

Risk-based AML measures to support financial inclusion

In October, the Financial Action Task Force ('FATF') issued its guidance for the banking sector, which alongside its statement on de-risking practices, sets an international agenda for the use of risk-based anti-money laundering and terrorist financing measures to build a more inclusive financial system. Rachpal Thind, a Partner at Sidley Austin LLP examines how firms will need to reassess current policies and procedures in light of the FATF's new guidance.

Risk-based anti-money laundering and counter terrorist financing ('AML/CTF') measures have formed the basis of international AML/CTF standards since the 2003 FATF 40 Recommendations were adopted. Notwithstanding, more and more financial institutions are simply terminating business relationships using geographical, sectoral or other screens as a means of de-risking their business profiles, rather than applying such risk-based standards. This practice has raised concerns amongst regulators that financial services firms are overreacting to increased regulatory scrutiny of AML/CTF controls and failing to strike an appropriate balance between risk aversion and managing risk in line with a risk-based approach. Roger Wilkins, president of the FATF, recently observed:

"You wouldn't close a toll road because there may be a few criminals travelling down it every now and then - but that is what is happening if you take it to extremes."¹

Whilst regulators and banks are right to continue to focus on protecting the financial system from criminal misuse, there is an enhanced international

commitment to financial inclusion, which must also be considered. At its plenary meeting in October, the FATF issued a statement on de-risking² and adopted its risk-based approach guidance for the banking sector³, which is to be read in conjunction with the FATF guidance on financial inclusion⁴; collectively these provide guidance on the use of risk-based AML/CTF measures to build a more inclusive financial system ('FATF Guidance'). At the Brisbane Summit in November, the G20 Leaders also committed to take 'strong practical measures' to prioritise financial inclusion, and approved an updated Financial Inclusion Policy⁵.

The FATF's new 2012 Recommendations have been revised to reinforce the risk-based approach as a general and underlying principle of all AML/CTF systems, and as countries move to implement the Recommendations, financial institutions will need to reassess their current controls to take account of financial inclusion from both an AML/CTF and policy perspective.

Wholesale de-risking - current trends and consequences

In a growing environment of supervisory and enforcement actions against banking institutions for AML/CTF control failures, wholesale de-risking (whereby banks have been exiting particular services and/or sectors) is becoming a more prevalent means of reducing money laundering and terrorist financing risks. Recent examples include the closure of accounts of money services businesses, correspondent banks, foreign embassies, digital currency operators and online gambling companies, on the basis that such customers may elevate the risk of money laundering, due to,

amongst other factors, global reach, anonymity in trade, lack of identification of participants and overall supervision of the market.

However, the FATF has identified that wholesale de-risking has the potential to force entities and persons into less regulated or unregulated channels, which in turn creates greater money laundering and terrorist financing risks within the financial system as funds will be moving through less transparent and traceable channels. The systemic consequence is that rather than eliminating risk, de-risking is transferring such risks into the hands of those less capable of handling high risk customers, due to insufficient expertise, systems, and resources.

FATF Recommendations and Guidance

The FATF warns that de-risking should not be used as an excuse to avoid implementing a risk-based approach in line with its standards, clarifying that the FATF Recommendations 'only require financial institutions to terminate customer relationships, on a case-by-case basis, where the money laundering and terrorist financing risks cannot be mitigated.' It would be contrary to AML/CTF objectives to terminate 'entire classes of customer, without taking into account, seriously and comprehensively, their level of risk or risk mitigation measures for individual customers within a particular sector.'

This is a pertinent provision of the FATF's de-risking statement and emphasises that financial institutions should be risk-sensitive as opposed to risk averse, and address the risks they identify rather than discard them. The FATF Guidance builds on these principles by fostering a more balanced approach to (but perhaps for some institutions, a new model

of) AML/CTF monitoring measures.

The FATF sees financial inclusion and AML/CTF as complementary objectives. The FATF Guidance focuses on the financially excluded and underserved groups (e.g. low income, rural sector and undocumented groups, in both developing and developed countries) and sets out how the FATF's Recommendations on matters such as customer due diligence, record keeping requirements and the reporting of suspicious transactions, can be interpreted to support financial inclusion.

Taking the example of customer due diligence ('CDD'), under the FATF Recommendations (Recommendation 10) financial institutions must perform CDD in order to identify their clients and ascertain information pertinent to doing business with them. CDD is composed of three core elements - 'identification', 'verification' and 'monitoring' - and can present a number of practical difficulties when rigidly applied to unbanked individuals who lack identification documents (e.g. low income migrant workers). The FATF Guidance provides the example of a 'tiered' CDD approach that would enable banks to establish a relationship with such customers on the basis of simplified due diligence for limited/basic services, and then advance to a full or expanded range of services or higher transaction ceilings, as and when full identity and verification can be conducted. In addition to reducing the administrative costs for operating small value accounts, a tiered approach would also allow for a more efficient allocation of resources to higher risk threats.

Focusing AML/CTF policies on financial inclusion

Financial inclusion is likely to

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continue to attract regulatory attention for the foreseeable future. The FATF intends to continue to collate evidence and analysis on the drivers and scale of de-risking to consider whether further work is required on specific issues. Some AML/CTF supervisory bodies are also starting to focus on de-risking. In the UK, the Financial Conduct Authority has indicated that it is working closely with the UK Government and others on de-risking issues, including the Cross Border Remittance Action Group on providing banking services to money transmitters⁶. In light of the movement towards financial inclusion, financial institutions will need to consider their current AML/CTF policies and procedures in anticipation of potential future regulatory developments.

The FATF Guidance identifies examples of commercial actions that financial institutions can take to support financial inclusion. These include a rapid extension of delivery channels, innovation in products, channels and processes in partnership with others such as mobile phone operators, and active participation in discussions on regulatory changes. As regards risk assessment policies, financial institutions will need to revisit any generic risk assessment practices that categorise customers on the basis of common characteristics. A policy intended to support financial inclusion will need to promote a holistic assessment on the basis of each customer's individual specifications. In this regard, any such risk assessment process will need to be supported with an effective risk-based framework, and the FATF identifies a number of related key requirements including, amongst others, a strong senior management that provides oversight and facilitates the implementation of the risk-based

approach, and monitoring internal controls regularly to ensure the policies are being adhered to.

Financial institutions in a number of jurisdictions should already be conversant with the requirements of risk-based AML/CTF controls. The main challenge will be extending such controls to the financially excluded and underserved, particularly for global institutions with a presence in both developing and developed countries, which differ with regard to the origin and extent of financial exclusion. This tension is further heightened by the regulatory pressures financial institutions are currently under to tighten AML/CTF controls, which may mean that in certain cases they will have to 'close a toll road' in order to meet the demands of their regulators. For this to work, both the regulators and financial institutions are going to have to find a common ground to combine AML/CTF measures with financial inclusion.

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1. Financial task force warns on banks' approach to de-risking, Financial Times, 13 November 2014.
2. FATF clarifies risk-based approach: case-by-case, not wholesale de-risking, FATF Press Release, 23 October 2014.
3. Guidance for a Risk-Based Approach, the Banking Sector, October 2014.
4. FATF Guidance on AML/CFT and Financial Inclusion, February 2013.
5. Financial Inclusion Action Plan, 2 September 2014, Global Partnership for Financial Inclusion.
6. Financial Conduct Authority Anti-Money Laundering Annual Report 2013/14.