Funded by the European Union

EUROPEAN UNION

COUNCIL OF EUROPE

CONSEIL DE L'EUROPE

Implemented by the Council of Europe

Project against Money Laundering and Terrorist Financing in Serbia

MOLI Serbia

DGI(2013) 29 September 2013

TECHNICAL PAPER:
A risk-based approach to AML/CFT inspections
Prepared by Council of Europe Expert Ms Maud Bokkerink

ECCU-MOLI SERBIA-TP15-2013

September 2013

Table of Contents

1. Executive Summary

Recommendation 1 of the FATF 40 Recommendations requires supervisors to apply a risk-based manner to AML/CFT supervision. Consequently, supervisors should first understand the ML/TF risks present in their jurisdiction by identifying possible risks and by assessing their potential impact on the supervised obligors.

A risk analysis of potential ML/TF risks is the basis for strategic planning and policy setting. A risk analysis can be done at a strategic level to determine if there are new products or markets that pose an ML/TF risk, at the tactical level to assess the ML/TF risks per sector or type of obligors, and at the operational level to assess the risks per obligor or group of obligors. By determining in advance where the ML/TF risks are high, the supervisor can allocate resources and define the scope and depth of inspections.

The following methods can assist a supervisor in adopting a risk-based approach to supervision:

1. **Assessing overall ML/TF risk per (sub)sector** to identify (sub)sectors with higher ML/TF risks in order to focus supervisory efforts and resources on those sectors where ML/TF vulnerabilities are higher so that the efforts can have more impact at the tactical level.
2. **Trend analysis of new ML/TF risks** to ensure that risks are identified early on and can be addressed with mitigating programs. Identifying new ML/TF risks will allow supervisors to determine strategic priorities.
3. **Thematic approach to AML/CFT supervision** to focus on risk areas and to allow for effective use of sparse supervisory resources. Thematic supervision means that the supervisor will select a risk area and for that risk area will examine a group of obligors at an operational level.
4. **Risk-based approach to inspections of individual obligors** to examine specific issues at an individual obligor (or group of obligors) in depth.

None of the AML/CFT supervisory authorities currently takes a full risk-based approach to AML/CFT supervision in such a way that obligors that pose a higher ML/FT risk because of their type of business, products, and clients are inspected with higher intensity or more comprehensively.

All supervisory authorities should therefore make an overall risk assessment of the sectors under their supervision and set up a method to identify new ML/TF risks. The thematic approach can be used by supervisory authorities that already have (some) experience in AML/CFT supervision or for a large number of obligors. The risk-based approach for inspecting individual obligors can be used by all supervisory authorities in all instances.

2. Introduction

Recommendation 1 of the 2012 Financial Action Task Force (FATF) 40 Recommendations and its Interpretive Note require supervisors to apply some of the FATF Recommendations in a risk-based manner. In order to apply a risk-based manner to anti-money laundering and combatting the financing of terrorism (AML/CFT) supervision, supervisors should first understand the money laundering and terrorism financing (ML/TF) risks present in their jurisdiction by identifying possible risks and by assessing their potential impact on the supervised obligors.

A risk analysis of potential ML/TF risks is the basis for strategic planning and policy setting. A risk analysis can be done at a strategic level to determine if there are new products or markets that pose an ML/TF risk, at the tactical level to assess the ML/TF risks per sector or type of obligors, and at the operational level to assess the risks per obligor or group of obligors. By determining in advance where the ML/TF risks are high, the supervisor can allocate resources and define the scope and depth of inspections.

This paper describes four methods that will assist a supervisor in adopting a risk-based approach to supervision, and in addition, this paper also provides some recommendations per supervisory authority to adopt a risk-based approach.

