million)	1,610.2
Specialized Leasing Companies (Rs. million)	1.0
Money or Value Transfer Service Providers (Rs. million)	425
E-Money Service Providers (Rs. million)	424.52
Licensed Microfinance Companies (Rs. million)	9.9
Restricted Dealers ^(a) (USD million)	170.3
Co-operative Societies (Rs. million)	220.8

(a) Performance (Amount deposited into banking system + Amount of USD sold by RDs)

Sources: Annual Report 2022, Central Bank of Sri Lanka
Annual Report 2022, SLTMobitel
Financial statements as at 31.12.2022 Dialog
Axiata PLC, MMBL Money Transfer (Pvt) Ltd.

According to the above figures, it is obvious that the LFCs are the main player of the other FIs sector.

6.2 Sector Overall Assessment

In the regulated category, MVTS Providers, LFCs, EMS Providers and RDs have a **Medium** level of vulnerability for ML, among which MVTS Providers have the highest vulnerability. Further, SLCs, LMFCs, CSs and Samurdhi Banks have **Medium Low** level of vulnerability for ML, among which CSs and Samurdhi Banks have the lowest vulnerability for ML. On the other hand, in the unregulated/informal/under-regulated category, informal money transfer systems (Hawala/ Hundi) have the highest vulnerability for ML which is assessed as **High** followed by IMLs and UMFIs having **Medium** level of vulnerability for ML while IPBs have **Medium Low** vulnerability for ML.

6.3 Methodology used for Information Collection

A questionnaire was used to collect information relating to regulated category while research, articles and mini projects assigned to WG members were used to collect information for the unregulated category.

6.4 Regulated Sector

6.4.1 Licensed Finance Companies

By the end of 2022, there were 36 LFCs licensed by the Monetary Board of the CBSL under the FBA. All LFCs are subjected to the supervision and regulation by the DSNBFI of CBSL under the powers vested by FBA. Compared to the other FIs, LFCs are the major player in the sector.

Most of the products offered by LFCs are savings accounts, fixed deposits, loans, and leasing while most of the customers of the LFCs perform cash deposits, cash withdrawals and fund transfers. LFCs are high cash intensive institutions performing domestic transactions predominantly over cross border transactions. Apart from FBA, all LFCs are subjected to the AML/CFT requirements. During the last 5 years, there were some instances where LFCs have identified several incidents of integrity failures. There are some lapses identified relating to training such as inadequate training conducted for the employees in the compliance function even though those employees directly correspond with the customers. Absence of procedures to identify unusual and suspicious transactions, inadequate trainings carried out on suspicious transaction reporting leads to the ineffectiveness of the process and hence number of STRs reported by LFCs is low (2020 – 16 STRs, 2021 – 21 STRs, 2022 – 26 STRs). Based on the above, ML vulnerability of LFCs was rated as **Medium** which is similar to the vulnerability assessed in 2014 NRA.

6.4.2 Money Value Transfer Service Providers

MVTS providers are mainly Bank/Finance Company related and Non-Bank MVTS Providers. This sub-sector only covers Non-Bank MVTS Providers. This includes 2 mobile money operators who are predominately offering domestic money transfer services and one FI (hereinafter referred to as “non-mobile MVTS provider”) which acts as the representative of Western Union, Money Gram, and Ria money transfer services.

This is also a high cash intensive sector performing a considerable volume of cross-border transactions which include remittances. Apart from remittances, cash deposits, cash withdrawals, fund/value transfers are also offered by the MVTS Providers. All MVTS Providers are subjected to the AML/CFT requirements. During the last 5 years, there were no incidents of integrity failures of the 3 institutions. All MVTS Providers have provided training to their employees including agent/sub-agents, new recruits based on the job role in a periodic manner. However, limited training has been conducted for Board of Directors (BOD) and senior management of MVTS Providers. Based on the above, ML vulnerability of MVTS Providers was rated as **Medium**.

6.4.3 E-Money Service Providers

There were two EMS Providers operating in the country via mobile devices. Payment and Settlement Systems Act, No. 28 of 2005 (PSSA) and Payment Cards and Mobile Payment Systems Regulations, No. 1 of 2013 vest prudential supervisory powers on Payments and Settlements Department (PSD) of the CBSL on EMS Providers. Section 17 of the PSSA states that the Minister may make regulations with respect to any matter required by the PSSA. Accordingly, the Payment Cards and Mobile Payment Systems Regulation was issued for the supervision of payment cards and payment systems.

