Risk-Based Approach to AML/CFT

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Background

- 2003 revision of FATF Recommendations provide, for first time, explicit recognition of the risk-based approach (RBA)
- Multiple references to ML/FT risk and risk management
  - Application of standards to financial institutions
  - Extent of CDD
  - Nature of institutions' internal controls
  - Scope of supervision
- It is not mandatory to apply RBA, except when dealing with higher risks

Risk within the Financial System

- **Some scope to limit or not apply standards:**
  - To a particular financial activity or type of institution “in strictly limited and justified circumstances, and based on a proven low risk of money laundering…”
  - To entities “when a financial activity is carried out by a person or entity on an occasional or very limited basis…such that there is little risk of money laundering…”
- **DNFBPs, and money or value transfer services (R12, R16 and SRVI) cannot be exempted entirely from the requirements, but may apply measures (e.g. R5) on a RBA**

CDD Risk Principles (R.5)

- Financial institutions should apply each of the CDD measures, but may determine the extent of such measures on a risk sensitive basis, depending on the type of customer, business relationship or transaction
- The measures should be consistent with any guidelines issued by competent authorities
- For higher risk categories, financial institutions <u>must</u> perform enhanced due diligence
- In proven low-risk situations, countries <u>may</u> decide that financial institutions can apply reduced or simplified measures

Internal Controls (R15)

- ❑Development of “appropriate” policies, audit procedures and training
- ❑Type and extent of measures dependent on
  - AML/CFT risk
  - Size of business
  - Geography
  - Environment

Supervision (R23, 24, 29)

- **Application of relevant "Core Principles" necessary for banks, insurers and securities companies (but these principles recognise RBA)**
- **Other financial institutions to be supervised on risk-sensitive basis**
  - Except that money or value transfer services or currency exchanges services must be registered/licensed and subject to effective compliance monitoring
- **DNFBP to be monitored for compliance on risk-sensitive basis**
  - Except that casinos must be licensed, regulated, supervised and subject to "fit and proper" tests

Some Challenges

- For many countries the RBA is new and untested
- There is relatively little documentation to assist countries to implement the RBA
- There is no clear agreement on what in fact the RBA involves
- Very few external assessors have practical experience of structured risk-based frameworks
- Financial institutions are unclear as to what the authorities are expecting
- Consequently, there are inconsistencies in expectations and understanding