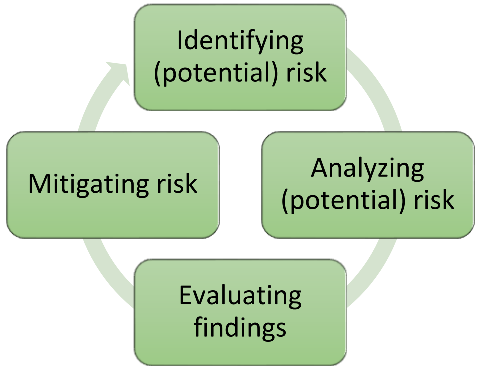
5. **Assessing overall ML/TF risk per (sub) sector**[1] to identify (sub)sectors with higher ML/TF risks.
6. **Trend analysis of new ML/TF risks** to ensure that risks are identified early on and can be addressed with mitigating programs.
7. **Thematic approach to AML/CFT supervision** to focus on risk areas and to allow for effective use of sparse supervisory resources.
8. **Risk-based approach to inspections of individual obligors** to examine specific issues in depth.

All supervisory authorities should make an overall risk assessment of the sectors under their supervision and set up a method to identify new ML/TF risks. The thematic approach can be used by supervisory authorities that already have (some) experience in AML/CFT supervision or for a large number of obligors. The risk-based approach for inspecting individual obligors can be used by all supervisory authorities in all instances.

Essentially, the risk-based approach to AML/CFT supervision and the four methods detailed below all revolve around the process of identifying, analyzing, evaluating and mitigating ML/TF risks. Additionally, all supervisory authorities should make use communication to influence the behavior of the obligors. Also, the APML should provide to the other supervisors statistical information on suspicious transaction reports that can assist in applying a risk-based approach to AML/CFT supervision (e.g., number of reports per obligor, sort of transactions reported, time between transaction date and reporting date).

---

[1] A subsector is for instance corporate banking within the banking sector; reinsurance within the insurance sector; casinos within the gaming sector.



Assessing overall ML/TF risks per (sub)sector

By assessing the ML/TF risks per (sub)sector, the supervisory authorities can focus their efforts and resources on those (sub)sectors where ML/TF vulnerabilities are higher so that they can have more impact at the tactical level. This does not mean that (sub)sectors with lower risk can be ignored, but supervisory efforts for those sectors can have a lower intensity.

Once the supervisor has determined the risk level of each (sub)sector, the supervisory methods can be determined in line with the perceived risk. As risk increases, so does the complexity of the supervisory toolset. For instance, mainly offsite supervision for lower risk sectors, and for higher risk sectors more onsite examinations.

Methodology:

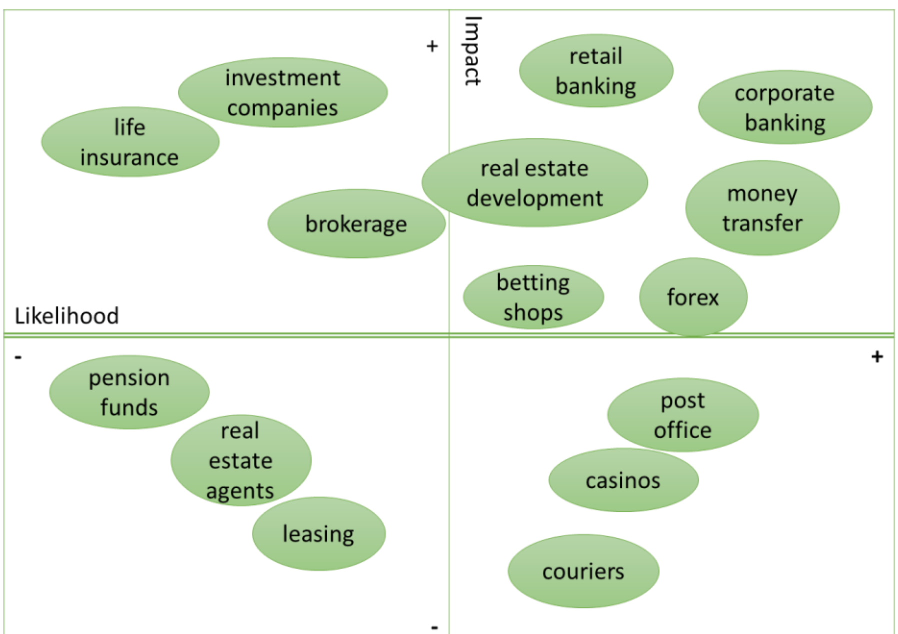
First, the supervisor will have to assess the threats and vulnerabilities of a (sub)sector: the likelihood that ML or TF can occur. Per sector the supervisor can rate the several (inherent) risk factors: cash intensity of the sector, unknown/unclear sources of funds, manner of client contact, obligors with operations in high risk countries, client base (e.g., non-resident, high net worth clients, or corporate clients with complex structures), and amount of international business. Additionally also more objective factors can be used, such as size of the sector, turnover, number of obligors. This rating does not take into account the control measures that individual obligors have in place. The supervisors can rate the factors in the following way:

