Examining FATF’s Recommendation On Risk Based Approach (RBA)

Analysis of The Risk Categories of FATF’s Guidance For Financial Institutions and Recommended Internal Controls and Areas For RBA Application

Nathaniel Cole, CAMS, CPA, FCA, CFE, FCA, CFC, Cr.FA, CFF, CEO, Forensics & Compliance Institute
R 1: Risk Based Approach (RBA)

• FATF Recommendation 1 permits countries and Financial Institutions (FIs) to adopt a Risk Based Approach (RBA) in discharging their obligations in respect of countering AML and CFT.

• RBA is based on the principle that resources are limited therefore such resources needs to be allocated in the most efficient manner and RBA does this.

• Adopting RBA implies that a risk management process is in place to recognize AML/CFT risks, undertake assessment of the risks and develop strategies to manage and mitigate the identified risks. This process is not static but dynamic as the risks may change over a period.
Benefits & Challenges of RBA

- A well-designed RBA will provide appropriate and effective control structure with the understanding that not all AML/CFT will be identified.
- AML/CFT Risks can be effectively managed when both the supervising or competent authorities and the FIs have a good cooperative arrangement.
- FATF also notes that adopting RBA present some challenges and there are barriers that needs to be addressed when implementing the RBA. Such as identifying the appropriate data or information to use, transitional costs, human capacity development as staff who can make appropriate judgment are needed. RBA involves a good element of making sound judgments.
Guidance for Countries in their RBA

FATF provides five high level principles that need to be considered:

• A national Risk Assessment is required in order to understand and respond to the AML/CFT threats and vulnerability.
• A regulatory framework that supports the application of RBA.
• The design of a regulatory framework that supports the application of RBA.
• Identification of the main principals or actors and also to ensure consistency.
• Effective information exchange between the public and the private sector.
Implementation of RBA

- To implement an effective RBA, FIs need to identify the criteria to assess potential AML/CFT risks of customers or categories of customers and transactions.
- Risk assessment should always be performed at the time of on boarding a customer and in certain instances this may only be more effective once the customer starts conducting transactions with the account thereby making monitoring of customer transactions an important element of a well-designed and effective risk management or RBA process.
- AML and CFT risk management can effectively be undertaken using various risk categories that provide strategies for managing potential risks when FIs subject their customers to appropriate controls and supervision.
Risk Criteria and Categories

- The most commonly used risk criteria and categories are:
  a. Country or Geographic risks
  b. Customer Risks and
  c. Product or services risks
- The weight assigned to each category will vary from FIs to FIs, as this will depend on their individual characteristics or a combination of the various risks. FIs must make their own determination based on their circumstances in weighting the risks. In certain instances, law or regulation may limit FIs discretion.
- There is no one single methodology to apply to these risk categories. Applying these risk categories only provides strategies for managing the potential AML and CFT risks.
Credible Sources

“Credible sources” are sources of some information used in addressing risks criteria or categories. Such credible sources are deemed credible enough to place importance and reliance on the information they provide and includes:

- Financial Action Task Force (FATF)
- FATF-style regional bodies such as GIABA for West Africa
- International Monetary Fund
- World Bank
- Egmont Group of Financial Intelligence Units
- Relevant National Government
- Non-Governmental Organizations (NGOs)
Country or Geographic Risks

There is no one acceptable definition of whether a particular country or geographic area represents higher risk. However, country risks in combination with other risk factors provide useful information in terms of the potential for ML and FT risks.

The following factors should be considered in determining if a particular country poses a higher risk:

a. Countries subject to sanctions, embargoes or similar measures such as the ones issued by the United Nations is an important factor. However, in certain instances some countries may not recognize the measures because of their peculiar situation with the issuer of the measures and their nature.

b. Countries identified by credible sources as lacking appropriate AML/CFT laws, regulations and other measures.
Country or Geographic Risks

c. Countries identified by credible sources as providing funding/support for terrorists activities or that have designated terrorist organizations operating within their borders.

d. Countries identified by credible sources as having significant levels of corruption, or other criminal activity.
Customer Risk

• Identifying the extent of the risks that a particular customer or categories of customer pose is important in developing an overall risk framework.