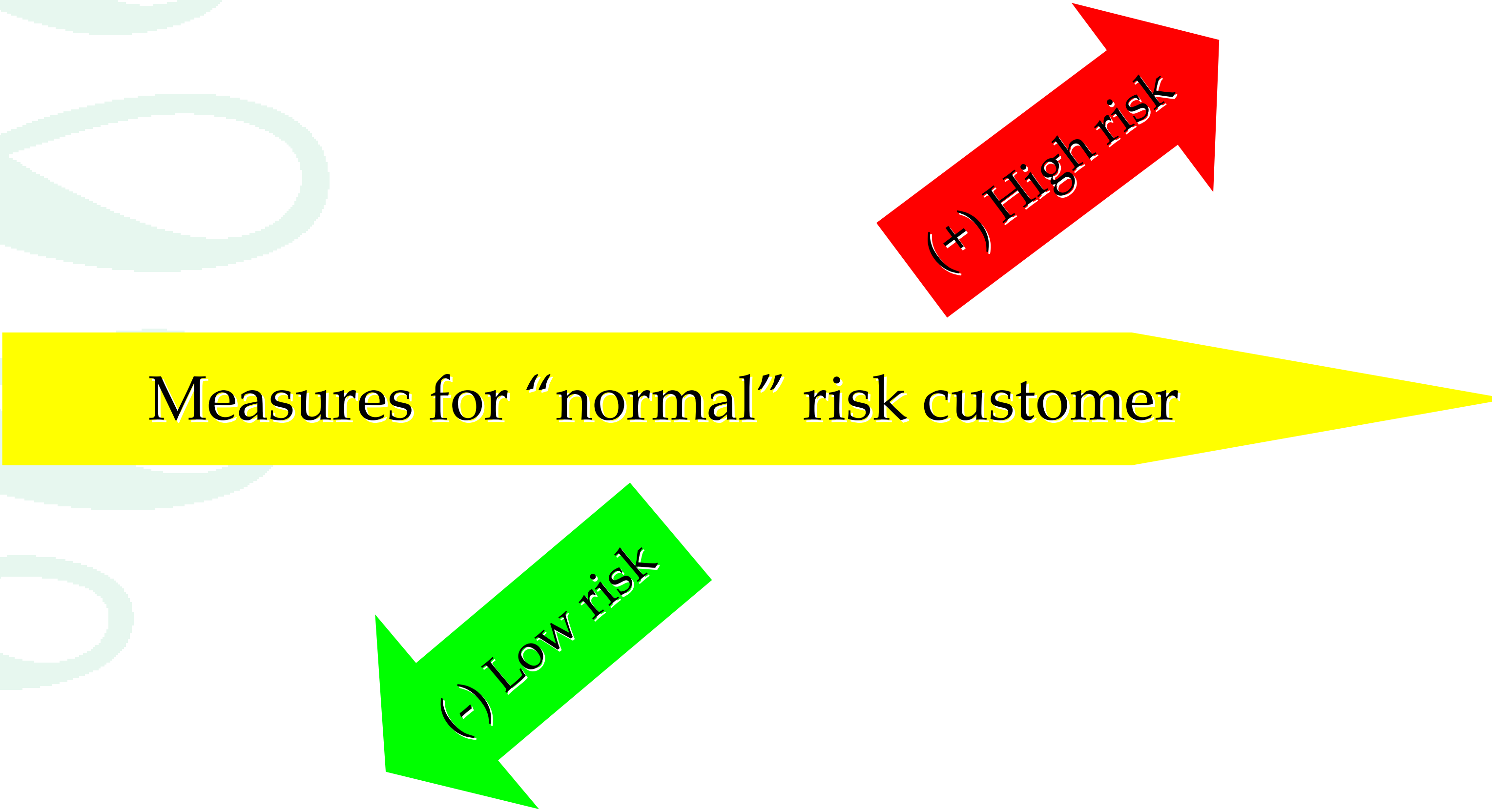
Addressing the Challenges

- FATF has established “Electronic Advisory Group” (reporting to WGEI)
- Joint public/private sector project
- Terms of reference
  - Undertake fact-finding on current initiatives on RBA
  - Identify the key elements of the RBA
  - Produce guidance for publication
- Draft paper circulated for consultation in April 2007
- Guidance paper expected for June 2007

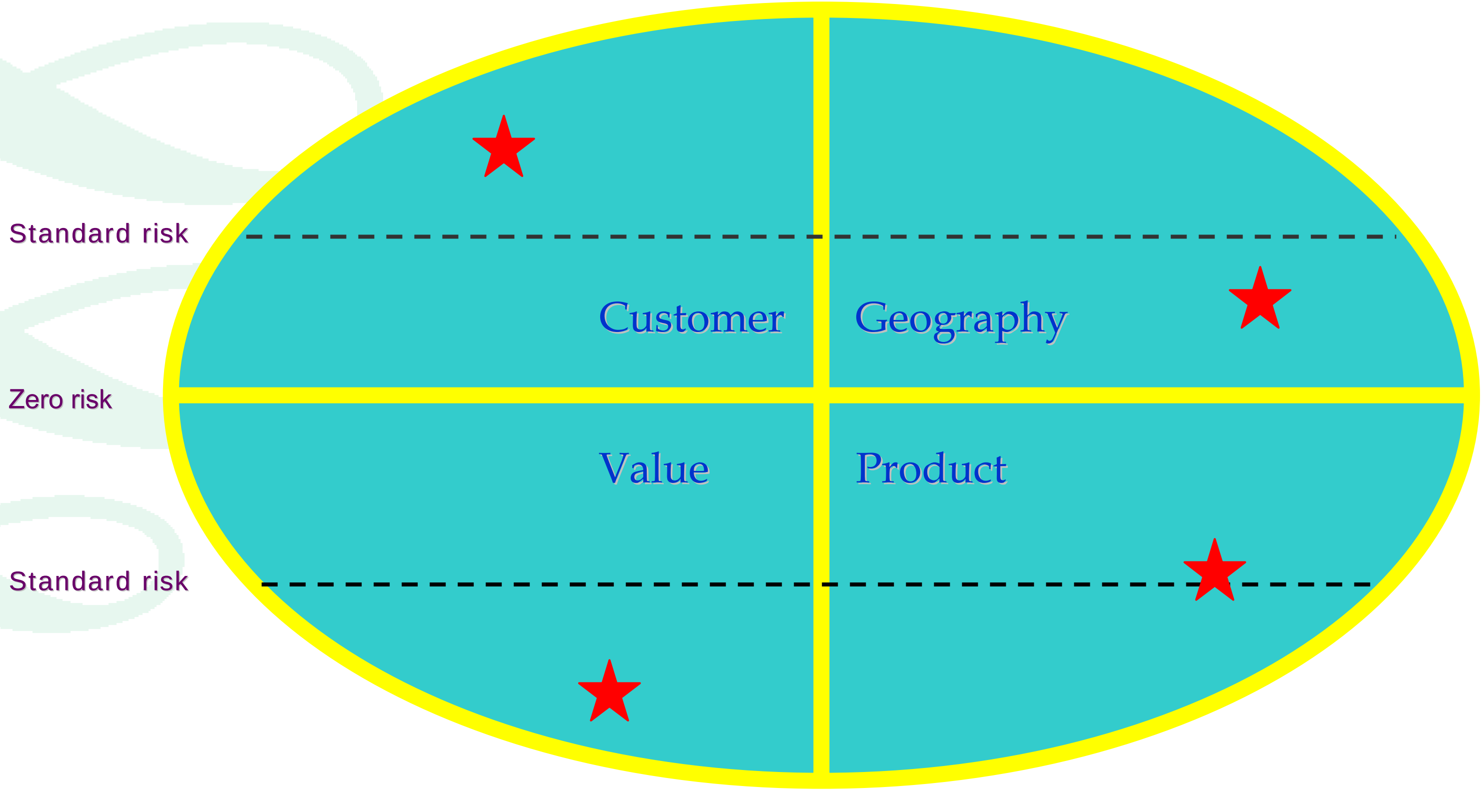
Benefits of the RBA

- It requires institutions to engage with AML thoughtfully
- Institutions can focus on real AML/CFT risks (rather than rigid checklist compliance) which allows for:
  - Better risk mitigation
  - Better cost-benefit
- Flexibility to adapt to risks that change over time
- Less inconvenience to the majority of legitimate customers
- More buy-in by financial institutions' staff
- No single blueprint for the launderer to discover and find a way around
- Institutions are better placed to assess their own individual ML/TF risk exposure

