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Perspectives on FATF's risk-based guidance

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Abstract

Purpose – The purpose of this paper is to investigate Financial Action Task Force (FATF)’s risk-based guidance to combat money laundering and terrorist financing to determine its approach to the identification and management of low-risk providers, products and transactions.

Design/methodology/approach – The paper analyses the relevant FATF recommendations and its guidance notes and reflects on key questions for regulators and financial institutions.

Findings – FATF has not defined “risk” for purposes of the risk-based approach. The absence of a clear definition complicates the identification of low-risk products. FATF does provide an example of a risk matrix that can be used to identify low-risk banks, but the example is based on assumptions and generalisations that are not sustainable. In addition, it identifies certain low-value transactions as “low risk” transactions. The paper reflects on the role of value as an indicator of risk and concludes with a number of suggestions to clarify the conceptual framework.

Originality/value – Low-risk products and transactions are often overlooked because the risk-based approach focuses attention on high-risk matters. Low-risk products are however crucial to the efforts to increase financial inclusion. The paper identifies gaps in the current conceptual framework and indicates ways in which they can be addressed.

The 2003 revised 40 Recommendations of the Financial Action Task Force (FATF, 2003) allow countries to implement a risk-based approach in relation to key elements of their anti-money laundering (AML) and combating of financing of terrorists (CFT) frameworks. A risk-based approach involves the development of appropriate risk control measures based on a process of identification and categorization of risk.

In the AML/CFT context, the phrase is used in connection with regulation, supervision and compliance. Risk-based regulation refers to the tailoring of rules to focus on instances of higher risk. Risk-based supervision is an approach where the supervisor focuses on risk as posed and managed by regulated entities and allocates supervisory resources on the basis of their risk profiles. A risk-based approach generally leads supervisors to devote less attention to entities that pose a lower risk and rather focus their attention and resources on those posing a higher risk[1]. Regulated entities that follow a risk-based approach to AML/CFT compliance tailor their control measures to fit the risk profiles of their different products and clients. The main benefit of a risk-based approach in all three cases is an appropriate and efficient allocation of resources[2].
Although the introduction of a risk-based approach to AML/CFT was welcomed, it was not clear how this approach should be implemented within the FATF framework. As a consequence, FATF issued a number of guidance notes during 2007 and 2008. This article highlights key aspects of that guidance for financial service providers that offer low-risk products and identifies a number of matters that FATF will need to consider.

Much of FATF’s guidance focuses on the identification and management of high-risk cases. This is a natural consequence of the risk-based approach. However, the correct identification and management of low-risk products, clients, and transactions is of great regulatory and corporate importance. The AML/CFT framework is broad and captures many products and transactions that do not pose a significant money laundering or terror financing risk. The risk-based approach allows appropriate, often simplified, controls to be implemented in respect of such products and transactions. Simplified controls are easier and cheaper to implement and maintain. They also impose a lesser burden on clients. When correctly implemented, these controls free up resources that can be focused on higher risk cases. They also ensure that AML/CFT controls do not pose an unnecessary barrier to low-risk clients wishing to access low-risk financial products. Correctly designed and implemented controls for low-risk products and clients are therefore regarded as an important element of a facilitative financial inclusion regime (de Koker, 2006a, b; Bester et al., 2008; Chatain et al., 2008).

Primary challenges lie, of course, in the correct identification of those providers, products, and clients that pose a lower money laundering and terrorist financing risk and in the formulation of responses that are proportionate to that level of risk. These challenges can only be met if we clarify our understanding of risk and especially the meaning of “low risk” in the AML/CFT context. FATF listed some indicators of low-risk providers and products in the recommendations and in their guidance on the risk-based approach. These indicators and some of the thoughts that underlie them are discussed in this article.

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1 FATF and the risk-based approach

The “FATF” is the international AML/CFT standard-setting body. It issued its first set of standards regarding the countering of money laundering in 1990. In 2001 these recommendations, known as the 40 Recommendations, were complemented by a set of special recommendations on the combating of terrorist financing. The recommendations are not binding in law but the international community expects countries to comply with the standards[3]. The majority of countries in the world form part of a framework that evaluates their compliance with the FATF recommendations in terms of a stringent standard evaluation methodology.

The 40 Recommendations were extensively revised in 2003. The revised recommendation introduced a number of new principles that underpin a risk-based approach to AML/CFT[4]. In essence, the recommendations allow a risk-based approach at two levels. Firstly, countries are allowed to be guided by their assessment of
AML/CFT risk when they design or amend specific elements of their AML/CFT regulatory framework. Secondly, countries are allowed to permit individual institutions to design elements of their AML/CFT control measures on a risk sensitive basis (FATF, 2007a, para. 1.7).

It is important to note that the application of the risk-based approach is limited to specific elements of the framework and controls. A country is, for instance, not allowed to argue that its exposure to money laundering is so low that it does not need to adopt laws to criminalise money laundering or does not need to establish a financial intelligence unit. Similarly, countries cannot allow their regulated institutions to design their controls as if a group of clients designated as high-risk by FATF, for instance politically exposed persons, are not posing a high risk.

In general, FATF's risk-based approach guides countries and institutions to focus their attention and resources on persons and activities posing a higher risk of money laundering and terror financing, while allowing them, within limits, to devote less attention and resources to those posing a lesser risk of abuse. Within this framework, regulated institutions determine the relevant risks and tailor their controls on the basis of their risk appraisal. Institutions are then inspected for the reasonableness of, and justification for, the design of the controls. This approach is often contrasted with a so-called “rule-based” approach where the regulator determines the controls that the regulated must apply. In a rule-based system institutions are inspected to determine whether they implemented the prescribed controls. Risk is not unimportant in the latter context because a reasonable regulator will determine the relevant controls based on its assessment of the risks. The main difference between the two approaches is the allocation of responsibility for determining the risk as well as the appropriate risk management actions: the regulator (rule-based) or the regulated (risk-based). In practice, the approaches may be even be combined with some elements being regulated in a rule-based and others in a risk-based manner.

