IMPROVING AML/CFT RISK-BASED APPROACH IN SERBIAN BANKS: EVIDENCE FROM A SURVEY

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Abstract

The aim of this paper is to give a contribute in searching solutions to improve the anti-money laundering (AML)/Combating financing of terrorism (CFT) risk-based approach in banks. To achieve this goal, we decided to directly involve the banks, calling them for a kind of self-assessment about some factors associated with the performace of their AML/CFT risk-based approach. For this purpose, we carried out a survey, in the period between September 2013 and October 2013, addressed to a sample of banks in the Republic of Serbia. The answers provided have identified some factors that banks consider strategic to improve the internal AML/CFT risk-based approach and, at the same time, highlighted some deficiencies charged to regulators and supervisors.

Keywords: AML/CFT risk-based approach, Client Risk Assessment, Serbian Banks

Introduction

The commitment to improve the anti-money laundering (AML)/combating the financing of terrorism (CFT) risk-based approach involves an increasing number of countries all around the world (FATF, 2013); among them, also those currently engaged in the EU accession process. Serbia, officially Candidate Countries from March 2012, carries on the fight against money laundering and terrorism financing by adopting appropriate measures to prevent and punish these crimes. Serbia relies on a specific national legislation and on other official documentation (Law on the National Bank of Serbia, 2004; Law on the Prevention of Money Laundering and the Financing of Terrorism, 2009; Decision on the Guidelines for assessing the risk of money laundering and terrorism financing, 2009; Decision on minimal content of the "Know Your Client" Procedure, 2009), as a member of the Committee of experts on the evaluation of anti-money laundering and the financing of terrorism Measures (MONEYVAL, 2012). With this paper, we want to contribute in searching solutions for the implementation of AML/CFT risk-based approach in bank. Paying particular attention to client risk - in our opinion, a profile of central importance - we structured a survey that allows to obtain, directly from a sample of Serbian banks, an evaluation of those that we consider key factors for an effective AML/CFT client risk assessment, ie: the AML/CFT staff training organization; the national AML/CFT regulation; and the role of National Competent Bodies and Institution.

We think that this work, although for the most part is an exploratory study, may contribute to research in the field of anti-money laundering because it try to fill the gap, which could occur, between a set of international measures - however necessarily standardized - and case-sensitive contextual specificities. We used direct method by calling

the banks to identify those elements which they consider crucial for an effective AML/CFT risk-based approach.

With respect to these considerations, the remainder of this paper is organized as follow.
i) review of some literature contributions; ii) survey's questionnaire and sample description; iii) discussion of survey's results; iv) conclusions and future proposals.

Some contributions from the literature

Despite a long period that the scientific community has addressed the anti-money laundering issue, by trying to make its own contribution with studies focusing on different aspects of the problem, there are still many questions that require the continuous attention of researchers. With particular reference to the AML/CFT risk-based approach, we tried to organize the literature – able to detect - in two main lines of research. In the first, we included studies that analyze this topic by proposing directly improvement solutions (application of theories and quantitative models, adaptation of tools usually used in other areas, etc.). In the second line of research, always remaining the underlying aim to advance enhancement suggestions, we considered the contributions which start from critics, often negative, on the AML/CFT risk-based approach so as it defined by international standards.

Among the contributions of the first research strand, there are some suggesting to strengthen the AML/CFT risk-based approach by applying a mixed method of the type "rule based but risk-oriented", designed for the particular situation in China (Ai, L., Broome, J., & Yan, H., 2010); others, considering the possibility to improve it expanding the extent of money laundering (ML) risk, making it fit into the broader category of the integrity risk (Simonova, A., 2011); or further studies based on the application of a risk matrix to define the client profile, with the belief that the imperative "Know You Customer" should be considered as the core of the entire AML/CFT system (Albanese, D. E., 2012); or others thinking to an effective AML/CFT system as a driver for financial sector stability not underestimating, at the same time, the need for more technical assistance in the prevention of such crimes, especially for developing countries or where is the financial inclusion to be considered as key element for the improvement (Shehu, A. Y., 2010 and 2012). Among these researches, also contributions focused on problems arising from the hierarchical relationship among competent public authorities, financial institutions, and supervisors (Dalla Pellegrina, L., Masciandaro, D., 2009); and others which argue on the cost/benefits of the AML/CFT improvement (Johnston, R. B., Carrington, I., 2006).

