FATF guidance for the banking sector on the application of the risk-based approach
In October 2014, the Financial Action Task Force (FATF) issued Guidance for a Risk-Based Approach (RBA) for the Banking Sector. This guidance updates the 2007 guidance to bring it in line with the new FATF Recommendations. This guidance is intended for the banking sector, including both the competent authorities as well as the banks they supervise. The guidance was drafted by a group of FATF members and private sector representatives, who provided input for the document.

This is the first of two articles addressing this guidance, focusing on the overall RBA concept and the guidance provided for supervisors. The next article will focus on the guidance for banks.

The guidance has four key principles:

1. Outline the principles involved in applying an RBA to anti-money laundering (AML)
2. Assist countries, competent authorities and banks in the design and implementation of an RBA by providing general guidelines and examples of current practice
3. Support the effective implementation and supervision of national AML measures by focusing on risks and mitigation measures
4. Support the development of a common understanding of what the RBA entails

The guidance recognizes that an effective RBA will build on, and reflect, a country’s legal and regulatory approach, the maturity and diversity of its banking sector and its risk profile. It sets out a framework of considerations for an RBA, but does not override the purview of competent authorities and the regulatory framework.
Risk-based approach

It is helpful to have an understanding of what is meant by RBA. In FATF’s revised 40 Recommendation, an “essential foundation” of a country’s AML framework and it applies to all the remaining 39 Recommendations. The RBA is intended to provide a flexible set of measures that enables targeted application of limited resources to effectively mitigate risk.

The RBA is not a zero tolerance approach and it recognizes that there will be instances when money laundering or terrorist financing will occur within it. While the RBA emphasizes effective mitigation, it does not mean effective elimination of risk. The only way a bank can likely completely eliminate risk is to completely avoid risk, which would mean having no customers—and no reason to be in business. The RBA is generally well understood by the banking sector, as it is fundamental to its core nature, since banks are in the business of managing risk. It is critical to understand that sometimes mistakes will be made. It is helpful to consider the analogy of credit underwriting. A bank will have a model it uses to determine who to lend to and on what terms, and sometimes, despite the best efforts of the model, borrowers will default. In these cases, the bank loses money and writes down the loss. Over time, the model is enhanced by patterns detected as a result of these losses (banks are also in the business of making money, so it has a vested interest in minimizing losses), as well as those noted by others in the sector (e.g., credit reporting databases).

The RBA also must be commensurate with the risks presented. This starts with an assessment of the risk. As in the lending analogy, the underwriting process assesses risk, such as by reviewing the application, the creditworthiness of the applicant and the nature of the request (e.g., a mortgage or revolving line of credit). Once the risk has been assessed, the mitigating controls should be applied; those with higher risks of defaulting will require more stringent requirements, such as lower or more stringent limits on the amount of credit provided, higher collateral requirements or a higher interest rate. Similarly, those with lower risks may be provided with more lenient terms, such as lower interest rates or collateral requirements.

Lastly, the RBA does not allow for banks to neglect their obligations to mitigate risk, even in low risk situations. Competent authorities should establish some minimum standards to mitigate the risks and set up a framework that provides for additional requirements as the risk increases.

Challenges

The RBA, by its very nature, is not easy to implement. Since it must be flexible, but also specific enough to mitigate risk in a complex and varied financial services industry, it is best understood in terms of general principles, rather than fixed rules. However, in some instances, the general principles will require fixed rules. It is this vagueness that seems to drive most of the confusion around the RBA.

To start with, a series of risk assessments must be undertaken, both at the national and the individual bank levels. This process starts with identifying the risks. Countries need to determine the maturity of the banking sector and its own supervisory oversight, particularly the ability to understand the risks that are present and how to mitigate those risks. For competent authorities, this includes assessing the risks present in the country, the maturity of the AML risk mitigation of the banking sector, the degree of compliance within the sector and the resources the authority has to oversee compliance within the sector. Where the authorities’ assessment indicates weaknesses in the banking sector, more stringent rules may be deemed appropriate; as the industry matures, some of these rules may be relaxed in favor of more principle-based requirements. However, the industry must be subject to some level of oversight to ensure compliance with the national standards. This continual oversight—unhindered by banking secrecy limitations that limit the effectiveness of industry-wide oversight—will enable authorities to focus their resources on institutions in higher risk areas of the industry.