Risk often seen as two dimensional



In practice it has multi-dimensional components



Challenges of Implementation

- Institutions will need to build expertise in ML/FT risk analysis
- Potential diversity of RBA practice means that institutions and regulators will need to make greater efforts to identify and disseminate good practice
- Basic legal obligations must be in place to avoid a poorly implemented RBA leading to ineffective practices
- Institutions may be reluctant to change from current practices
- Transitional costs may arise from the need for institutions to invest in IT, training, etc to move over to a RBA
- Front line personnel may prefer to work on a checklist basis, but this is difficult to reconcile with RBA
- There may be distinct challenges over the RBA for cash-based economies

Elements of an Effective RBA

- Clear understanding by authorities of the ML/FT vulnerabilities and risks within the jurisdiction
- Laws and policies that
  - concentrate efforts towards business activities, customers, products, delivery channels and geographic areas that are assessed as high risk for ML/FT
  - reduce them where such risks are assessed to be low
  - Require institutions to tailor procedures to address risks
- Good flow of information on risks, including from the authorities to the regulated sector
- On-going co-operation between public and private sectors
- Firm commitment to RBA by all stakeholders

Elements of an Effective RBA

- **Regulatory and supervisory policies that:**
  - Operate by reference to an assessment of
    - the AML/CFT risks faced by institutions; and
    - the effectiveness of their risk management systems
  - Reflect the importance of engagement by senior management
  - Give increased attention to institutions that engage in high-risk activities
  - Are consistent and transparent in their application
  - Require CDD procedures, monitoring of customers and transactions, and staff training to be consistent with RBA