It is not compulsory for countries to introduce a comprehensive risk-based approach to AML/CFT. They have a choice. They may design their regulatory framework in a manner that incorporates some or all of the elements of such an approach or, alternatively, may implement a rule-based approach. Both options, are, however, subject to the condition that matters classified as posing a high-money laundering or terrorist financing risk by FATF, should be managed by regulators and the regulated as high-risk matters. It is optional, on the other hand, whether lighter or simplified regulation or controls will be applied to those classified as low-risk matters.

The risk-based approach is highly complex and FATF (2007a), after many requests, issued some high-level general guidance on the implementation of this approach in the financial sector in June 2007. Further and more specific guidance were issued for those businesses and persons classified as “non-financial businesses and professions”[5] (accountants (FATF, 2008d), real estate agents (FATF, 2008g), trust and company service providers (FATF, 2008h), dealers in precious metal and stones (FATF, 2008a), legal professionals (FATF, 2008f) and casinos (FATF, 2008e)). These guidance notes should be read with other risk-related guidance issued by FATF (2008c), for instance its 2008 guidance on money laundering and terrorist financing risk assessment strategies.
2 The framework for the FATF’s risk-based approach

The FATF’s guidance notes on the risk-based approach are rich documents that record and flesh out various aspects of the recommendations. From the perspective of financial institutions with low-risk products, the following general principles are particularly relevant.

First, the implementation of a risk-based approach to combating money laundering and terrorist financing risk requires appropriate risk management resources and expertise within the regulators and the regulated. It requires, for instance, the ability to exercise sound judgement and to respond appropriately to the identified risks. If controls are unnecessarily tight and rigid, resources may be wasted. On the other hand, if the controls are too lax, they will be ineffective to counter the risk (FATF, 2007a, para. 1.20). Regulators, in particular, should also realize that a risk-based approach will lead to greater complexity in the regulated sector. Institutions will have different risk profiles and will respond differently to risk. The regulator will need sufficient resources to supervise and regulate the diverse institutional responses while ensuring a sufficient measure of consistency to avoid regulatory arbitrage.

Second, the quality of the controls depends heavily on appropriate risk-related information and the correct assessment of the risk. Countries that wish to implement a risk-based approach should ideally have a thorough understanding of actual and potential money laundering and terrorist financing risks. This understanding can flow from a national risk assessment process undertaken by the government and informed by public and private sector expertise (FATF, 2007a, para. 1.9, 2008c). Countries must provide their regulated institutions with sufficient, reliable information about these risks to enable them to design and implement proportionate controls.

Third, risk assessment and risk management are continuing processes. The outcome of risk assessments will change as threats and vulnerabilities change (FATF, 2007a, para. 1.9). This, in turn, will require a review of the adequacy of the controls.

Fourth, reasonable controls that are designed on the strength of a reasonable risk assessment process will provide reasonable protection against money laundering and terrorist financing but will not prevent all instances of money laundering and terrorist financing abuse (FATF, 2007a, para. 1.13). Failures of the controls will often be due, at least in part, to an inadequate understanding of risk and the limited ability to correctly identify and evaluate future risk based on past experiences or predictive abilities (FATF, 2008c, para. 18-22). Authorities should understand the benefits and limitations of a risk-based approach and should create an environment that empowers regulated institutions to take reasonable and appropriate steps to counter money laundering and terrorist financing risk. An institution that implemented appropriate and reasonable controls should not be exposed to regulatory or other enforcement action if money laundering or terrorist financing occurs. Such action is best reserved for those cases where there was inadequate implementation of the risk-based approach (FATF, 2007a, para. 1.13).

It is submitted that these principles are sound and pragmatic. They are far removed from some of the more theoretical and cautious responses that came primarily from
Europe when the risk-based approach was first debated. European regulators were initially critical about the progressive way in which the UK implemented an AML/CFT risk-based approach in respect of its financial sector (Financial Services Authority, 2003). Consensus about the current principles developed in the processes around the adoption and implementation of the Third European Union Money Laundering Directive[6] and the 2007 third FATF mutual evaluation of the UK’s compliance with the FATF (2007b) recommendations.

The FATF guidance notes also present its thinking regarding a risk-based approach in respect of terrorist financing. Even though the guidance notes discuss a risk-based approach to “AML/CFT” the guidance is slanted towards AML. This is intentional. Although FATF (2007a, para. 1.38) recognizes that it is preferable to apply a risk-based approach to CFT where reasonably practical, it believes that further consultation with key stakeholders is required to compile a more comprehensive set of indicators of terrorist financing.

In essence, terrorism can be funded in two ways:

1. with money earned legitimately, for instance where ordinary citizens or another state supports a terrorist group and donates funds to it; or
2. with proceeds of crime, for instance where the terror group engages in crime to generate funds for its activities.

In its guidance on the risk-based approach, FATF (2007a, para. 1.35) remarked as follows:

Where funds are derived from criminal activity, then traditional monitoring mechanisms that are used to identify money laundering may also be appropriate for terrorist financing, though the activity, which may be indicative of suspicion, may not be identified as or connected to terrorist financing. It should be noted that transactions associated with the financing of terrorists may be conducted in very small amounts, which in applying a risk-based approach could be the very transactions that are frequently considered to be of minimal risk with regard to money laundering. Where funds are from legal sources then it is even more difficult to determine that they could be used for terrorist purposes. In addition, the actions of terrorists may be overt and outwardly innocent in appearance, such as the purchase of materials and services (i.e. commonly held chemicals, a motor vehicle, etc.) to further their goals, with the only covert fact being the intended use of such materials and services purchased (own emphasis).