EMS Providers offer the service through nearly 190 outlets in all districts in the country via agents or sub-agents numbering approximately 240. These institutions provide mobile or value transfer services and digital/virtual wallet services facilitating cash deposits, cash withdrawals, and intra fund/value transfer, receive funds or value from abroad, Internet Payment Gateway (IPG) transactions, peer to peer transactions, and business-to business transactions, Lanka QR transactions, utility and institute bill payments and agency banking services. This is also a high cash intensive sector whose customers perform high value and volume of cash transactions. As per the Payment and Settlement Systems Circular No. 8 of 2019, basic customer wallet limit is Rs. 10,000 while enhanced wallet limit is Rs. 50,000 of both EMS Providers per day as at May 2023. Compared to the domestic transactions, international transactions are very low, which is 1 per cent. This sector is also subject to the AML/CFT requirements. Both e-money service providers provide AML/CFT training to the relevant employees including agent/sub-agents, new recruits, senior management based on the job role in a periodic manner. However, limited training has been conducted for BOD. Both EMS Providers have an effective compliance function enriched with sufficient resources and independent audit function. Based on the above, ML vulnerability of EMS Providers was rated as **Medium**.

6.4.4 Restricted Dealers

There were 59 money changing companies, 6 finance companies and 14 hotels who operate as restricted dealers in the country at the end of 2022 (permits were issued to 59 companies which include 69 money changing outlets/branches. Out of these 69 outlets, 58 were permitted to buy and exchange foreign currency, while the remaining 11 were permitted to buy, sell and exchange foreign currency). FEA vests prudential supervisory powers on DFE of the CBSL on RDs. Accordingly, DFE has powers to issue directions and guidelines, conduct investigations on RDs, and impose administrative sanctions on non-compliances with the provisions of the FEA, and regulations, orders, directions and guidelines, issued under FEA.

In order to reduce the impact of COVID-19 pandemic and economic crisis on foreign currency status of the country, DFE has issued Regulations No. 3 of 2021 published in the Extraordinary Gazette Notifications No. 2213/36 dated 03 February 2021, under Section 22 of FEA which is subjected to the renewal in every 6 months.

This is a high cash intensive sector, and their international transactions are low. The AML knowledge of the staff is also at a low level. Staff of RDs are lacking awareness in respect of the Directions issued to RDs in relation to customer identification and reporting suspicious transactions. All RDs are subject to the AML/CFT requirements. Based on the above, ML vulnerability of RDs was rated as **Medium**.

6.4.5 Specialized Leasing Companies

By the end of 2022, there was 1 SLC whose asset value was nearly Rs. 1 billion. At the beginning of NRA in 2021, there were 3 SLCs out of which 2 companies were granted finance company licenses under the non-bank financial institutions sector consolidation plan of CBSL.

The SLCs are subjected to supervision and regulation by the DSNBFI of the CBSL under the powers vested by the Finance Leasing Act, No. 56 of 2000 (FLA). FLA vests the prudential supervisory powers on DSNBFI in respect of SLCs.

Mostly offered products by the SLCs are loans and leasing. Apart from that, hire purchasing, trade financing, factoring and margin trading are also offered by SLCs. SLCs are also a high cash intensive sector but cash intensiveness is less than that of the LFCs sector. SLCs in Sri Lanka do not perform cross-border transactions. Some of the lapses observed by DSNBFI in relation to AML/CFT knowledge include inadequate training conducted for the employees in the compliance function. Main lapses observed during the on-site examinations of certain companies are, lack of dedicated compliance officers, inadequate allocation of human and technological resources to the function, lapses in the policies and procedures related to compliance risk management, absence of comprehensive information systems to capture data on testing the compliance levels. Some of the lapses observed by DSNBFI relating to AML/CFT monitoring and raising STRs include absence of procedures to identify, obtain and examine information on unusual and suspicious transactions, inadequate trainings carried out for all employees of SLCs. Considering the above, ML vulnerability of SLCs was rated as **Medium Low**.

6.4.6 Licensed Microfinance Companies

In the Micro-Finance Institutions sector of the country, there are LMFCs, NGO MFIs (registered under the NSNGO) and unregulated MFIs. However, in this assessment, only the LMFCs are considered. There were 4 LMFCs as at the end of 2022. Microfinance Act, No. 6 of 2016 (MFA) and Directions and Rules issued thereunder vest prudential supervisory powers on the DSNBFI with respect to LMFCs. Operations carried out by LMFCs are covered within the finance businesses defined under FTRA.

