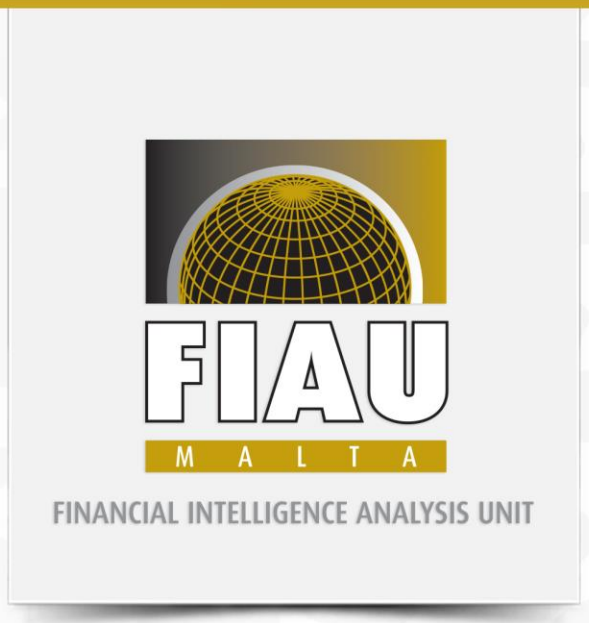

The Risk-Based Approach: An Overview

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What is the Risk-Based Approach? (1)

- Financial Action Task Force ("FATF")

  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 … The principle is that resources should be directed in accordance with priorities so that the greatest risks receive the highest attention.

  FATF Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing (2007)

- Directive (EU) 2015/849 ("4AMLD")

  The risk of money laundering and terrorist financing is not the same in every case. The risk-based approach … involves the use of evidence-based decision making in order to target the risks of money laundering and terrorist financing facing the Union and those operating within it more effectively. Underpinning the risk-based approach is the need for Member States and the Union to identify, understand and mitigate the risks of money laundering and terrorist financing they face.

  Recital 22 and Recital 23

What is the Risk-Based Approach? (2)

- The key elements of the risk-based approach are:

  a. The identification of ML/FT risks;
  b. The understanding and assessment of the ML/FT risks identified;
  c. The adoption of measures to prevent or mitigate the ML/FT risks identified; and
  d. The application of measures to prevent or mitigate the ML/FT risks identified.

- These correspond to what is set out in Regulation 5 of the Prevention of Money Laundering and Funding of Terrorism Regulations ("PMLFTR"):

  a. Business Risk Assessment / Customer Risk Assessment Procedures – identification, understanding and assessment of the ML/FT risks identified; and
  b. Have in place and implement measures, policies, controls and procedures which address the risks identified

What is the Risk-Based Approach? (3)

- **Risk** - What is the risk to be considered?

  'Risk' means the impact and likelihood of ML/TF taking place. Risk refers to inherent risk, that is, the level of risk that exists before mitigation. It does not refer to residual risk, that is, the level of risk that remains after mitigation.
  The Risk Factor Guidelines (2017)

- **Likelihood –** The probability that one will be abused for ML/FT. Likelihood is dependent on the **threats** one is exposed to and on the **vulnerabilities** within one's structures and activities, i.e. on the **risk factors** one is exposed to.

- **Impact –** The consequences resulting from the materialization of risk.

- This identification, understanding and assessment of risk forms part of the **Business Risk Assessment**.

What is the Risk-Based Approach? (4)

- Mitigating measures have to be adopted and resources deployed that are commensurate to the level and nature of risk identified.

- To effectively address risk, stronger mitigating action is required where the likelihood of something going wrong and the impact this would have is higher than in other situations.

Likelihood	Impact	Mitigating Action Required	(Desired) Residual Risk
High	Great	Strong	Minimal
Low	Minimal	Weak	Minimal

- **Residual risk** will indicate if the situation falls within one's **risk appetite**, i.e. the level of risk the Subject Person is willing to accept.

What is the Risk-Based Approach? (5)

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- **The Mitigating Measures - AML/CFT Measures, Policies, Controls and Procedures:**

  - Measures, policies, controls and procedures, proportionate to the nature and size of the subject person's business to address the risks identified as a result of the Business Risk Assessment.

  - What are these measures, policies, controls and procedures?
    - Customer due diligence measures, record keeping and reporting procedures.
    - Risk management measures including customer acceptance policies, customer risk assessment procedures, internal control, compliance management, communications, employee screening policies and procedures, and employee training.