Risk factors	Higher likelihood	Lower likelihood
Size of sector	Numerous obligors Many obligors with operations abroad	Few or small (in size) obligors Obligors operate only domestically
Products & services	High number of cash products or cash transactions Complex products Source of funds not always known	Limited/no cash products or cash transactions Simple products Source of funds is clear
Customers	Many non-resident or high net worth clients Many clients with complex structures	Only domestic clients
Delivery channels	Client contact is never face-to-face	Always direct client contact
Transactions	High value transactions High number of transaction with entities abroad	Low value transactions Only domestic transactions

Second, the supervisor will have to rate the impact if in a (sub)sector ML or TF indeed occurs. There are different 'levels' of impact that have to be considered: the financial-economic and reputational impact on an obligor, on the sector, on the supervisor, and on Serbia. This rating will be subjective as it is difficult to quantify this impact.

A risk assessment of several of the Serbian (sub)sectors that are obliged under the AML/CFT Law could result in a matrix[2] as below. The matrix below is an example for several sectors. Such a matrix can be developed by all the AML/CFT supervisors, but the supervisors should at least make such a matrix for those sectors under their remit. Once such a matrix is developed, a supervisor can determine at a tactical level which obligors in which quadrant need more intense or frequent attention and which supervisory methods can be used to mitigate the risks.

Besides supervisory methods as onsite and offsite supervision, supervisors can also use communication as a tool to influence behavior of obligors. By using the matrix, the supervisor can tailor its communication efforts, for instance by having a seminars for lower risk sectors, but direct discussions for higher risk obligors. Also, by means of newsletters, communiqués or cooperation with the sector associations supervisory efforts can be tailored.



Needless to say that the sectors in the upper right quadrant will need more intense and frequent supervisory efforts, such as onsite visits, awareness raising and cooperation with associations. The sectors in the lower right quadrant where the likelihood is higher but the impact low can for instance be supervised with less intensity or in a lower frequency. The sectors in the upper left quadrant where the likelihood is low but the impact high should ML/TF occur, can be supervised through

---

2 This matrix is a rough estimate by the CoE expert. It does not cover all types of obligors and is not founded in a detailed risk assessment based on likelihood and impact.

offsite methods and awareness can be raised through seminars. The sectors in the lower left quadrant can be supervised in a very light touch –offsite- manner.

An assessment of the ML/TF risks per (sub)sector should be reviewed and where necessary revised periodically.

3. Trend analysis - identifying new ML/TF risks

Identifying new ML/TF risks will allow supervisors to determine strategic priorities. A supervisor should continuously undertake this process to identify new risk and trends to ensure that they are detected early on and can adequately be addressed with risk mitigating programs.

Supervisors have to use several sources to see if there are (new) threats of money laundering or terrorism financing. The sources are numerous: there is no comprehensive list of potential information sources and the number of potential threats is practically countless. By checking open sources (internet, twitter, Linked-in groups) supervisors can be alerted to new financial providers, markets, products, payment methods, or ML/TF techniques. Sources can also be counterparts such as other (foreign) supervisors or the APML. Moneyval and FATF typology reports, but also research reports from professional parties can give new insight into ML/TF trends. As trend analysis calls for permanent information gathering, research and analysis, the supervisor should allocate sufficient resources to this.

Based on different signals and information the supervisor should analyse potential threats for the Serbian financial and non-financial sector. The supervisors can consider whether obligors indeed provide that product or payment method in Serbia. And if so, the characteristics of the product or payment method, the number and type of clients the product or payment method are offered to, and the amounts involved. Information from domestic and international counterparts, such as the FIU, law enforcement and other supervisors can assist and support the analysis.