Given these difficulties, FATF believes that the success of a risk-based approach to CFT depends on a good understanding of terrorist financing methods and specific intelligence provided by the authorities. In the absence of such information and intelligence, the CFT risk mitigation measures are generally based on perceptions of and general knowledge about terrorist financing. Transactions linked to countries or regions where terrorists or their funders are known to operate will therefore be regarded as posing a higher terrorist financing risk than those linked to countries that are not regarded as relevant for terrorist financing purposes. Measures such as these are often combined with the normal indicators for money laundering. The latter are useful to detect terror financing involving proceeds of crime. Further controls include monitoring
mechanisms that screen the names of customers against the names of known terrorists and terrorist front organizations on various national and international sanctions lists[7].

Against the backdrop of these general principles relating to a risk-based approach, the guidance that is pertinent to low-risk products are discussed below.

3 FATF’s guidance and the identification of low-risk providers and products

3.1 Low-risk service providers

The FATF’s guidance regarding lower risk providers of financial services is mainly aimed at the policy makers and regulators who are considering the reach of a country’s AML/CFT framework. While FATF requires all financial institutions to be adequately regulated and supervised for AML/CFT purposes, it recognizes that such regulation and supervision may, to some extent, be adjusted to their AML/CFT risk profiles (FATF, 2007a, para. 1.24).

Recommendation 23 addresses the need for appropriate regulation and supervision of financial institutions. It differentiates between two broad groups of financial institutions. The first group comprises banks, insurance companies and securities brokers[8]. FATF recommends that the regulatory and supervisory measures which apply for prudential purposes to these institutions and are relevant to AML/CFT, should be applied in a similar manner for AML/CFT purposes. The second group comprises all other financial institutions that do not fall within the first group[9]. They should be licensed or registered and appropriately regulated and supervised for AML/CFT purposes “having regard to the risk of money laundering or terrorist risk in that sector”. Countries should follow a risk-based approach when they determine the reach and the depth of the regulation of the institutions in this group. The application of this principle is, however, limited as recommendation 23 stipulates that, at a minimum, specific measures need to apply to businesses providing money or value transfer services and those providing money or currency changing services. They should be licensed or registered and subject to effective systems to monitor and ensure compliance with national AML/CFT requirements.

Recommendation 24 introduces a similar risk-based principle in respect of the designated non-financial businesses and professions and also divides them into two groups. According to the glossary to the recommendations this group includes casinos, real estate agents, dealers in precious metals and stones, lawyers, notaries and other independent legal professionals, accountants and trust and company service providers. Casinos are differentiated from the rest of the group. Given their vulnerability to AML/CFT abuse, countries are required to have a comprehensive regulatory and supervisory regime for casinos. This regime must meet a list of minimum requirements that are set out in recommendation 24(a). Countries are required to ensure that the remaining designated non-financial businesses and professions are subject to effective systems that monitor and ensure their compliance with AML/CFT requirements. Recommendation 24(b) proceeds to state in relation to these measures: “This should be performed on a risk-sensitive basis”.
FATF also allows countries to limit the application of some of the recommendations to financial institutions in specific low-risk cases. Countries are also allowed to do so in respect of those institutions that form part of the first group of institutions for purposes of recommendation 23 (essentially banks, insurance businesses and securities brokers). This can, however, only be done on a strictly limited and justified basis but the exemption may be partial or comprehensive and may:

- exempt a person or entity from the application of the standard AML/CFT measures if that person carries on a financial activity on an occasional or very limited basis (having regard to quantitative and absolute criteria) such that there is little risk of money laundering or terrorist financing activity occurring; and
- exempt some financial activities from the application of some or all of the recommendations, based on a proven low risk of money laundering or terrorist financing[10].

The recommendations do not set out principles that countries can apply to identify low-risk providers of financial services[11]. Further indications are, however, provided in the risk-based guidance notes.

FATF’s 2007 Guidance on the Risk-based Approach to Combating Money Laundering and Terrorist Financing includes an Annex 2. This annex is attributed to the Working Group on Cross-Border Banking of the Basel Committee on Banking Supervision. It is appended to the guidance note as an example of an assessment matrix that regulators may wish to consider when prioritizing supervisory work within the framework of a risk-based approach to supervision. According to its heading it is an analysis of specific risk categories that financial institutions and supervisory authorities may use in assessing AML risks. The matrix is divided into indicators of low, moderate and high-risk banks. The matrix uses essentially the same indicators and merely scales them for low, moderate and high-risk categories. For purposes of this paper, the indicators for the low-risk category are of interest. The following are listed:

- Stable, known customer base.
- No electronic banking (e-banking) or the web site is informational or non-transactional.
- There are a few high-risk customers and businesses.
- No foreign correspondent financial institution accounts. The bank does not engage in pouch activities, offer special-use accounts, or offer payable through accounts.
- The bank offers limited or no private banking services or trust and asset management products or services.
- Few international accounts or very low volume of currency activity in the accounts.
- A limited number of funds transfers for customers, non-customers, limited third transactions and no foreign funds transfers.
- No transactions with high-risk geographic locations.
- Low turnover of key personnel or frontline personnel such as customer service representatives, tellers or other branch personnel).
The set of indicators paints a picture of a small, traditional retail bank that has served a predominantly middle class client base for a number of years. From the perspective of a supervisor that is concerned about systemic risk, it seems sensible to regard such a bank as enjoying a lower priority than large, international financial institutions. However, the indicators do not throw much light on the money laundering risk posed by such an institution or on the FATF’s definition of risk and especially of the concept of “low money laundering risk”.