As anticipated just above, we decided to include, in the second line of research, works which propose improvement solutions for AML/CFT risk-based approach, starting from a constructive critics. Among these, studies that identify an alleged gap in the current AML framework, attributed to the excessive consideration given to high-risk situations at the expense of the low-risk products (De Koker, L., 2009 and 2011). Follow this line of critical profile also the researches which detect paradoxes behind the classifications of risks, denouncing observed an oversimplification (Demetis, D. S., & Angell, I. O., 2007).; and others that attribute the slowdown in improving AMLCFT risk-based approach to the excessive bureaucratization of some control systems, which makes it more difficult to detect situations of real risk (Killick, M., & Parody, D., 2007); and others that highlights a mixture of criticality which may affect the AML/CFT risk-based approach effectiveness, as the not compulsory nature and the incompleteness of the indications contained in EU and international standards, which may lead to the adoption of discretionary behaviors, often cause of prevention measures failure (Costanzo, P., 2013); or still other studies that have identified the lack of flexibility in the procedures to comply with the imperative "Know Your Customer" (Gill, M., & Taylor, G., 2004).

In addition to the described strands of research, it is also possible to identify a series of studies specifically related to the experience of Serbia in the fight against ML/FT risks. Among them, we decided to highlight particularly those focused on the banking sector: thus, empirical studies that have contributed to the knowledge of the level of harmonization of the AML system in Serbia with the FATF's Recommendations and the Third European Directive on anti money laundering (Fijat, L., 2013a; Fijat, L., Božić, D., & Tomašević, S., 2013; Muminović, S., & Ljubić, M.,2013); or others that have investigated the role of Institutions and Bodies competent and specific legislation in support of Serbian banks in the prevention and combating of ML/FT (Fijat, L., 2008, 2013b; Fijat, L., & Živković, A., 2010; Lukić, T., 2010). The paper we propose ranks among the researches belonging to the first line of those described just above and, at the same time, among those specifically referred to the situation in Serbia. The additional contribution we would like to give is to boost the number of studies that aim to emphasize the importance of an accurate definition of client risk and the factors that affecting on it, seeking ways of implementing the AML risk-based approach with proposals that directly involve who in fist person have to manage, even if from opposite positions (Bosworth-Davies, R.,1998; Holder, W. E., 2003; Ross, S., & Hannan, M., 2007; De Wit, J., 2007; Johnson, J., 2008; Geary, J. M., 2009; Tsingou, E., 2010; Van den Broek, M., 2011).

Explanation of the survey and sample description

The survey proposed in this paper has been conducted administering a questionnaire to a sample of Serbian banks, in the period between September 2013 and October 2013. For a better understanding of the research project and its aims, questionnaire was previously explained via telephone to the employee of the anti-money laundering department and then sent via mail for answers. The questionnaire consists of three sections, each corresponding to an aspect of the analysis. The first section introduces some preliminary aspects of the research; the questions that compose it have the purpose to obtain information on the overall exposure level to ML/FT risks. Therefore, banks in the sample have responded about the numerosity of ascertained danger situations; about which risk profile they consider more difficult to manage; and about which, among the internal and external principals, they consider most effective.

By the second section of the questionnaire, the survey starts focusing on the client risk assessment. The first element considered is the AML staff training. To evaluate the contribution of this element to the risk-based approach improving, banks have responded to questions about many important aspects of AML training paths, from technical and formal organization, to the assessment of contents, participants and trainers.

In the third and final section of the questionnaire, the sample banks proceed to the evaluation of the role played by domestic legislation and National Competent Bodies and Institutions, assessing the contribute given by the provisions contained in national AML Law and in other official documents and by national institutions with role of regulators and supervisors.