Similar as with the overall risk assessment described under 1, for this trend analysis the supervisor can also evaluate the likelihood that the threat will occur in Serbia and what the impact will be. For instance, it might be less urgent to take immediate action if the problem is only relevant for one obligor compared to when it is a common issue for several obligors.

4. Thematic approach to supervision

Thematic supervision means that the supervisor will select a risk area and for that risk area will examine a group of obligors at an operational level. Certain risks will occur at several obligors. Supervision will therefore have to focus on these risk areas in a supra-institutional way. The risk areas can be selected based on the trend analysis described under 2 or based on the results of previous examinations (e.g., obligors where similar deficiencies in control measures have been found). Especially when a large number of obligors have to be inspected, a thematic approach can be an optimal way of supervision and making use of limited supervisory resources. Examples of themes are: high risk and non-cooperative jurisdictions (FATF lists), corruption, real estate investments, transaction monitoring.

Once the supervisor has selected a theme, a representative sample of obligors has to be selected. This will be obligors with similar characteristics and where the risk is likely to be high(er). The sample should include obligors with good practices, systems and risk controls which may stand as an example for the peer group and also obligors with lesser controls. For instance, if the theme is "high risk and non-cooperative jurisdictions", obligors can be selected with activities or clients in those jurisdictions. If the theme is "real estate", focus has to be on obligors that have real estate investments or serve real estate developers. Or, for example for money transfer operators a risk-based approach can be that those agents will be inspected that have larger than average remitted amounts (thus, for instance if the average remitted amount is 500 euro, agents with a large number of remitted amounts above 2000 euro, can pose higher risk). For betting shops a similar risk-based approach can be taken in analyzing betting transactions.

The thematic approach can thus be used for risk mitigation purposes. For this purpose supervision can consist of offsite examinations and/or onsite inspections whereby questionnaires, interviews with staff of the obligor and sampling the customer files and transactions will focus on the selected theme.

By examining a number of obligors with respect to a certain theme, it will be easier for supervisors to benchmark compliance and to identify outliers within the obligors and best practices. The supervisor can publish the generic findings and the best practices and it that way influence the behavior of a sector in a preventive manner.

The thematic approach can also be used for further risk analysis. For this, the thematic approach can for instance exist of offsite information collection of a selected group of obligors and review of other (open) sources to further analyse the risk to determine if the risk is relevant for Serbia. The supervisor can thus quickly address new developments within the area of AML/CFT.

5. Risk-based approach to inspections of individual obligors

For the inspection of an individual obligor (or group of obligors) a risk-based approach can also be adopted. This can be scheduled regular inspections or special inspections because of incidents, complaints or other signals that there are compliance issues (for instance a betting shop that has many winning tickets, or a bank that could have correspondent relationships with banks on UN or EU sanctions lists). The inspection will then focus on the issues concerning that incident or signal.

The scope and depth of the inspection will be determined on the basis of an assessment of the specific issue or the obligor's risk profile.[3] By focusing on policies and procedures around the specific issue and discussing implementation of policies and procedures with staff that deal with that issue and sampling only transactions and customer files around that issue, the supervisor can focus on the core problem.

[3] For larger obligors, the supervisors can develop a method to determine the risk profile of an obligor. Such a method could for instance be based on the risk rating methodology described on page 2.

Because of this in-depth inspection supervision will shift from mainly assessing the existence of policies and procures to also determining the effectiveness and implementation of the policies and procedures.

6. Recommendations per supervisory authority

None of the AML/CFT supervisory authorities currently takes a **full** risk-based approach to AML/CFT supervision in such a way that obligors that pose a higher ML/FT risk because of their type of business, products, and clients are inspected with higher intensity or more comprehensively. Several supervisors do take a risk approach, based on an assessment of risk factors in their supervised sectors, in selecting obligors for inspections. This is sometimes called for because of the large number of entities under their remit. In the "Report on assessing possibilities for an AML/CFT risk-based approach to the guidelines for obligors and to the supervisory inspection regimes" of March 2013, the CoE expert already provided some advice on adopting a risk-based approach to inspections. This advice is summarized and adapted below.

