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Strengthening the anti-money laundering programme through institutional risk assessments

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Background

The Reserve Bank of India (RBI) has advised banks and financial institutions (FIs) to adopt a risk-based approach (RBA) while designing the anti-money laundering (AML) and combating the financing of terrorism (CFT) programme. One of the fundamental elements in implementing an RBA is institutional risk assessment (IRA). This enables banks and FIs to understand how and to what extent they are vulnerable to money laundering and terrorist financing (ML/TF) risks and helps in the judicious and efficient allocation of resources to create a robust AML and CFT compliance programme.

On 20 April 2020, the RBI mandated banks and FIs to carry out 'ML and TF Risk Assessment'. As a part of the assessment, banks and FIs are required to carry out an 'ML and TF Risk Assessment' exercise regularly. The exercise will help banks and FIs identify, assess, and take effective measures to mitigate money laundering and terrorist financing risks for clients, countries, or geographical areas, products, services, transactions, delivery channels, etc. The assessment process needs to consider the relevant risk factors before determining the overall risk level, and appropriate mitigation level and type. As part of this exercise, the first internal risk assessment would need to be completed by 30 June 2020 and thereafter, reviewed periodically.

Historically banks and FIs have undertaken risk assessments as part of their enterprise or operational risk assessment. However, these are not specific to AML and CFT. Sometimes, risk ratings/assessments conducted as part of the AML compliance programme are often confused with institutional risk assessment.

These risk ratings include the following:

- **Country risk rating matrix:** It is a mathematical model that rates countries by risk based on various independent sources; for example, membership in supranational bodies or presence on various lists.
- **Products and services risk rating matrix:** It is a mathematical/judgmental model that rates products/services risk based on a list of factors; for example, product/service designated as a high risk by regulators and product/service with high risk attributes.
- **Customer risk rating model:** It is a mathematical model that rates customer risk based on a list of factors, including customer demographics, products/services/channels, geographies, and other risks.

Unlike some of these risk assessments, an IRA is an AML/CFT risk assessment performed at business unit, branch, and sub-entity levels, which can then be aggregated at an institutional level. IRA facilitates the identification and assessment of general and specific ML/TF risks, as well as the identification and assessment of mitigating controls in an entity's AML/CTF programme to establish residual risks. Undertaking an IRA could be a complex and resource-intensive assessment. However, understanding an institution's AML/CFT risk environment is necessary. The scale and scope of an IRA should commensurate with the nature, size, and complexity of the company's business, and be supported by quantitative and qualitative assessments.

A bank or FI could consider the following risk factors while undertaking an IRA:

- **Customers** - Consider aspects such as transaction volume, services sought, customer risk rating (CRR), and the business's ownership structure.
- **Products and services** – To help determine how to rate each product and service, greater awareness is required around aspects such as does the product or service enable significant volumes of transactions and does the product or service inadvertently facilitate anonymity around the client business or involve unusual payments to third parties.
- **Channels** – Distribution channels should consider the extent to which FIs deal with customers or rely on third parties to manage accounts and client experience.
- **Geographies** – Organisations need to consider where their clients reside and operate from, and what is the origin and destination of business transactions.

How can banks make IRA work for them?

To do this, banks and FIs can avoid the following common pitfalls encountered while undertaking an IRA.

- Integrate controls into inherent risk assessments. For example, banks may not take into account the inherent risks related to transactions, as a transaction monitoring system tends to be in place. However, a standalone transaction system usually looks at risk microscopically and not holistically at an enterprise level. Therefore, the controls associated with the transaction monitoring system are likely to be inadequate (and perhaps irrelevant) when applied to enterprise-wide risk assessments.
- The current risk assessment is mostly qualitative and does not take into consideration quantitative aspects, such as transaction volume and value.
- Specific risk assessments (such as customers, products and services, and geography specific risk assessments) are often used as a substitute for an integrated risk assessment. This can make it challenging to get a complete picture of the risk.
- Institutional risk assessment may not be in line with the risk appetite statement issued by the bank. For example, the risk of providing 'high risk products' and services such as private and online banking may not commensurate to financial crime risks assessed at
an enterprise level.
- The risk assessment tool/process is not dynamic to account for changes in regulatory requirements, internal policy, or launch of new business products, etc.

For instance, an update and period review of policies is necessary whenever a change in regulation or new products is introduced.

Conclusion

As the world experiences greater uncertainty sometimes, banks need to factor in their risks effectively. An effective Institution Risk Assessment can assist in:

- Communicating and informing senior management of the ML/TF key risks and control gaps;
- Identifying opportunities for improvement in AML/ Counter TF programs;
- Making informed decisions about the organisation's risk appetite and ensure growth doesn't come at the cost of compliance;
- Enabling the management to see whether their resources and priorities are aligned and proportionate to the risks; and
- Developing risk mitigation strategies to lower residual risk exposure

In a dynamic risk ecosystem, such an exercise may initially prove to be cumbersome but over time help banks and FIs have better control over crisis situations.

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