Of the 31 banks operating, in 2013, in the Republic of Serbia, 11 agreed to participate in the survey, representing around the 35% of the total sample. The 14% of the sample responded that they will not be part of our survey. Explanation of one bank was that requested information are confidential and that they can give information about this area just to the National Bank of Serbia, Administration for the prevention of money laundering or the Securities Commission of Serbia. Other banks explained that answering on the topic such as money laundering is forbidden by the bank own policy.

The assessment of client risk in Serbian banks: results of the survey

Section 1 - Deals with preliminary information about the risk assessment

At the beginning of the questionnaire is a multiple-choice question concerning the main causes of the bank's exposure to the risk of money laundering. The reason most indicated by the survey respondents concerns the economic and political situation of the Nation (40%). This answer is followed by four others: the lack of support from the competent Bodies (33%), the inadequacy of the legislation (13%), the inadequate training of staff (7%), and in particular the poor training of the staff to identify and manage risk situations (once again 7%).

Moreover, some banks add interesting comments. For example, a bank underlines that in reality the combination of all the causes indicated in the questionnaire influences bank's exposure to the risk of money laundering: none of the factors by itself can be considered as dominant. Similarly, another bank specifies that all the factors are relevant.

The second question asks how many situations of ascertained risk have been found during the last five years. Most of the banks (73%) note the option "more than 10", reflecting a high exposure to the risk. The exposure derives primarily from the number of clients assessed as risky subjects and the number of suspicious transactions.

However, banks claim they have suffered very few penalties for failure to comply with the provisions of the money laundering regulations: even 91% have never been sanctioned; the remaining percentage of banks was sanctioned from 1 to 5 times.

Among the causes for which have been applied penal provisions as per Articles 88-91 (Economic offences, Minor offences, and Minor offences for which a lawyer may be held liable) of the Law on the Prevention of Money Laundering and the Financing of Terrorism, only one bank indicates the reason: lack of documents relevant for conducting "Know Your Customers" procedure. Some institutions underline in the space reserved for comments the absence of penal provisions, giving answers such as the following: "The control of Serbian National Bank did not find any omission in relation to money laundering and terrorist financing" and "There was no sanction against the bank".

Based on the Guidelines for Assessing Money Laundering and the Risk of Terrorism Financing, the profiles that the banks feel more critical to manage are the transaction risk and the product risk (31% in both cases). Geographic risk and the client risk show lower percentages of answers, although one bank emphasizes the critical issues implied by the client risk: experience has shown that, for example, two clients characterized by the same profile (business operations, business volume, residency, etc.), classified in the same category of risk, can carry different risks in doing business with the bank. One bank differs from the others: it states that its employees are well-trained and ready to face any risk situation resulting from the recycling, with no particular distinction between the different types of risk.

Finally, with specific reference to defining client risk, the tool considered to be the most useful is staff training (56%). The other options included in the questionnaire show similar rates of response: the direct relationship with the customer (18%), the provisions of the money laundering legislation and other official documents (13%), and the role of competent Bodies (again 13%).

Section 2 - Client Risk assessment: the role of training activity

The role of the anti-laundering money training activity has been investigated from different perspectives: the used teaching approaches and teaching materials, the frequency of the activities, the origin of trainers (in-house or external), the adopted evaluation mechanisms and the effectiveness of the training activities in terms of determination of the Client Risk.
Concerning the teaching approach adopted in the training courses, almost all the banks indicate "lectures with the use of slides". The main reason of such widespread choice is the possibility of facilitating interactivity: thanks to examples and illustrations of various

problems, questions and answers it is in fact possible to discuss the different issues about money laundering and terrorism financing in greater depth and to understand how to resolve ambiguities in the treatment. Only a few banks use also or uniquely an e-learning method, by means of a corporate network.

Training programs are always supported by supplementary materials. Training activities are mainly proposed once a year; for a very little number of the banks of the sample, the frequency occurs every six months. Some banks add that training could occur also in different times, on the basis of specific needs: for example, a bank underlines the opportunity to organize training activity if there is a relevant change in regulations, in order to support all the employees who work closely with clients.