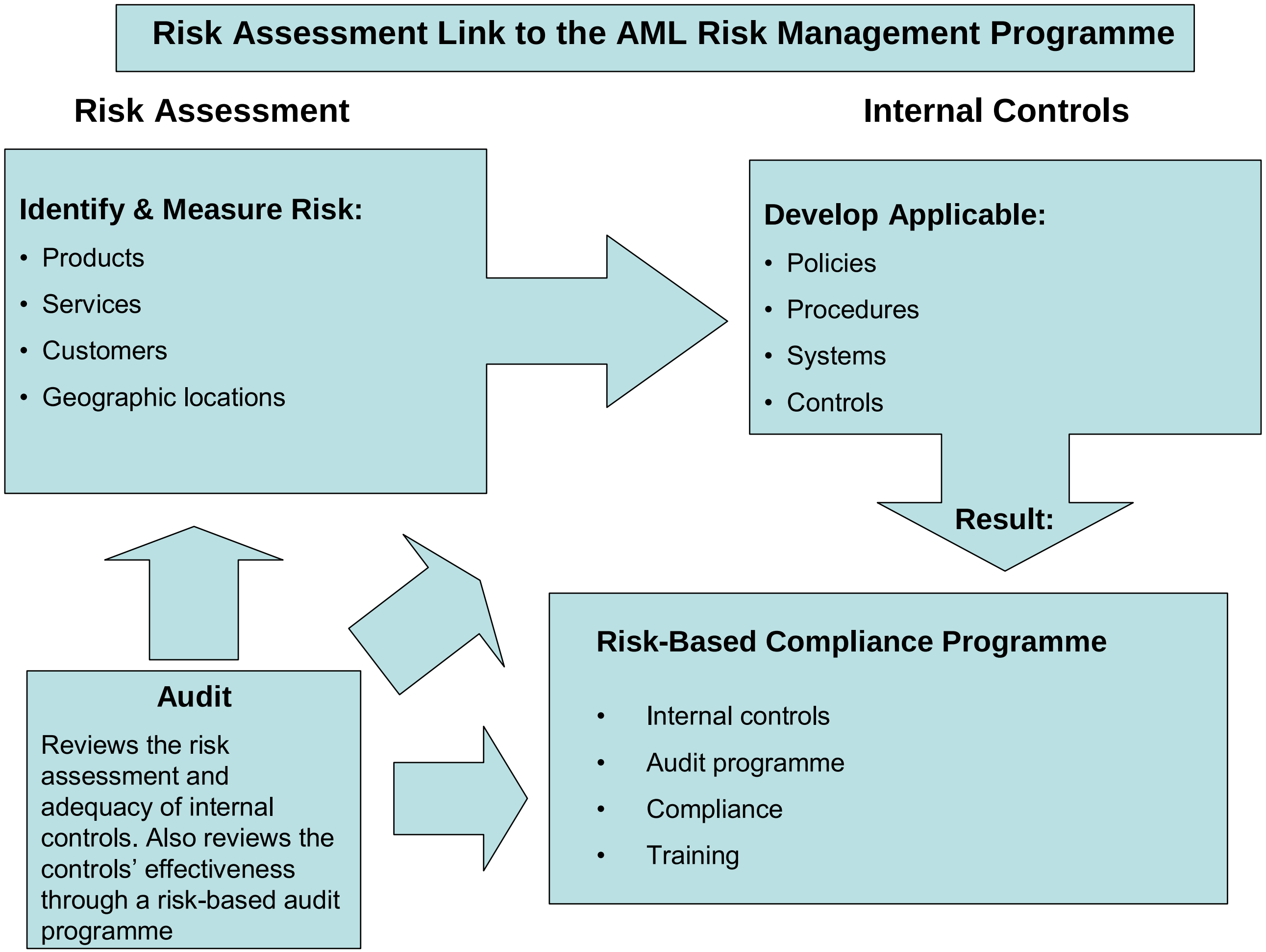
Elements of an Effective RBA

- **Sanctioning policies and procedures that**
  - Recognise that an effective RBA cannot mitigate all risks
  - Encourage effective implementation of RBA through proportionate and consistent sanctions
    - Avoid fear that institutions will be sanctioned when they have acted responsibly and implemented appropriate internal systems and controls, even if not all risks have been mitigated
    - Focus on institutions that have poorly conceived or weakly implemented systems and controls

Elements of an Effective RBA

- **Financial institutions that:**
  - Carry out an assessment of ML risks that will result in risk management programme involving
    - application of appropriate and proportionate CDD when entering into a relationship
    - ongoing due diligence
    - Appropriate control environment
  - Recognise that risks may only become evident once the customer has begun conducting transactions, making on-going monitoring of transactions an essential component of a reasonably designed RBA

Basel CBB WG model



Limitations to the RBA

- **Certain minimum issues must be in place**
  - Customer identification
  - Knowledge of the intended business relationship
  - Ongoing CDD
  - Transaction monitoring
  - Record-keeping
  - Suspicious transaction reporting
  - Freezing and sanctions orders

Costs of the RBA

- Expensive to set up and maintain systems
- Complex modelling for large and diverse institutions
- Involves significant senior management time
- Application of measures is less easy to quantify and monitor than check-list
- Risk analysis is open to challenge
- Poor initial risk analysis can be very costly in terms of legal and reputational risk

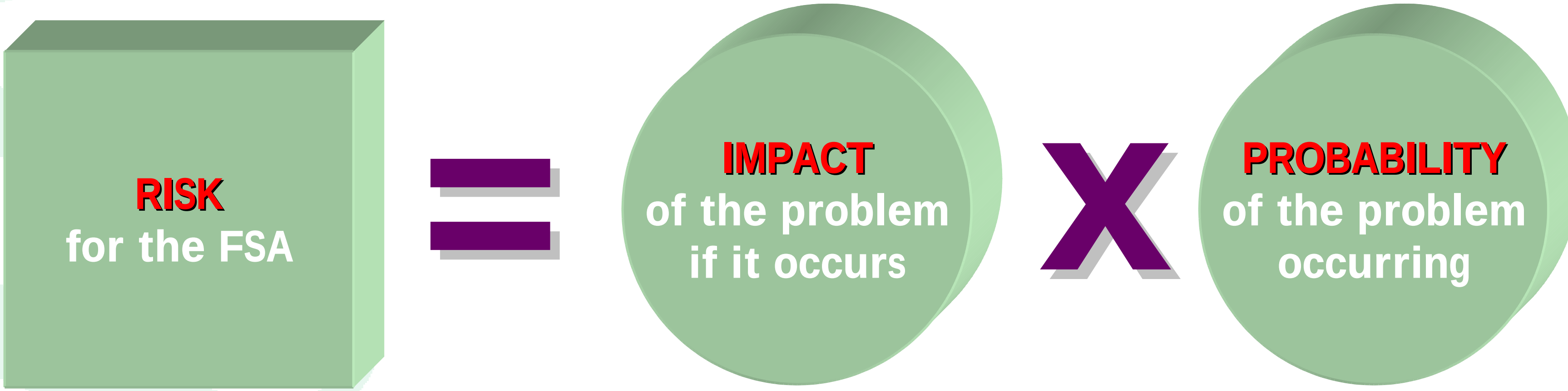
Example of Risk-Based Supervision: UK

- "**ARROW**" is the name given to the risk-based approach to front-line supervision.
- **A**dvanced **R**isk-**R**esponsive **O**perating frame**W**ork.
- It not only provides the risk metrics, but also specifies the processes used to identify, record, analyse and mitigate risks.
- Applicable to supervision generally, not simply AML/CFT
- Two components:
  - ARROW Firms framework
  - ARROW Themes framework

The Risk Basis

- **Basis of the risk assessment is the threat to FSA’s statutory objectives**
  - Maintaining confidence in the financial system
  - Promoting public understanding of the financial system
  - Securing the appropriate degree of protection for consumers
  - Reducing the extent to which it is possible to commit financial crime