LMFCs offer products and services including savings accounts, loans, micro-financing as well as cash deposits. The number of active customers of LMFCs is comparatively low. Cross-border transactions are also negligible. The majority of customers of LMFCs are low-income earners and micro entrepreneurs. LMFCs are required to always be in the position of a net lender and are only permitted to accept limited saving deposits only from their borrowers, as a collateral, where the total deposits of a LMFC shall not be more than 60 per cent of its total performing loans, limiting the deposits that can be acceptable from a depositor. The AML knowledge of the staff is relatively low. LMFCs have implemented procedures and processes to identify violations of the internal code of ethics and code of conduct as well as they have developed specific actions that should be taken against such violations. Integrity failures and compliance breaches have been identified only in 3 LMFCs during the recent past. All LMFCs have computer-based systems that facilitate monitoring and recording of client profiles and transactions. Considering the above, ML vulnerability of LMFCs was rated as **Medium Low**.

6.4.7 Co-operative Societies

In the Co-operative Societies sector, there are 2,333 Co-op Rural Banks, more than 6,000 Sanasa Societies (Primary), 13 Co-op Rural Banks Federations, 40 Co-op Sanasa Federations and other CSs. At the end of 2022, total assets of CSs were Rs. 220.8 billion which is 0.7 per cent of share of the financial system. All CSs are subjected to supervision by the Department of Co-operative Development (DCD) under Cooperative Societies Act, No. 05 of 1972¹ and its amendment as well as Provincial Charters² applicable for different provinces.

CSs perform high level/frequency of cash transactions. But cash intensiveness is lower than that of the LFCs. This sector has no international transactions. CSs have implemented procedures and processes to identify violations of the internal code of ethics and code of conduct as well as developing specific actions that should be taken against such violations. There was lesser number of instances where the CSs have removed employees due to integrity failures during recent past. As operations of CSs are covered under the finance businesses within the FTRA, CDD Rules are also applicable to CSs. Accordingly, CSs should design and implement suitable AML training programmes for relevant employees. However, AML knowledge of its business staff is comparatively low. Some CSs have compliance officers/department to perform compliance function. And there are CSs which do not have such a function. However, most CSs have internal and external audit functions which conduct respective audits at regular intervals. Monitoring and reporting of suspicious transactions is also not effective as only some of the CSs have computer-based systems that facilitate monitoring and recording of client profile and transactions. Considering the above, ML vulnerability of CSs was rated as **Medium Low**.

6.4.8 Samurdhi Banks

As at the end of 2018, there were 1,073 community-based banks and 331 community-based banking societies operating in all districts. The share capital of Samurdhi Banks has grown to Rs. 15,848 million in 2018 from Rs. 11,791 million in 2016. The number of deposits has grown to 8,177,216 (amounting to Rs. 55,627.64 million) in 2018 from 7,417,540 (amounting Rs. 43,716 million) in 2016. As per the Divineguma Act, No. 1 of 2013 (Samurdhi Act) and Divineguma (Amendment) Act, No. 2 of 2017, Samurdhi Development Department who is accountable to Auditor General of Sri Lanka has powers to supervise, manage, monitor and audit Samurdhi Community Based Banks and Samurdhi Community Based Banking Societies.

Samurdhi Banks have relationships mostly with individual customers. Savings accounts, fixed deposits, loans and micro-financing are the most accessed products by customers while most customers perform cash deposits and withdrawals. The Banks limitedly use non face-to-face channels including SMS, telephone and email. Samurdhi Banks are not maintaining relationships with walking customers and foreign customers. Some Samurdhi Banks employ agents for their operations and perform moderate level of cash transactions. Further, the banks do not perform international transactions. AML knowledge of business staff is at a low level. The banks have implemented procedures and processes to identify violations of the internal code of ethics

1 Applicable to Line Department, Northwestern Southern, North and Eastern Provinces.

2 Co-operative Societies Charter No. 03 of 2007 of the Sabaragamuwa Provincial Council, Co-operative Societies Charter No. 05 of 2009 of the North Central Provincial Council, Co-operative Societies Charter No. 03 of 2011 of the Uva Provincial Council, Co-operative Societies Charter No. 03 of 1998 of the Western Provincial Council, Co-operative Societies Charter No. 06 of 2018 of the Central Provincial Council.

and code of conduct as well as developing specific actions that should be taken against such violations. There were limited instances where the Samurdhi Banks have removed employees due to integrity failures during the recent past and have taken disciplinary actions against staff due to compliance breaches. According to the sample, a smaller number of Samurdhi Banks have a Compliance Officer/ department to perform compliance function. Average monthly transactions of Samurdhi Banks are between Rs. 1 million – Rs. 10 million. All Samurdhi Banks have internal and external audit functions which conduct their respective audits at regular intervals. Some Samurdhi Banks have computer-based systems that facilitate monitoring and recording of client profiles and transactions. By considering the above, ML vulnerability of Samurdhi Banks was rated as **Medium Low**.