Although the FATF provided extensive guidance regarding the implementation of the risk-based approach, it has not clearly defined “risk” for purposes of this approach. Is it, for instance, the risk that significant sums of money may be laundered or is it perhaps the risk that any sum of money may be laundered? In the case of a service provider, is it perhaps the risk that occasionally a significant sum of money may be laundered through the provider or is FATF focusing on more frequent abuse of a provider, despite the total value of such transactions being lower? FATF identifies value as an important element of the money laundering risk profile of a transaction (Section 3.2.1) but does not regard it as appropriate to indicate the level of risk of a transaction for terrorist financing purposes. The set of indicators refer to a “very low volume of currency activity” in any international account but does not refer to the volume or value of transactional activity in respect of its other domestic business. It therefore leaves a question mark as to whether FATF regards it as a relevant general element of the risk profile of a financial institution.

The vagueness regarding the definition of risk undermines this attempt at defining indicators for low, medium and high-risk service providers. In terms of this set, a county bank may be classified as a low-risk bank when it displays all of these indicators. However, the few, long-standing high-risk clients that it may have, may pose a very high-AML risk.

Further weaknesses in the set of indicators are owing to the assumptions and generalizations that underlie the indicators. The drafters appear to assume, for instance, that a bank that does not offer transactional electronic banking services is less vulnerable to AML/CFT abuse than a bank that offers a wide range of such services (for instance, account transfers, e-bill payment or accounts opened via the internet). This, in turn, seems to be linked to an assumption that money launderers and terrorist financiers tend to choose electronic banking services rather than normal banking services. The correctness of this assumption, especially when made in a global context incorporating developed and developing economies, is arguable. While the anonymity and ease of electronic banking may make it attractive to some launderers and terrorist financiers, those who may access it would also be deterred by the traceability of these transactions and the scrutiny to which they are subjected. It is also risky to generalize about the preferences of money launderers and terrorist financiers. This is a diverse group comprising many individuals that have different skills sets and preferences. Some may prefer high technology while others may feel more comfortable using the more familiar traditional banking services, especially where they have accomplices or contacts inside the bank.

Those favouring the identification of indicators of low-risk financial institutions may argue that the reliability and sophistication of the indicators will improve as we grow
our knowledge of money laundering. Institutions can, however, be abused in so many ways by money launderers and terrorist financiers, that it may not be worthwhile to invest too much effort in an attempt to produce a list of globally applicable indicators of low-risk institutions. The set of indicators may become so extensive and qualified that it would serve little practical purpose. The value of such a national list is also questionable. Like any list of this nature, it would tend to induce a sense of false security in those institutions that are classified as “low risk” institutions. It may, on the other hand, be helpful to accept that all institutions can be abused by money launderers and terrorist financiers and that their risks can only be mitigated by appropriate control measures. The focus can then shift to the types of products that an institution offers and the effectiveness of the AML/CFT controls that it employs in respect of those products.

3.2 Low-risk products and transactions

The FATF’s recommendations (especially the interpretative notes to the recommendations) and its risk-based guidance notes list a number of customers, products and transactions that may be subjected to simplified or reduced customer due diligence measures. The list of customers focuses mainly on those where information on their identity and beneficial ownership is publicly available, for instance publicly listed companies, and those institutions that are already subject to adequate controls in the national systems, for instance financial institutions. In its 2007 guidance note on the risk-based approach, however, these examples are listed together with others as examples of “recognized lower risk scenarios” (FATF, 2007a, para. 3.11). The following are listed as such:

- Publicly listed companies subject to regulatory disclosure requirements.
- Other financial institutions (domestic or foreign) subject to an AML/CFT regime consistent with the FATF Recommendations.
- Individuals whose main source of funds is derived from salary, pension, social benefits from an identified and appropriate source and where transactions are commensurate with the funds.

The original listing of the first two categories of institutions in the recommendations seems more defensible. They were listed not necessarily because they pose a lower AML/CFT risk but because information about their ownership and control is publicly available or because they are subject to other forms of regulatory controls. As a result, FATF indicated that they may warrant simplified due diligence measures. However, it does seem incongruous to list them together with salaried or pensioned individuals as examples of lower risk scenarios as was done in the guidance note. Financial institutions are involved in most of the high profile money laundering cases and there are unfortunately too many examples of publicly listed companies’ involvement in serious fraud, corruption and other offences.

The list concludes with a final bullet point listing an example of low-risk transactions:

- Transactions involving de minimis amounts for particular types of transactions (e.g. small insurance premiums).
This bullet point refers to FATF’s indication in the interpretative notes to the recommendations that simplified or reduced customer due diligence measures could be acceptable in respect of various transactions or products that are either difficult to abuse for money laundering or involve small amounts such as[12]:

- A life insurance policy where the annual premium is no more than USD/EUR 1,000 or a single premium of no more than USD/EUR 2,500.
- An insurance policy for a pension scheme if there is no surrender clause and the policy cannot be used as collateral.
- A pension, superannuation or similar scheme that provides retirement benefits to employees, where contributions are made by way of deduction from wages and the scheme rules do not permit the assignment of a member’s interest under the scheme.

Monetary limits are also present in other elements of the FATF framework. While FATF’s recommendation five requires financial institutions to undertake customer due diligence measures when an account is opened, it is, for instance, more relaxed in its requirements regarding occasional (non account-based) transactions. Unless there is a suspicion of money laundering or terror financing, regulated institutions are only required to undertake these measures if the transaction or a series of linked transactions exceeds USD/EUR 15,000[13]. The FATF’s (2008i, para. 4) Revised Interpretative Note to Special Recommendation VII: Wire Transfers also uses a monetary limit. Cross-border wire transfers should be accompanied by accurate and meaningful originator (sender) information. However, the interpretative note allows countries to adopt a minimum threshold that may not be higher than USD/EUR 1,000. For cross-border transfers below this threshold countries may decide not to require financial institutions to identify, verify, record, or transmit originator information.