• Criteria applicable to any particular customer is used to determine if that customer or categories of customers pose a higher ML or TF risks to the FI. Application of some risk variables may mitigate or worsen the risk these customers pose.
Categories of Higher Risk Customers

• Categories of customers whose activities may be considered as posing a higher risk include the following:
  - Customers that conduct their business transactions in unusual circumstances such as significant unexplained geographic distance between the FI and the location of the customer; frequent and unexplained movement of funds.
  - Customers where the structure or nature of the entity or relationship makes it difficult to identify the true owner or controlling interests.
Categories of Higher Risk Customers

• Cash intensive businesses or businesses that generate substantial amounts of cash on particular occasional transactions.

• Charities, not-for-profit organizations or NGOs that are not subject to monitoring or supervision, especially those operating on a cross border basis.

• Gatekeepers such as accountants, lawyers, or other professionals that hold accounts at FIs on behalf of their clients.

• Customers that are Politically Exposed Persons (PEPs)
Product/Services Risk

• The overall risk assessment should include determining the potential risks posed by the products or services offered by financial institutions. This means that FIs must be constantly aware of the risks associated with new or innovative products or services. Including products or services not specifically offered by the FI but such make use of the FIs services to deliver the product.
Factors FIs Should Consider

• Services or products identified by competent authorities as being potentially of higher risks such as international correspondent banking services such as commercial payments for non-customers, pouch activities, and international private banking services.
• Services provided involving bank note and precious metal trading and delivery.
• Services that inherently have provided anonymity or can readily cross international borders, such as online banking, stored value cards, international wire transfers, private investment companies and trusts.
Variables That May Impact Risk

a. A financial institution’s RBA methodology may take into account specific risk variables for a particular customer or transaction. They may increase or decrease the perceived risk posed by the customer.
b. The purpose of an account or relationship may influence the assessed risk.
c. The size of transactions and level of assets to be deposited in such account.
d. The type and level of regulation, oversight or governance the customer is subject to.
e. The regularity or duration of the relationship
f. Familiarity with a country including knowledge of local laws
g. Use of intermediate corporate vehicles or structures that have no apparent commercial or other rational, that could result in lack of transparency.
Internal Controls & RBA

• For an effective RBA, the risk-based process must be imbedded within the internal controls of the FI. Since Internal Controls system is the responsibility of senior management, it must therefore show strong leadership and engagement in AML and should create a strong culture of compliance.
Nature & Extent of AML/CFT Controls For RBA Depends Upon These Factors

- The nature, scale and complexity of an FI’s business
- The diversity of an FI’s operations, including geographical diversity
- The customers, product and activity profile
- Distribution Channel used
- Volume and size of transactions
- Degree of risk associated with each area of the FI’s operation
- The extent to which the FI is dealing directly with the customers or is dealing with third parties, correspondents, non-face to face access or through intermediaries
Nature & Extent of AML/CFT Controls For RBA Depends Upon These Factors (contd.)

- Provide increased focus on FI’s operations such as products, services, customers and geographic location that are more vulnerable for use in ML or FT activities.
- Provide regular review of the risk assessment and management process.
- Designate an individual or individuals at management level to be responsible for managing AML/CFT compliance.
- Have an AML/CFT compliance function and review program
- Ensure adequate controls are in place before new products are offered
Nature & Extent of AML/CFT Controls For RBA Depends Upon These Factors (contd.)

- Include a process that inform senior management of compliance initiatives, identified compliance deficiencies, corrective action taken, and suspicious activity reports filed.
- Provide for program continuity despite changes in management or employee composition or structure.
- Focus on meeting all regulatory record keeping and reporting requirements for AML compliance and timely response to regulatory changes.
- Implement Risk-based customer due diligence policies, procedures and processes.
Nature & Extent of AML/CFT Controls For RBA Depends Upon These Factors (contd.)

- Provide for higher risk customers, products, and transactions.
- Have the ability to provide for a timely identification of reportable transactions and accurate filing.
- Provide for appropriate training to be given to all relevant staff.
- For a group with common control there should be a common control framework.
- Independent testing and reporting on the related AML/CFT internal controls including the adopted risk based methodology whether it reflects the risk profile of the financial institution.