6.5 Unregulated/ Informal/ Under-Regulated Sector

Due to the absence of a comprehensive legal framework for supervision, registration, documentation and other requirements, quality of AML controls is low in this sector. Accordingly, ML vulnerability of the sector totally depends on the inherent vulnerability of each individual sector.

6.5.1 Informal Money Transfer Systems (Hundi/ Hawala Dealers)

There are no restrictions for the establishment of an agency to conduct transactions through informal money transfer systems. Informal money transfer systems are trustworthy, and they maintain minimal documentation. It is observed that criminals take advantage of the anonymity of the systems to move the proceeds of illegal activities. Since the documentation involved in such deals is minimal, it makes the system vulnerable to being abused for ML. There is still limited knowledge of these systems and therefore they are more likely to operate for illegal purposes including ML.

External oversight of Hawala transactions is limited and detection of risk is minimal. This makes them susceptible to abuse by individuals and groups transferring proceeds of crimes or funds to finance illegal activities. On the other hand, when the formal financial sector has been subjected to oversight or supervision under a well-established legal framework, the Hawala system will provide opportunities for criminals to transfer proceeds. Considering these facts, at present informal money transfer system in Sri Lanka is more vulnerable to ML. Accordingly, ML vulnerability in the informal money transfer sector has been rated as **High**.

PSD of CBSL is in the process of issuing a regulation in order to introduce registration requirement for the sector.

6.5.2 Informal Money Lenders

Unlike LBs, LFCs, LMFCs, Microfinance NGOs, Co-operative Rural Banks and Thrift and Credit Co-operative Societies, and Samurdhi Community-Based Banks, IMLs are not regulated or supervised. These IMLs operate in the form of individuals, sole proprietors, partnerships or companies. Though the absence of regulatory framework causes various malpractices and customer harassments in the money lending businesses, lack of collaterals in the informal financial sector and low financial literacy increases the popularity of informal money lending. As informal money lenders are not reporting information, collecting information on the sector is difficult. Informal money lending is popular amongst close knit communities (e.g., plantation community)

due to word-of-mouth marketing. There are various instant online cash loans offering within Sri Lanka such as “OnCredit”, “Loanme”, “Lotus Loan”, “Credit ONE”, “CashX”, “Cashwagon”, “Cashray”, etc. These types of loans create negative consequences to borrowers which include unaffordable repayments, high interest rates and fees and late repayments owing to poverty and other serious social issues. Accordingly, ML vulnerability of the sector was rated as **Medium**.

In order to address the above stated issues, CBSL has proposed the enactment of the Microfinance and Credit Regulatory Authority Act and it will enable the establishment of Microfinance and Credit Regulatory Authority which is mandated to regulate both unregulated MFIs and informal money lenders. The draft of the proposed Act has been approved by the Monetary Board of the CBSL and forwarded to the Ministry of Finance on 23.11.2021.

6.5.3 Unregulated Micro Finance Institutions

UMFIs mostly offer micro-financing and loans facilities to rural customers for house repairing, small businesses, education, agriculture, consumption, etc. As per the interviews conducted with the MFIs, use of these loans granted are continuously monitored by the field officers of the relevant MFIs. There are 200 – 400 UMFIs possessing a lending market share of 10 per cent - 15 per cent. UMFIs mostly have relationships with individuals/sole proprietorships, partnerships and corporates. These institutions do not have relationships with high-risk customers such as foreign customers and walking customers. UMFIs perform low level of cash transactions and do not perform international transactions. Non face-to-face channels such as SMS, telephone and email are used by customers of UMFIs to conduct transactions. As this sector is unregulated in Sri Lanka, required control measures relating to AML have not been implemented. Awareness of ML in this industry is also at a low level. Market entry has been controlled to a certain extent by the existing industry players. Accordingly, ML vulnerability of the sector was rated as **Medium**.

6.5.4 Informal Pawn Brokers

Similar to the other informal sectors, IPBs are also not subjected to supervision by the banking and monetary authorities, as they are not registered. IPBs often do not comply with bookkeeping standards and are not reflected in official statistics.