The ARROW Risk Model

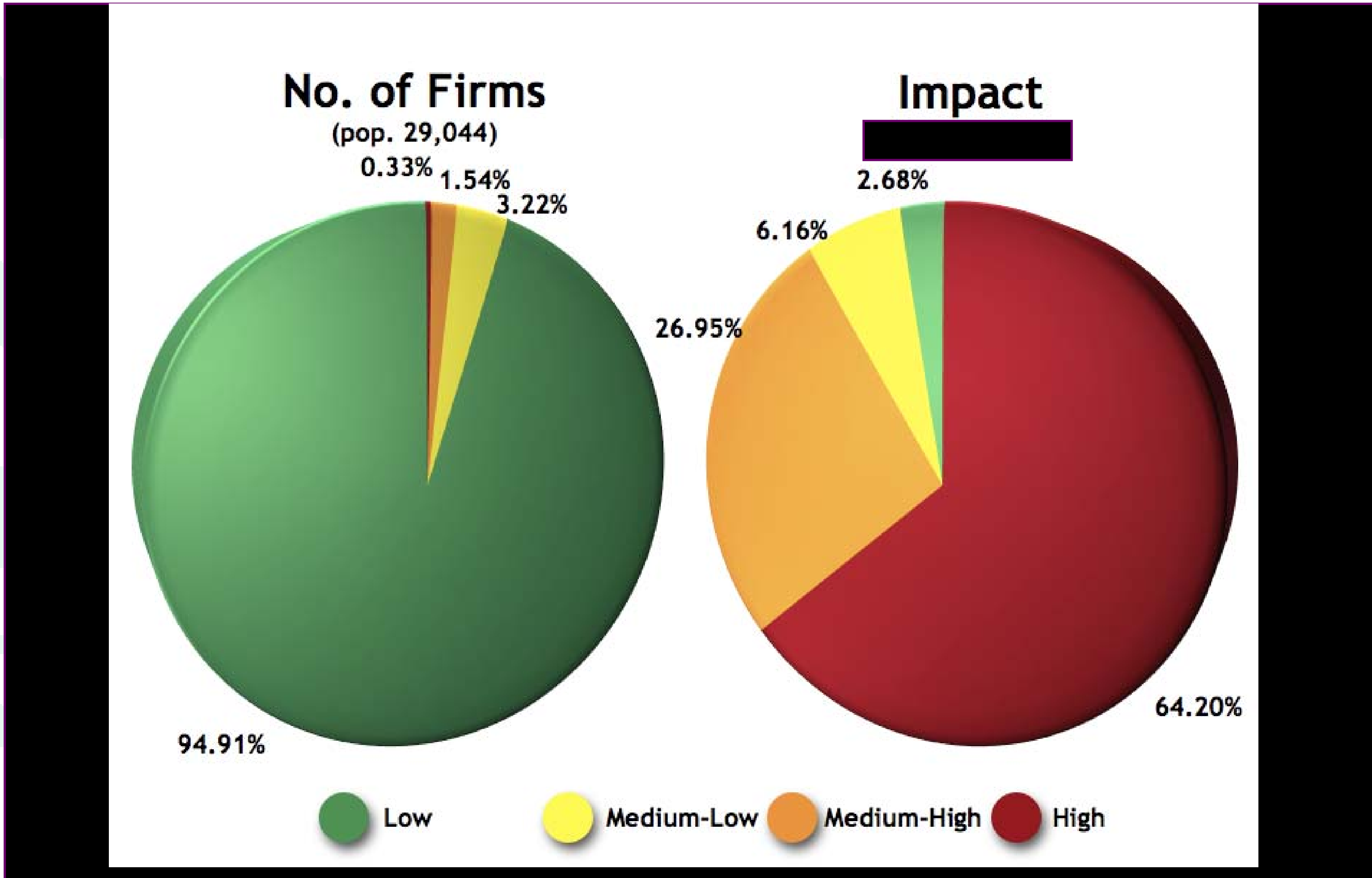


- **Impact**
  - The amount of harm that would be done to FSA’s statutory objectives if the event happens
- **Probability**
  - Likelihood of the event happening
- Ratings are high-level and largely subjective
  - **low** / **medium-low** / **medium-high** / **high**

Impact/Probability Scores

- **First stage is to determine the impact score for the firm.**
  - Essentially a measure of the overall size of the firm, calculated primarily on the basis of numerical data (assets, customers, funds under management).
  - Supervisors may input manual overrides
- **On the basis of the impact score, decision taken as to whether or not the firm needs a Full ARROW or ARROW Light assessment.**
- **Next stage is to make an initial assessment of probability.**