APML

The APML is supervisor for a range of different type of obligors. In 2012, it has focused on accountants and auditors. For the other obligors, such as domestic factoring & forfeiting, domestic money transfers and domestic postal communications, the APML has not undertaken any AML/CFT supervision.

For the accountants and auditors, the APML used a questionnaire to assess the level of implementation of the AML/CFT law, and prioritized their inspections using indicators as number of employees, yearly turnover, business relationships that are politically-exposed persons, and STRs.

Because of the large number of entities under supervision and the very little resources available to AML/CFT supervision, the APML needs to build knowledge of their sectors before taking a full risk-based approach. The APML should start by making an overall risk analysis of their sectors, preferably in cooperation with the other supervisors that supervise the same obligors.

The method of collecting offsite data to obtain information and prioritize supervisory methods is a good way to approach these numbers of obligors. A thematic approach to focus on those sectors or obligors with higher ML/TF risks would be a good approach once more experience is gained.

NBS

The NBS is in charge of AML/CFT supervision of banks, insurance companies, pension funds and leasing companies.

Banks

All 32 banks are supervised for AML/CFT purposes approximately once every two years. These are full scope AML/CFT inspections whereby all types of customers, products and business lines (e.g., retail, wholesale, correspondent banking, deposits, loans and credits) are inspected. Inspections generally take 3 to 4 weeks, and follow-up inspections take 1 to 2 weeks. The NBS prioritizes

AML/CFT inspections based on information, such as size of the bank, number of customers, and number of transactions. In addition, the NBS already started taking a risk-based approach in drawing samples of certain customer files or transactions, products and services.

The NBS should, based on a risk analysis of ML/TF risks and information from prior inspections, take a risk-based approach in its individual bank inspections by targeting inspections exclusively on certain types of customers, products or business lines. Furthermore, the thematic approach is an excellent way for the NBS to focus on the real ML/TF risks.

Leasing, insurance, pension funds

Up to now the 16 leasing companies have not been inspected onsite for AML/CFT purposes. The NBS has sent a questionnaire and requested the leasing companies to submit their relevant AML/CFT documents.

Of the 28 insurance companies, 7 provide only life insurance, 11 are non-life and 10 offer both life and non-life products. In 2012, there has been one onsite AML/CFT inspection. In general, AML/CFT supervision will be part of the full scope inspections.

During full scope onsite inspections of voluntary pension funds AML/CFT is cursorily inspected. In addition, once per year pension funds have to answer a questionnaire on AML/CFT.

For leasing, insurance and pension funds some experience and knowledge has been built on AML/CFT. The NBS estimates the ML/TF risks in these sectors as low, but the NBS should make an overall ML/TF risk analysis of these sectors to ascertain that. Seeing the small number of entities and also the (estimated) low risk, a risk-based approach for those sectors could exist of collecting offsite information and based on that information annually select a number of obligors that pose a higher ML/TF risk for inspections.

Securities Commission

The SC supervises 33 brokerage dealer companies, 5 investment companies, 10 custody banks, 16 authorized banks, also the Stock Exchange and the Central Securities Registry, Depository and Clearing House. The SC conducts full scope AML/CFT onsite inspections. The SC is still working on its first round of AML/CFT inspections and up to now has done 53 AML/CFT inspections and issued 22 sanctions. They have started collecting offsite data by way of (monthly) reports on for instance turnover and number of new clients and other data that is relevant for assessing the risk that obligors are exposed to (e.g., number of customers from offshore countries, number of blocked transactions).

The SC indicates that they probably use an inherent risk approach because the inspectors will focus their efforts on obligors with high volumes and large number of transactions and make use of results of previous inspections.

The SC should conduct an ML/TF risk analysis to assess the risk per sub-sector and focus its onsite and offsite efforts based on that outcome. The SC should, by making use of the knowledge gained during the inspections, also take a thematic approach to AML/CFT supervision.

Tax Administration – Department for Games of Chance

Department for Games of Chance reviews 800,000 to 1 million betting transactions per day. Supervision, including for AML/CFT, takes place offsite by way of an automatic control system of sold betting tickets. In addition, there is one casino in Belgrade with a license from the APML, and the Games of Chance Department cooperates with the casino and APML on accessing information in the casino's IT systems.