Two issues should be noted at this point: FATF allows countries to decide whether financial institutions could apply the simplified customer due diligence measures only to customers in its own jurisdiction or extend them to customers from any other jurisdiction it regards as compliant with the FATF recommendations. Furthermore, these examples are not absolute. If there is a suspicion of money laundering or terrorist financing or if there are other factors present that are indicative of a higher risk, simplified measures will not be appropriate.

The FATF examples refer to two different types of low-value products and transactions:

1. Those that are difficult to abuse for money laundering purposes (for instance an insurance policy for a pension scheme if there is no surrender clause and the policy cannot be used as collateral).
2. Those that are not necessarily difficult to abuse but involve amounts under a specified limit (for instance occasional (non account-based) transactions of less that USD/EUR 15,000).

The first group consists of transactions that are less likely to be abused by launderers because they do not readily lend themselves to such abuse. The criminal may invest proceeds of crime in these products but will not be able to extract it with ease. These products are therefore less vulnerable to money laundering abuse and are probably
truly low-risk products. It is submitted that they can also be regarded as such from a
terror financing perspective.

The second group consists of transactions that, in the normal course, may be subjected
to simpler AML/CFT controls because their value is capped. In essence, it means that a
transaction may involve proceeds of crime but the value involved will not exceed a
specified amount. Not all FATF examples involving involving monetary limits are
specifically classified as low-risk products by FATF, but they are often treated as such
within a risk-based approach. The role of value in respect of this second group requires
closer inspection.

3.2.1 Value involved in a transaction as an indicator of risk

Compliance risk is often measured in terms of the probability of the occurrence of an
event and its impact when it does occur (Ludwick, 2006; Birindelli and Feretti, 2008).
The probability of the abuse of a transaction or a product as well as the impact of the
abuse should it occur, can, to some extent, be limited by capping the amounts involved.

It is believed that money launderers are less attracted to products that restrict them to
laundering only a small amount at a time. If the value of the transactions that may be
concluded is restricted, it would therefore render the products unattractive. Given the
lack of comprehensive research about the phenomenon of money laundering, it is
difficult to determine whether this assumption is generally correct. However, common
sense suggests that it is probably correct in those cases where large sums of money
must be laundered in a short period. It may, however, not hold true for money
launderers with smaller amounts of money to launder nor for patient money launderers
who are content to launder only a limited amount at a time. These groups of launderers
may, however, depending on the country’s definition of money laundering and the
national circumstances, represent the majority of money launderers and the total
amounts involved in these smaller transactions may be quite significant.

A cap on the value that may be transacted may therefore, to some extent, lessen the
probability[14] of the abuse of that transaction or product. It may also, again to some
extent, lessen the impact of any abuse that may occur. Money laundering is often
described as activity that fuels crime (Bureau for International Narcotics and Law
Enforcement Affairs, 2000). A transaction involving a small amount cannot provide
much fuel for criminal activity. Individually the impact of such transactions may
therefore be limited, although their combined impact may be quite significant. However,
money laundering controls are often described as controls aimed at protecting the
integrity of the financial system. The value involved in a money laundering transaction
does not appear to be a sound indicator of its impact on financial integrity. An argument
that the laundering of USD/EUR 10,000 with the willing assistance of corrupt senior
bank officials causes less impact on the integrity of the financial system than a
transaction of USD/EUR 100,000 that was laundered without the knowledge of any
bank official seems fundamentally flawed, if “integrity” is viewed as an ethical and not
merely a technical concept.

The reference to “de minimis amounts” in the guidance notes indicate that other ideas
and perceptions may also be associated with FATF’s views regarding low value
transactions and products. “De minimis” refers to the old Roman maxim: “de minimis non curat lex” meaning that the law does not concern itself with trivial matters. There is of course a measure of socio-economic bias in the classification of a single insurance premium payment of USD/EUR 2,500 as a de minimis amount (and FATF does not state whether occasional transactions of less than USD/EUR 15,000 are also included in this category). However, more important for this discussion is a consideration of the ideas that underpin the de minimis classification. It is submitted that relevance, or lack thereof, and toleration of small money laundering transactions are associated with the de minimis classification.

If transactions involving small amounts are regarded as de minimis it seems to indicate that they are regarded as less relevant to the law enforcement system or as enjoying a lower priority than transactions involving large amounts. Law enforcement systems cannot act with equal effectiveness against every offence. Some systems manage their limitations by classifying crimes in order of priority. This is done to ensure that sufficient resources are devoted to those crimes that society regards as particularly heinous (for instance murder, rape, serious fraud, etc.). Generally violent crimes are regarded as more serious than economic crimes. In respect of economic crimes, those involving a breach of trust and large sums are generally enjoy a higher priority than those involving small amount amounts. In this scheme, theft of an apple is regarded as a lower priority offence than theft of USD/EUR one billion worth of pension funds. Money laundering involving USD/EUR 1,000 would also be less relevant or have a lower priority than the laundering of USD/EUR one million.