IPBs charge interest rates higher than the formal pawnbrokers which make customers pay for the extra risk involved in informal pawn broking since the risk of loan default is high. As there is a trend to pawn stolen items by the borrowers who do not have any intention to redeem them, there is a ML risk in relation to the informal pawn brokers’ sector. However, IPBs are closer to the clients than formal ones, as their needs are met at any time of the day with easy and simple procedures. Lending conditions and applicable interest rates in the informal pawning transactions can vary from borrower to borrower depending on the evaluation of the value of pawned article, creditworthiness, and the degree of relationship the borrower has with the lender. The informal pawning industry is carried out on a cash basis. Since the regulated formal pawning institutions are largely scattered in the country, attractiveness of informal pawning sector is low. It caters mostly to the local poor families who are financially illiterate. Accordingly, ML vulnerability of IPBs was rated as **Medium Low**.

6.6 Deficiencies and Gaps Identified with the Sector and Proposed Actions to Rectify the Issues.

After completing the assessment, the tool provided by the WB has generated the priority ranking for the AML control variables for each FI. Accordingly, priority ranking for the regulated FIs are shown in Table 2 (The lower the ranking, the more priority the item has).

Table 2: Priority Ranking for Anti Money Laundering Controls of Regulated Financial Institutions

	MVTS	LFCs	EMSs	RDs	SLCs	LMFCs	CSs	Samurdhi Banks
Comprehensiveness of AML Legal Framework						4	6	6
Effectiveness of Supervision/Oversight Activities	2			3		6	2	2
Availability and Enforcement of Administrative Sanctions				7		8	8	8
Availability and Enforcement of Criminal Sanctions	4	4	3	6	4	7	7	7
Availability and Effectiveness of Entry Controls				8			9	9
Integrity of Business/Institution Staff	3	2	2	4	2	3	5	5
AML Knowledge of Business/Institution Staff	1	1	1	1	1	1	1	1
Effectiveness of Compliance Function (Organisation)	5	5	4	2	5	4	3	3
Effectiveness of Suspicious Activity Monitoring and Reporting	6	3	5	5	3	2	4	4
Availability and Access to Beneficial Ownership information	8	7	7	10	7	10	11	11
Availability of Reliable Identification Infrastructure	7	6	6	9	6	9	10	10
Availability of Independent Information Sources	9	8	8	11	8	11	12	12

Accordingly, in summary followings are highlighted with respect to regulated FIs;

- Steps need to be taken to enhance the awareness relating to ML/TF risks in the other financial sector, especially, in RDs, LMFCs, CSs and Samurdhi Banks.
- Prudential supervisors of the respective sector should expand the AML/CFT supervision in relation to regulated FIs. In that case, consider amending the respective regulations (discussed in above sections) to include the AML/CFT aspects.
- Enhance the scope of entry controls by including AML controls implemented by FIs. Further, enhance the fulfillment of fit and proper criteria in relation to major shareholders when applying for the license or renewal of license of LFCs and SLCs.
- LFCs should increase the effectiveness of reporting STRs to the FIU.

Priority ranking for the unregulated/informal/under-regulated FIs are shown in Table 3.

Table 3: Priority Ranking for Anti Money Laundering Controls of Unregulated/Informal Financial Institutions

	Hundi/ Hawala	IMLs	UMFIs	IPBs
Comprehensiveness of AML Legal Framework	9	9	9	7
Effectiveness of Supervision/Oversight Activities	2	2	2	2
Availability and Enforcement of Administrative Sanctions	7	7	7	9
Availability and Enforcement of Criminal Sanctions	8	8	8	8
Availability and Effectiveness of Entry Controls	4	4	4	5
Integrity of Business/Institution Staff	6	5	6	6
AML Knowledge of Business/Institution Staff	1	1	1	1
Effectiveness of Compliance Function (Organisation)	3	3	3	3
Effectiveness of Suspicious Activity Monitoring and Reporting	5	6	5	4
Availability and Access to Beneficial Ownership information	11	11	11	11
Availability of Reliable Identification Infrastructure	10	10	10	10
Availability of Independent Information Sources	12	12	12	12

In summary, followings are recommended with respect to the unregulated/informal/under-regulated FIs;

- Strengthening the regulatory framework for the unregulated/ informal/ under-regulated FIs in order to enhance the effectiveness of supervision, enforcement of sanctions, monitoring and reporting of the transactions.
- Necessary actions are required to undertake to improve formal money lending facilities and formal money transfer systems by financial institutions in order to discourage the informal sector, especially, informal money lending activities and hundi/hawala businesses in the country.

Figure 1: Highlights of the Assessment of Vulnerability of Other Financial Institutions