Once the risks have been identified, they can be assessed, particularly as to how likely the risks are to materialize and if so, what impact they will have on the country or the individual banks? This assessment should be undertaken by skilled personnel that understand both the intricacies of the risks presented and the complexity of the country’s financial sector or the specific institution. This generally results in a three level assessment of low, medium and high, although in some instances a more graduated approach can be applied (e.g., low-medium, medium-high). The concept of RBA even allows for different ways to categorize risk.

After identifying and assessing the risks, countries and institutions must determine the most appropriate and effective way to mitigate the risks. This generally results in enhanced measures for higher risk situations and simplified measures when the risk is correspondingly lower. In some instances, exemptions from risk mitigation can even be considered, such as the exclusion of certain customers from the U.S. Customer Identification Program (CIP) rules or the exclusion of certain lower value insurance products from EU AML directives.

One of the biggest challenges is getting both the competent authorities and the supervised institutions to develop a common understanding of the RBA, as they each come at the risk/reward equation from different angles. Banks are for-profit companies and are generally looking to manage risk for a financial reward, whereas regulators are charged with overseeing compliance with regulations and the safety and soundness of an institution, which leads them to advocate more for minimizing risk. This is where it is helpful for the competent authorities to develop guidance on how to satisfy their regulatory obligations. Ideally, this is done in partnership with the industry, as they generally understand the business they are in better. A successful
partnership will provide greater understanding of the challenges and perspectives of each side and will generally result in a more satisfactory guidance that is practical and effective. Of course, with the RBA, enough flexibility needs to be allowed for different institutions to apply different approaches, based on their particular needs (for example, think of a small credit union as opposed to a large multinational bank). While certain aspects of AML controls may not be necessary (e.g., the credit union likely would not have international correspondent bank relationships), the institution must still implement effective AML controls for the business it does conduct. Regulators also need to be mindful of creating a level playing field for all regulated entities within a particular country to prevent higher risk business migrating to sectors that have weaker controls or oversight.

An additional challenge concerns financial inclusion. Being financially excluded does not mean a customer is lower risk, as there are several reasons why a customer may be excluded (e.g., criminal history, bad credit) and merit additional scrutiny. However, an RBA may be useful to foster financial inclusion, particularly for low-income individuals, if the country establishes clear exemptions for cases of clearly proven low risks. This will foster greater transparency and oversight of the financial activities of these individuals as a whole, instead of relegating them to an unsupervised channel.

**Supervisors clearly have a key role in the effective application of an RBA within the regulated sector**

**Guidance for supervisors**

Supervisors clearly have a key role in the effective application of an RBA within the regulated sector. They are responsible for allocating their resources in a risk-based manner and in a manner that is conducive to the application of an RBA by the banks they regulate. This is consistent with Recommendation 26, which requires applying resources to higher risk areas, based on the supervisor's informed assessment of the risks.

*Understanding money laundering risk*

To effectively apply resources to higher risk areas, supervisors must understand both the high level risks that the banking sector is exposed to and the lower level risks that apply to individual banks. For sectoral risks, this requires drawing on typologies, national risk assessments, input from the national financial intelligence unit (FIU) and supervisory experience. When assessing individual institutions, it is helpful to look at the inherent risk in the bank’s business model (e.g., products, services, size, customer base, delivery channels, countries/areas of operations) and the controls in place (e.g., policies, procedures, governance, the effectiveness of internal controls) based on information gleaned through the supervisory process or in partnership with other supervisors, law enforcement agencies or the FIU.

The guidance also contains an appendix with a number of examples of supervisory practices, showing how various countries have implemented the RBA. Some countries have developed specific matrices of risk and published their risk methodology for the industry, while others have developed more subjective assessments of risk and have not published their exam procedures. These varying approaches will have different ways of achieving AML compliance in the industry. As FATF continues its mutual evaluation efforts—focusing more on the effectiveness of the AML regime—this additional insight into what other countries are doing can be very helpful, both for the supervisors (to see other countries’ approaches and by looking at FATF evaluations to see how well they are doing) and for the industry and how they may need to adapt. As an example, the Office of the Comptroller of the Currency (OCC) recently announced a revision to the way it organizes its examination teams, based on work done in partnership with supervisors from other countries.