The de minimis and associated "low risk" classification also seem to be linked to a level of pragmatic toleration. Small money laundering transactions can or have be tolerated by the current AML/CFT system as it is not currently possible to design and operate an affordable system that can detect and prevent even the smallest tainted transaction while still allowing a bank to deliver the required services in a modern, global society. The money laundering control system was designed in the 1980s to capture the huge amounts generated by drug trafficking. It is better at detecting and monitoring unusual transactions involving large amounts than in respect of ordinary transactions involving small amounts. If the system must be re-designed to be focused on large and small transactions alike, it will be even more expensive and invasive. Given the practical challenges it is not difficult to see why a pragmatic decision may have been reached to carve out some smaller transactions (for instance, a wire transfer involving less than USD/EUR 1,000), especially when there are no other factors present indicating that such a transaction poses a higher risk. “Tolerated” however does not mean desirable. It simply means that some laundering activity involving small amounts is endured because we do not have an appropriate means to prevent it and, as it is limited, it does not pose a significant threat to the integrity of the AML/CFT system. Should the number of laundering transactions increase, and therefore also the total amount that is laundered through these products, it is reasonable to expect the regulator to revisit the capping level.

Value seems to be a pragmatic factor that can be used to limit risk. Conceptually it is more problematic and it is certainly far too general to serve as a sole determinant of risk. Ideally it must be combined with other factors such as the nature of the transaction and the profiles of the party or parties to the transaction to limit risk effectively. Risk is
Furthermore, context-specific and thought must be given to the appropriate amounts and values that will indicate and limit risk in a specific context. The use of USD/EUR 1,000 as a threshold amount may, for instance, be appropriate for some wire transfers in some developed economies but will be too high in a small developing economy to be regarded as less relevant and tolerable. What is tolerable and relevant in one context may not be so in another. This is illustrated by the reluctance to classify small sums as posing a low risk from a terror financing perspective (FATF, 2007a, para. 1.35).

Acts of terror can be funded by small amounts of money and FATF therefore balks at classifying such amounts as “less relevant” or “tolerable” from a terror financing perspective. Those combating terror financing are also burdened with psychological pressures that are not as evident in respect of money laundering. Money laundering is committed after the commission of the offence that generated the criminal proceeds. Criminals normally do not attempt to clean “dirty” money before reinvesting it in crime. Much of money laundering therefore represents the spending and enjoyment of ill-gotten gains. As a consequence those who combat laundering can tolerate transactions slipping through the net. Those who try to prevent terror financing do not allow themselves the same margin of error. They often view their objective as the prevention of actual terror attacks and the saving of innocent lives[15]:

Although terrorist financing as a law enforcement issue existed before 9/11, its focus was profoundly altered with the Attorney General’s November 8, 2001 announcement that, henceforth, the federal prosecutor’s core mission would be preventing terrorist attacks. Like all DOJ lawyers today, those who work in terrorist financing enforcement will be judged not by the number of convictions they secure but by how many innocent lives are saved.

Whether or not this goal is realistic and fair, it leaves the enforcers with no room to tolerate small transactions that may finance an attack. In addition, in the minds of policy makers the small sum is often directly linked to the most horrendous terror act, for instance the USD/EUR 100 that may slip through the net is visualized as the sum that will be used to buy the explosives for a bomb to be placed on the public transport system, while in actual fact it may be used to meet one of the many mundane operating expenses of the terrorist group[16]. It seems, however, as if the objectives with terrorist financing may be shifting. Although all stakeholders in the CFT system still hope that a small transaction can be interdicted and a terrorist attack prevented, the focus seems to be shifting to the broader disruption of money flows to the terrorist groups and the gathering of intelligence. This may lead eventually to a more pragmatic view of achievable deliverables by the CFT system and may make it easier to view low value transactions as posing a lower risk.

### 3.2.2 Low value transactions and financial inclusion

The AML/CFT risk of low-value transactions features prominently in discussions regarding the impact of AML/CFT on the broadening of financial inclusion. The majority of the world’s poor does not enjoy access to financial services. Their exclusion exacerbates their poverty. Efforts to provide financial services to the poor are complicated by insensitive AML/CFT regulation. This is often the case in developing countries where the regulators have not been able to adapt their national AML/CFT
laws to the realities of their countries and economies (de Koker, 2006a, b; Bester et al., 2008; Chatain et al., 2008).

Those who support financial inclusion have been at pains to point out that inclusion and AML/CFT are mutually supportive concepts. AML/CFT controls increase the quality of the financial services that are extended to previously excluded clients while financial inclusion increases the reach of the AML/CFT framework[17]. Financial inclusion initiatives often rely on new payment methods, for instance mobile phone banking and prepaid cards. These methods may introduce a measure of AML/CFT risk into the financial system. They can, however, also lower the overall level of risk because they ease dependence on cash and may support appropriate transactional controls. Cash poses significant AML/CFT risks because cash transactions are generally anonymous and difficult to trace. New payment methods not only provide an attractive alternative to cash but may provide monitoring and tracing systems and, in some cases, may enable client identification. Such methods provide additional measures to safeguard the integrity of the economy and decrease the overall level of AML/CFT risk.

The link between financial inclusion and AML/CFT was recognized by FATF. In its 2008 Guidance on Capacity Building for Mutual Evaluations and Implementation of the FATF Standards within Low Capacity Countries it lists some of the resource difficulties of low capacity countries (“LCCs”) and proceeds to state (FATF, 2008b, para. 5):

These structural characteristics often impede countries’ implementation of the FATF standards, and when supporting the LCCs it is important to enable them to take such constraints into account as they implement effective AML/CFT measures. This should help ensure consistency between AML/CFT measures and goals of universal access to financial services, expanding the formal financial sector and bringing more economic activities into the formal sector to reduce ML and TF risks.