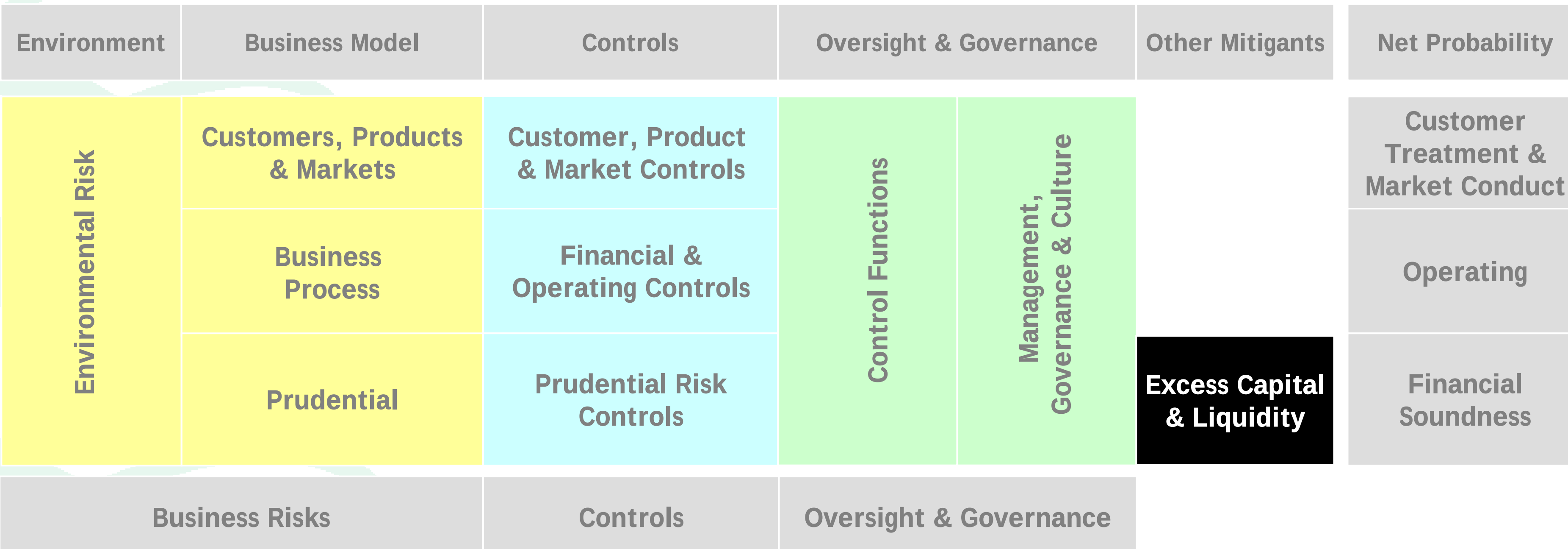
Proportion of firms in each impact category



Models of Firm Supervision

- Low impact firms:
  - "**Small firms**" approach – no relationship manager
  - Remote monitoring only – no routine on-site work
- Medium-low impact firms:
  - "**ARROW Light**" approach
  - Reduced scope assessment ("core areas")
  - Normally only around 1 day on-site visit
- Medium-high impact firms:
  - "**Full ARROW**" approach – full scope risk assessment
- High impact firms:
  - "**Close & continuous**" approach – full scope risk assessment
  - On-site work conducted throughout supervisory period

New firm probability risk model



- 10 high-level ‘risk groups’
- Combination of inherent business risks, specific controls and overarching governance
- AML risk included within controls and governance
- Capital / liquidity mitigates prudential risk only

New firm probability risk model (continued)

<table>
<tr><th>Environment</th><th>Business Model</th><th>Controls</th><th colspan="2">Oversight & Governance</th><th>Other Mitigants</th><th>Net Probability</th></tr>
<tr><td rowspan="3">Environmental Risk</td><td>Customers, Products & Markets</td><td>Customer, Product & Market Controls</td><td rowspan="3">Control Functions</td><td rowspan="3">Management, Governance & Culture</td><td></td><td>Customer Treatment & Market Conduct</td></tr>
<tr><td>Business Process</td><td>Financial & Operating Controls</td><td></td><td>Operating</td></tr>
<tr><td>Prudential</td><td>Prudential Risk Controls</td><td>Excess Capital & Liquidity</td><td>Financial Soundness</td></tr>
<tr><td colspan="2">Business Risks</td><td>Controls</td><td colspan="2">Oversight & Governance</td><td></td><td></td></tr>
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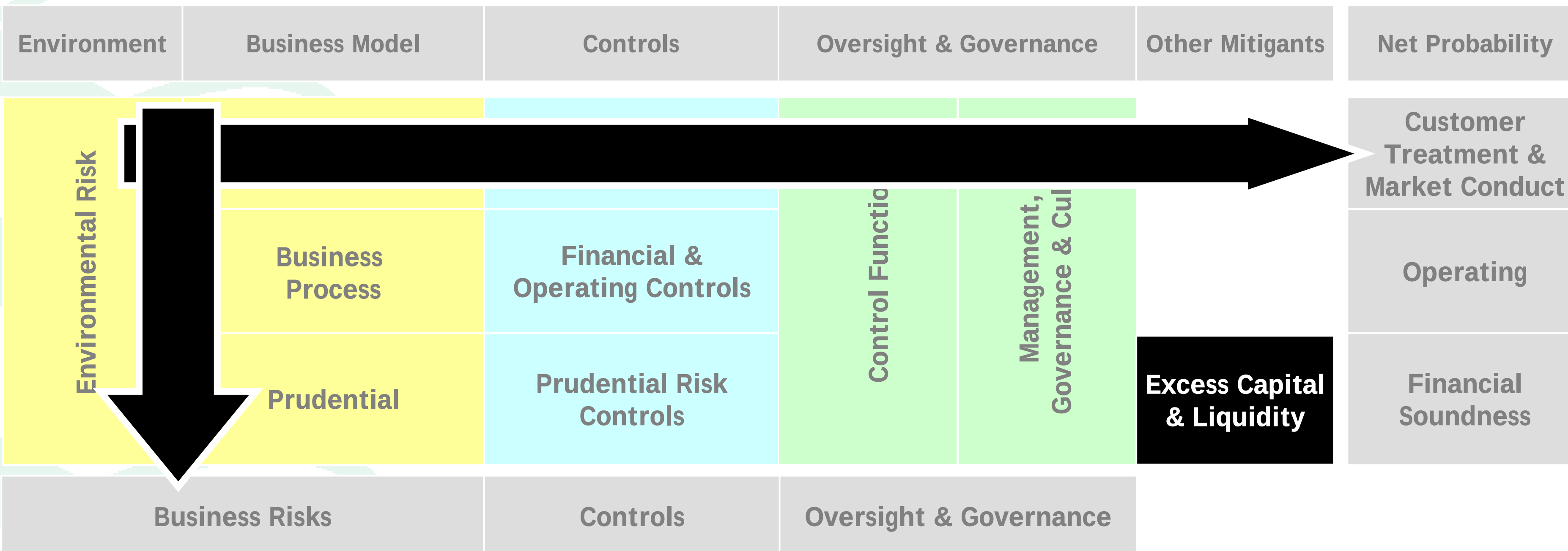
Risk types (horizontal rows):