The Department has good notion of the ML risks in the betting and online gambling sectors, but only little resources. Enhanced cooperation with other authorities and the private sector, as they already do, is a prerequisite. By sharing knowledge and building up more experience the Department of Games of Chance can start developing a risk-based approach. Seeing the large numbers of obligors and transactions, this risk-based approach has to be based on an ML/TF risk analysis and can consist of for instance awareness raising efforts (seminars) next to the (existing) offsite transaction analysis.

Postal Services Inspectorate

The Postal Services Inspectorate supervises the PTT Public Postal Operator and the postal services (1500 branches), as well as of over 50 private postal operators and courier services extending commercial postal services for compliance with the Law on Postal Services and the AML/CFT Law. AML/CFT inspections currently focus on checking procedures of the obligors and whether there are suspicious transactions in the internal PTT traffic. In their inspection of domestic postal money orders several unusual transactions were detected but upon further examination none of these were suspicious for the purpose of the AML/CFT Law.

As the Inspectorate is not authorised to examine the contents of parcels, the only indicators are the designated value of a parcel, the description of contents, the frequency of sending parcels with same description of contents, or the large number of postal parcels and postal money orders from one sender to the same recipient or group of recipients. These indicators do not give information to assess ML/TF risks. The Postal Services Inspectorate started its AML/CFT work in 2012 and they have centered on explaining requirements to the obligors. The Inspectorate indicated that they have already conducted approximately 100 direct inspections of postal operators and have found no irregularities in the inspected documents.

The Inspectorate's objective is to fully inspect all obligors, but with the limited powers it will be cumbersome to gain the necessary experience on AML/CFT supervision. The Inspectorate has drawn up a questionnaire on the activities of postal service providers to carry out an ML/TF risk analysis of its sub-sectors and based on the outcome of that analysis it can decide which group of obligors need to be examined onsite because of higher risks and which can be supervised in an offsite manner.

Inspectorate for Real Estate Intermediaries

The Inspectorate for Real Estate Intermediaries has inspected all known real estate agents, which means that the approximately 270 agents were inspected every year for AML/CFT compliance. These inspections focused on checking whether the obligors had appointed a compliance officer, had indicators in place in accordance with the law, and if agent fees were paid in cash or by bank transfer. Because the Inspectorate visited all agents several times over the past years, they concluded that the AML/CFT Law is complied with and that there is no ML/TF risk as agent fees are generally not paid in cash but via banks.

The Inspectorate for Real Estate Intermediaries has built up knowledge of their sector through their inspections over the past years and as such is in a good position to assess the ML/TF risks of agents. To implement a risk-based approach they could choose to collect offsite information, for instance on types of customers and transactions and based on the analysis of that information focus their inspections on specific agents that pose higher ML/TF risks.

Tax Administration – Department for Foreign Exchange Operations and Transactions

The Foreign Exchange Operations and Transactions Department is in charge of AML/CFT supervision of factoring & forfeiting services, money transfer operators and more than 2600 authorized exchange dealers (which in turn have more than 3500 exchange offices). For the first two sectors they only supervise the international activities (the APML is in charge of supervision of domestic activities).

The Department closely follows the law during inspections by checking procedures, indicators and the appointment of a compliance officer. In addition, they also collect detailed offsite information once per year from all obligors. For selecting obligors to be inspected they check the amount of total transactions and the currencies the obligor trades in. With respect to factoring services they select obligors based on geographical risk (country of origin of obligor) and whether the services are also provided for foreign currencies. After they merged into the Tax Administration in October 2012 no onsite inspections were performed for some time and focus was more on offsite. The Department indicated that in March 2013 the onsite inspection started again.

The Foreign Currency Inspectorate assesses that the exchange offices pose the highest ML risk because of the cash involved and the fact that it concerns instant/occasional transactions.

Based on the Foreign Currency Inspectorate's experience, they can assess the ML/TF risks of their obligors. The Inspectorate already takes risk into account when selecting obligors for inspections by analyzing the data already collected. They can therefore enhance the risk-based approach using the onsite and offsite information they have, for instance on types of customer and transactions, and based on the analysis of that information focus their inspections on specific obligors. The Inspectorate should also take a thematic approach to AML/CFT supervision.