It is therefore important that a country’s AML/CFT policy should support access to formal financial services (Bester et al., 2008). One way of achieving that is to allow simplified and cheaper customer due diligence measures in relation to low-value transactions that will typically be used by low income persons. It is submitted that this approach is sound but that it raises important questions that should be addressed in the FATF’s risk-based guidance. For instance, is increased participation in regulated transactional activity so important that the policy may allow some risk exposure in respect of low-value transactions where this will bring persons who operate outside the banking sector into the banking system? How much risk can be tolerated in the short to medium term if it will lessen risk in the longer term? Should a policymaker consider the possibility that proposed AML/CFT measures in the formal part of the economy may actually increase the AML/CFT risk in the informal economy? If so, how and where should that be considered within the risk-based framework?

4 Concluding observations

FATF’s 2007 and 2008 guidance on the implementation of the risk-based approach provides very helpful perspectives on its views of this approach. However, when viewed from the perspective of low risk products and transactions, some deficiencies in the guidance become apparent.
Differentiating between low- and high-risk products is, for instance, complicated by the fact that FATF did not clarify its conceptual definition and understanding of money laundering risk and terrorist financing risk. The examples that it provides of low-risk customers and transactions, especially read with the generous carving out of occasional transactions involving less than USD/EU 15,000, create uncertainty as to what FATF understands under “risk” and “low risk”. The value of FATF’s examples is further undermined by the generality of the assumptions that underlie them and by the complexities of identifying globally applicable indicators and categories of examples and scenarios of risk. Complicating factors include the following:

- Money laundering risks differ from country to country. Countries, for instance, have different definitions of money laundering. The FATF recommendations allow countries some leeway in the design of the money laundering offence. Countries may, for instance, criminalise money laundering acts by the person who committed the predicate offence or may criminalise only such acts by third parties. Some countries criminalise negligent money laundering acts while others criminalise only acts that are committed willfully. Some criminalise the laundering of the proceeds of all offences while others restrict the offence to the laundering of the proceeds of serious offences or the proceeds of specific listed offences. As a consequence a range of offences that are all styled as “money laundering offences” are very different in nature and impact. Their methodologies and the attendant risks also differ. Further variation is of course due to differences in the national environments, for instance the sophistication of the financial services and other business services that are offered in the country, the rate of general access to and usage of financial services, the quality of financial and business regulation, levels of legal compliance and corruption and the prevalent types of predicate offences.

- Money launderers do not share the same attitudes and behavior patterns. Launderers have different personal preferences. One may prefer buying high-value art with proceeds of crime and another may prefer laundering the money through a nightclub, a farming business or an internet business. Behavior patterns may also differ from country to country and region to region. It is improbable that a money launderer in a developed European country and a money launderer in a predominantly cash-based economy in a Middle Eastern or African country will prefer the same laundering methodologies. What may pose a low risk in one country may therefore pose a higher risk in another country.

- Those measuring risk may have different risk appetites. “Low risk” does not mean “no risk”. When we consider low risk scenarios we therefore admit, albeit reluctantly, that some laundering activity will be tolerated. In the absence of consensus about the meaning of “low risk” and general consensus about levels of tolerable abuse, it will be very difficult to identify indicators that can apply globally. This challenge is even more pronounced in respect of terrorist financing, where those at the forefront of the fight are not prepared to tolerate any financing activity.

In view of these difficulties, it seems advisable for FATF to provide a clearer and principled conceptual framework for the management of risk but to refrain from identifying examples and indicators, especially of low-risk products and transactions, unless they are truly universal or correctly contextualized. The framework should
entrust individual countries with the responsibility to consciously determine their own risk appetites and to compile, on reasonable and justifiable grounds, their own lists of indicators of money laundering and terrorist financing risk. Such an approach, it is submitted, will be in keeping with the philosophy that underpins the FATF’s risk-based approach. In contrast, some of the examples of low-risk cases recorded in the recommendations and the guidance notes, especially the value-capped transactions, appear to be closer aligned to a rule-based than a risk-based approach.

Within this context it seems more useful to focus on products, transactions and clients rather than on providers. The indicators of low-risk providers that emerged are not convincing because, in principle any provider is vulnerable to abuse. Clients interact with providers by taking up their products and by engaging in transactions with them. If the products and transactions are particularly vulnerable to abuse, the provider will be highly vulnerable, especially if the client group poses a high risk too. If, on the other hand, the products and transactions do not lend themselves to wide-scale abuse, the provider will be less vulnerable, even though the client group may pose a high risk. Whether a particular product is vulnerable, depends on its features as well as the appropriateness and quality of the AML/CFT controls that apply in respect of that product.

In this regard risk can, to some extent, be limited by capping the value of a transaction. If the cap is set at an amount that is regarded as restrictive by money launderers, it will lessen the attractiveness of the transaction for money laundering abuse and the financial impact of the transaction if it is abused. This is, of course, dependent on the value being truly minimal, given the context of the country concerned. In a developing country it may need to be amounts equivalent to USD/EUR 10 or 100 rather than the large mounts mentioned in FATF’s interpretative notes. Even in developed economies, the risk introduced by a large occasional transaction that involves less than USD/EUR 15,000 merits careful consideration. A low-value transaction may, however, still have a considerable impact on the ethical integrity of the financial system and may make a significant contribution to terrorist financing. To limit risk more effectively, a capping of the value of a transaction should therefore be combined with further elements that limit the risk of AML/CFT abuse. The total value that can be transacted by means of that product should, for instance, also be limited to guard against its abuse for smurfing purposes. Clients may be restricted to daily and monthly transaction limits in respect of a low-risk bank account. The risks posed by a particular product, for instance a bank account, could be limited further by restricting the product to clients posing a relatively low risk, for instance those with transparent income streams and transaction patterns that correlate with their known income and by requiring enhanced monitoring of the products and clients using them, especially where the clients were subjected to simplified customer due diligence. The types of controls to be employed will however depend on the definition of risk and low risk in the AML/CFT context.