- Customer treatment and market conduct
- Business process / operating risk (including AML)
- Prudential risk

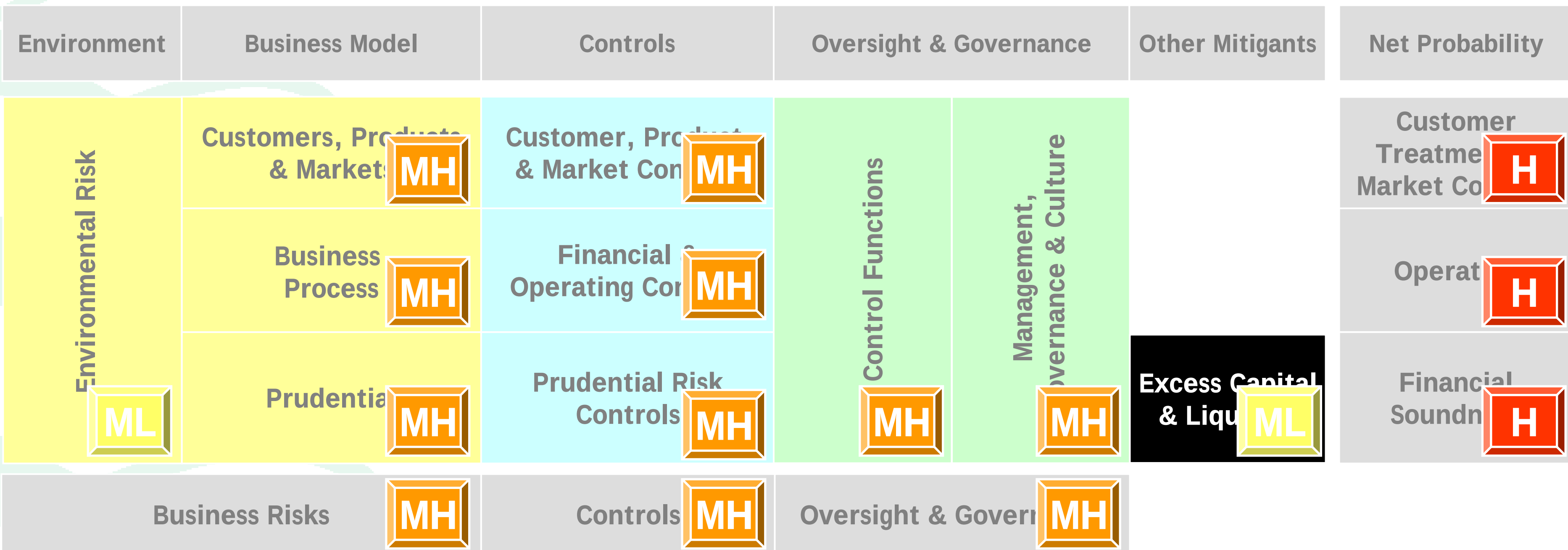
New firm probability risk model (continued)



Aggregation:

- Across rows – “multiplicative” approach (to give net probability)
- Vertically – average (to give summary scores)