*Mitigating money laundering risk*

As part of the RBA, supervisors should determine the frequency of exams for banks within the sector, focusing resources on those that present the greatest risk, whether in terms of conducting more rigorous exams, more frequent exams (including ad hoc exams when appropriate) and/or conducting targeted exams within higher risk areas of banks. This can be done by looking at specific business units or the controls related to CDD, reporting, record keeping, such as via conducting testing and/or interviews with relevant members of management and/or staff. Supervisors can also determine the appropriate level of on-site vs. off-site supervision. In this case, some countries require their banks to complete surveys, which the supervisors use as part of their risk-based approach. In cases where foreign operations are present (i.e., with offshore branches), additional considerations come into play, including the level of cooperation with the host country supervisor, the ease with which information to conduct an exam remotely (especially in jurisdictions where information cannot be shared outside the country) and the feasibility of conducting on-site examinations in a foreign country (depending on the risk of the branch and the cost of sending a team of examiners). Also, since supervisors are charged with ensuring compliance with the FATF Recommendation to prevent criminals and their associates from owning banks, they may also adjust the intensity of their authorization requirements to achieve
Supervisory staff can develop sufficient knowledge through ongoing training

...this, such as by requiring additional information when greater risks of criminal ownership of banks are present.

Supervisors should use their findings to update their risk assessments, which will in turn determine higher risk areas that should merit further scrutiny. They should also update rules and guidance as appropriate to ensure they are relevant and adequate. As needed, this should be communicated with the broader industry to ensure that they update their AML programs appropriately to help foster a stronger AML effort. In the case of specific examinations—to the extent permitted—the results of these should be communicated to the examined bank to enable it to improve its RBA.

**Supervisory responsibilities and considerations**

Supervisors are responsible for ensuring that they discharge their functions in a way that is conducive to bank’s adoption of an RBA. This entails having a knowledgeable staff that understands the risks (at both the sectoral level and at the institution level) and that can assess the effectiveness of the bank’s controls at mitigating these risks. It also should entail setting forth clear expectations to the regulated sector on what should be done to comply with the regulatory framework, such that supervisory actions are consistent and proportionate.

Supervisory staff can develop sufficient knowledge through ongoing training as well as by learning from others’ experiences. As noted earlier, this can involve comparisons with other jurisdictions and by reviewing information from international and local authorities to help them gain greater AML knowledge and supervisory expertise. In addition, it may be useful to gain a better understanding of industry best practices, such as learning what some banks do to mitigate risks. However, it is important to note that due to varying factors within banks, what works well at one bank may not work as well at another. Supervisors should engage the banks in discussions as to these differences, as the discussion may be beneficial for both parties. For instance, the institution may be able to provide additional insight to the supervisor about their controls and the bank may gain valuable knowledge that will help them mitigate their AML risk.

To facilitate the RBA within the industry, supervisors should issue guidance to the industry, clearly outlining their expectations. This should be based on appropriate consultation with appropriate stakeholders, including the industry and other interested government parties such as law enforcement and other regulatory authorities, to ensure a consistent approach is taken at the national level. The form of the guidance may also vary between high-level requirements, risk-based rules, interpretations of rules and detailed guidance on the application of particular controls.

In addition, supervisors should consider addressing the issue of financial inclusion in their guidance to institutions. Financial inclusion has been an increasing focus of FATF, as it is concerned about the lack of transparency into and traceability of financial activities of those who are not included within the financial system. For low-income individuals who have difficulty accessing the financial system, countries may apply simplified due diligence in instances where the risk is proven to be low. This might include providing for lower standards of verification, as many of these individuals may not have the same documentation that other clients have (e.g., driver’s licenses, credit histories or documentation evidencing address). However, certain individuals, such as those with poor credit histories or criminal backgrounds, should not be subjected to simplified due diligence merely because they are financially excluded, as the risks do not justify such treatment.

**Summary**

Ultimately, AML efforts involve a collective partnership between supervisors and the industry to serve the national interest in preventing and deterring criminal activity. Since both parties have limited resources to do this, the RBA has evolved to enable the application of additional risk mitigation where the risks are higher, recognizing that not all risks can be completely eliminated, but rather can be effectively mitigated or managed. This requires a mutual understanding of what the risks are and what can be done to effectively mitigate these risks. Given the varying complexity and operational models of the industry, there is not necessarily a one-size-fits-all approach that will work, hence the need for an RBA.

Since the RBA is meant to create a common framework to mitigate money laundering and terrorist financing risk, perhaps the most important aspect is that of mutual understanding between the regulators and the regulated. Ongoing and open dialogue is critical to ensure full understanding of the varying perspectives on risk and risk mitigation. Just as launderers change their methodology, supervisors and banks need to keep communicating about these changes to stay abreast of the typologies and effective risk mitigation strategies. Ultimately, this dialogue should foster a culture of compliance that enables an effective means to prevent and deter money laundering and the underlying criminal activity that it represents.

**Kevin M. Anderson, CAMS, director, Bank of America, Falls Church, VA, United States, kevin.m.anderson@bankofamerica.com**