It is furthermore important that FATF provides more guidance regarding strategic risk management. Its guidance notes are provided for policymakers, regulators and financial institutions alike. These groups do not necessarily view AML/CFT risk in the same way. A financial institution is chiefly concerned about its abuse by money launderers and terrorist financiers and about potential enforcement action should its control systems fail. A regulator is mainly concerned about AML/CFT risk in the sector that it regulates.
Policymakers on the other hand, should have a broader and more strategic view of AML/CFT risk. Effective risk controls in one economic sector may displace the criminal activity to another sector where effective controls cannot be imposed. The interplay between AML/CFT controls and financial inclusion illustrates the challenge. The guidance notes, however, do not provide guidance on the integration of this aspect of strategic risk management into the risk-based approach. Governments of developing countries are therefore not certain whether they are allowed by the FATF framework to consider this issue. This uncertainty impacts on financial inclusion and on the appropriate management of AML/CFT risk.

A clear understanding of the meaning of “risk” in the AML/CFT context and a flexible jurisdiction-based approach may therefore assist in identifying risk more accurately and designing more appropriate controls. This is important for high- and low-risk cases alike. Correct identification of low-risk cases will assist in freeing resources that can be devoted to higher risk cases without allowing undue risk into the system. It will, however, also enable financial institutions to design with greater confidence products aimed at extending financial inclusion.

Notes

1. FATF (2007a, para. 1.44-46) is careful to outline the distinction between its risk-based approach and risk-based supervision.
2. FATF (2007a, para. 1.7): “By adopting a risk-based approach, competent authorities and financial institutions are able to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate to the risks identified. This will allow resources to be allocated in the most efficient ways. The principle is that resources should be directed in accordance with priorities so that the greatest risks receive the highest attention.” Expectations were also raised that the risk-based approach will increase the quality and effectiveness of AML/CFT controls as it shifts the responsibility of risk assessment and mitigation to the regulated institutions who were regarded as better placed than regulators to manage their institutional risks. This view, of course pre-dates the global financial crisis. On the rationale behind the approach see Ross and Hannan (2007).
4. Some FATF Recommendations, for instance, recommendation 5, 6, 8, 20, 23 and 24, refer explicitly to risk and risk management from a regulatory and corporate perspective. Risk, especially the management of risk, is inherent in other Recommendations too, for instance Recommendation 9 and 15 (FATF, 2007a, para. 1.25).
5. See the glossary to FATF (2003).
7. These lists are normally produced by international bodies and countries. Screening of client names against these is therefore generally not a risk-based measure (FATF, 2007a, para. 1.36-137).
8. They are financial institutions that are subject to the “Core Principles” which is defined in the glossary to the FATF Recommendations as the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision, the Objectives and Principles for Securities Regulation issued by the International Organization of Securities Commissions, and the Insurance Supervisory Principles issued by the International Association of Insurance Supervisors.

9. Note that “financial institutions” are defined in the glossary to the FATF Recommendations.

10. See the definition of “financial institution” in the glossary to the Recommendations.

11. The phrase quoted above from the glossary to the Recommendations (“if that person carries on a financial activity on an occasional or very limited basis (having regard to quantitative and absolute criteria) such that there is little risk of money laundering or terrorist financing activity occurring”) is the most comprehensive indicator that is mentioned in the Recommendations, read with the glossary and the interpretative notes to the Recommendations.


13. FATF (2003), Interpretative Note in respect of Recommendations 5, 12 and 16.

14. “Less vulnerable” in this sense also links with “occasional” and “limited” as used in the context of service providers that are rated as low risk because they carry on financial activity on an occasional or very limited basis (measured in terms of the number of transactions and the value involved).

15. Breinholt (2003), first, see HM Treasury (2005): “Counter-terrorist finance measures have helped to save lives and hold terrorists to account for their actions.” See also Samy (2006), second: “[...] Cutting access to funds by terrorists can pre-emptively prevent future terrorist attacks and save lives by destroying or degrading their operational capabilities, regardless of the results from cost-benefit analyses.”

16. Terrorist groups are often expensive to operate. For research in this regard see Tupman (1998). See also the testimony before the US Senate Committee on Finance of Stuart Levey (US Under Secretary for Terrorism and Financial Intelligence) in Levey (2008): “The real value of all of our counter-terrorist financing efforts is that they provide us with another means of maintaining persistent pressure on terrorist networks. Terrorist networks and organizations require real financing to survive. The support they require goes far beyond funding attacks. They need money to pay operatives, support their families, indoctrinate and recruit new members, train, travel, and bribe officials. When we restrict the flow of funds to terrorist groups or disrupt a link in their financing chain, we can have an impact.” See further FATF (2008).

17. de Koker (2006a, b, p. 43): “Financial exclusion not only impacts adversely on the individuals concerned, but also on the social and economic development of the country. It also impacts on the efficacy of the AML/CFT system of the country. Current AML/CFT controls are at their most effective in the formal economy. If only 60% of the adult population of a country holds bank accounts and uses formal financial services, it means that the system is unable to monitor the AML/CFT activity of 40% of the adult population. It may be argued that the activities of the 60% that can be monitored represent the most significant financial and criminal commercial activity in the country. That is, however, not
necessarily the case. The argument is even less sustainable in respect of CFT risk where smaller transactions by socially excluded persons may pose a significant risk. Financial exclusion also impacts on law enforcement. It is difficult to investigate and prosecute money laundering that has taken place in the paperless informal economy. It is therefore submitted that it is in the interest of law enforcement to increase financial inclusion.”

References


**Further Reading**


**About the author**

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