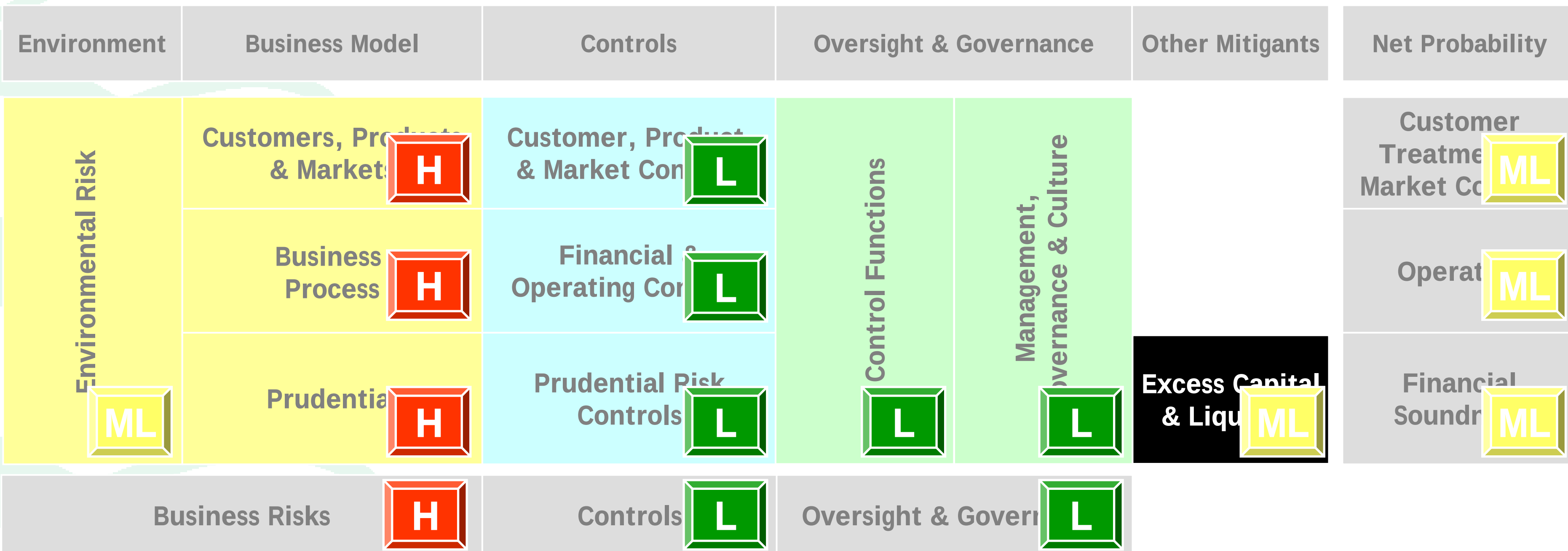
New firm probability risk model – calibration 1



Example Firm A

- Above average business risks; poor controls; poor oversight & governance (neutral environment and capital / liquidity position)
- Summary scores = Medium-high
- Net probability scores = High (problems compound)

New firm probability risk model – calibration 2

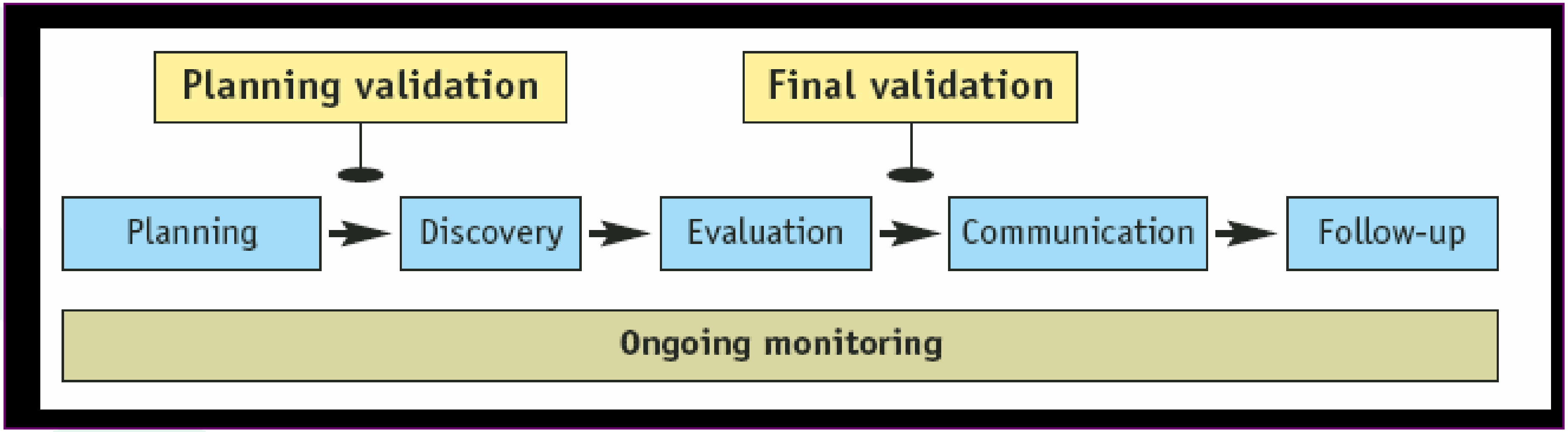


Example Firm B

- Very high risk appetite; excellent controls; excellent oversight & governance (neutral environment and capital / liquidity position)
- Summary scores = High (business risk) / Low (controls and O&G)
- Net probability scores = Medium low (risk acceptably controlled)

The Firm Assessment Process

- Periodic assessments (1-4 years) plus ongoing monitoring
- “Validation” – senior / independent review and challenge



Thematic work

- ❑ As well as supervising individual firms, the FSA engages in so-called "thematic work".
- ❑ This is done in relation to issues that go beyond an individual firm, perhaps affecting an industry sector, or the markets as a whole.
- ❑ Set up a specialist project team, which would analyse the issue centrally, and take action accordingly.
- ❑ Analysis often involves visits to a sample of firms, to gauge the size of the problem in the industry as a whole.
- ❑ As with firm-specific issues, the risk is measured in terms of impact on FSA's objectives and the probability of harm occurring.
- ❑ Can undertake thematic mitigation, e.g.:
  - ❖ "Dear CEO" letters
  - ❖ Rules changes