What is the Risk-Based Approach? (6)

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Customer Acceptance Policy

- The main policy setting out the kind of customers that a subject person is ready to service and offer its products to.
- Describes the indicators to consider in assessing the risk posed by a business relationship or occasional transactions
- Explains the measures, procedures and controls that are to be applied to different categories of customers, especially in which circumstances it may be possible to apply Simplified Due Diligence ("SDD") and in which Enhanced Due Diligence ("EDD") is required.
- The Customer Acceptance Policy is also to cover Politically Exposed Persons.

What is the Risk-Based Approach? (7)

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Customer Risk Assessment

- Process to determine the risk presented by a given business relationship to be entered into or by an occasional transaction to be carried out:

  Business Risk Assessment – general understanding of ML/FT risks exposed to.

  Customer Risk Assessment – application of the same process as for the Business Risk Assessment but in a specific context.

- On the basis of the risk level identified one would then be expected to apply the measures provided for in the Customer Acceptance Policy.

What is the Risk-Based Approach? (8)

Level of Customer Due Diligence Applied

- Through the Customer Risk Assessment a subject person identifies:

  - The specific risk factors that may give rise to a high risk of ML/FT; and
  - The overall risk level presented by the business relationship or occasional transaction.

- Calibrate accordingly the level of Customer Due Diligence to be applied:

  - Timing when Customer Due Diligence is carried out;
  - Quality and Quantity of information/documentation to be collected;
  - Frequency and/or intensity of on-going monitoring; and
  - Frequency of document/information/data updates.

What is the Risk-Based Approach? (9)

Level of Customer Due Diligence Applied

- Overall risk level is low --------> apply SDD

- SDD is not an exemption from Customer Due Diligence but:

  a. as a minimum identify the customer and level of on-going monitoring to ensure still low risk; and

  b. vary the extent of the other Customer Due Diligence measures or delay them till the happening of pre-determined events.

What is the Risk-Based Approach? (10)

Level of Customer Due Diligence Applied

The Implementing Procedures – Part I provide for a number of situations which could lead to the application of SDD due to a possible low risk of ML/FT.

Example: **Company carrying out Relevant Financial Business**

On-Boarding: Provide investment services to high-net worth individuals located in the Middle East

On-Going Monitoring: Regulatory action due to breaches of conduct of business and AML/CFT requirements

Can it be said that it is low risk?

What is the Risk-Based Approach? (11)

Level of Customer Due Diligence Applied

- Notwithstanding that the risk assessment may indicate a low level of risk, SDD cannot be applied where:

  - There is a suspicion of ML/FT;
  - There is a legal obligation to apply EDD measures; or
  - Any previous determination by authorities that a product/service is low risk is revoked.

What is the Risk-Based Approach? (12)

Level of Customer Due Diligence Applied

- Overall risk level is high --------> apply EDD

- Enhanced Due Diligence measures must address the risk factors actually giving rise to risk.

Example: If risk is originating from the activity carried out by the customer, the collection of additional identification document cannot be considered as an effective mitigating measure.

Collecting additional information on the nature of his activities, a higher level of on-going monitoring etc. may be more appropriate.

What is the Risk-Based Approach? (13)

Monitoring the Mitigating Measures

- The mitigating measures will be effective only if they are applied and implemented in a uniform manner.
- Require a degree of monitoring, especially in larger subject persons:

a. Where applicable a member of its management body to ensure overall adoption of these measures, policies, controls and procedures;

b. Depending on the nature and size of the subject person's business:

- Day-to-day on-going monitoring function; and
- Independent audit function.

What is the Risk-Based Approach? (14)

The Risk-Based Approach – Past, Present and Future

- Past – Still had to carry out a customer risk assessment (and possibly also a business risk assessment)

  Situations which were automatically considered as high risk were almost the same as under the 4AMLD

  Possibility to apply a risk-based approach allowed for.

- Future – Article 18a dealing with High Risk Third Countries setting out the measures that may be adopted to address the risk associated with these jurisdictions.

Why Apply the Risk-Based Approach?

If you know the enemy and know yourself, you need not fear the result of a hundred battles. If you know yourself but not the enemy, for every victory gained you will also suffer a defeat. If you know neither the enemy nor yourself, you will succumb in every battle.

The Art of War – Sun Tzu

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