The majority of banks state they use in-house trainers. Sometimes the training activities are arranged by specific organizational functions, such as the "Service of monitoring of compliance and anti-money laundering" or, more in general, by an authorized person. In the case of external training, the most common reference is to the participation of the employees to seminars.

All the banks of the sample verify the levels of learning of the personnel and use assessment techniques of the trainers at the end of the courses.

The opinion banks express on the utility of the training activity for the determination of the client risk is quite good: no bank gives a score less than six; this result seems to suggest that most banks recognize a great effectiveness to the personnel training for the assessment of the client risk.

Section 3 - Client Risk assessment: the role of National Regulations and Competent Bodies

The initial questions of this third and final section allow us to obtain an assessment, by the sample banks, on the contribution that the national AML regulation and the competent Bodies and Institutions provide determining the client risk profile. According to a 6 levels rating scale - from "essential" to "not enough" - the banks gave the following answers. The rating on the provisions of national *Law on the Prevention of Money Laundering and the Financing of Terrorism* is generally positive: 28% essential; 36% very helpful; 36% useful. Situation almost identical, but with slightly less positive results, with reference to the banks' utility judgment about another official document made available for the prevention of money laundering, ie the *Guidelines for assessing the risk of money laundering and terrorism financing* (not to be underestimated, however, a 9% of the sample giving a rating of nearly no sufficiency). Things change about the evaluation of the National Competent Bodies and Institutions. In this case, the ratings appear to be distributed among: 18% essential; 18% very helpful; 36% useful; 10% not very useful; 18% not sufficient, denouncing this result some deficiencies of these subjects or, at least, of some of them, and confirmed in the answers to the subsequent question, under which banks are required to disclose those most active in supporting the assessment of Client Risk (from a list that includes: Administration for the prevention of money laundering (APML); National Bank of Serbia; Securities Commission; Tax Administration; Ministry competent for supervisory inspection in the area of trade; Foreign Currency Inspectorate; Administration for Games of Chance; Ministry competent for finance; Ministry competent for postal communication; Bar Association and Chamber of Licensed Auditors, nearly all of the sample indicated the APML (92%). Third section concludes with a set of questions that require, to the sample banks, the expression of an overall usefulness opinion in relation to the support role, in the client risk assessment implementation, respectively played by domestic regulation, by National Competent Bodies and Institutions and by direct relationship with customers. Attributing a score, in a scale from 1 to 10, the results showed a predominance of high ratings only in the case of direct relationship with the customer (18% score 9; 55% score 10), consequently considered essential for an efficient AML risk-based approach.

Conclusion

The main purpose of this paper is to contribute in finding solutions to enhance the AML risk-based approach efficiency. The approach chosen to achieve this goal directly involves the banks engaged in combating money laundering and terrorist financing, collecting information about who and what banks believe could help win that fight. In order to better focus the scope of this investigation, we restricted the analysis on client risk, considering the "Know Your Customer" (KYC) imperative crucial to maintain a satisfactory efficiency level of the entire bank's AML/CFT risk-based approach.

The results seem interesting, as allow knowing what could be key factors in improving and implementing the AML risk-based approach in Serbian banks. Answers provided give an unequivocal importance to personnel training and to direct relationship with customers, valued as fundamental principals to ML/FT risks. Things change when to be evaluated is the role of national Competent Bodies and Institutions. Banks, in this case, point out the lack of a full participation of them, indicating just one as more involved in supporting role. A situation like this suggests that banks in Serbia consider the AML risk-based approach improvement essentially as an internal matter, when instead it should be the result of a constant commitment to share, even if from different roles and responsibilities, with subjects active in the role of regulator and supervisor.

In this regard, it might be useful to look for improving solutions starting right from the needs directly expressed by those actively involved in the process hoping, on the one hand, that regulated provide objective and consistent data and, on the other, that regulators use these information to make measures proposed more effective and enforceable.

We consider that increasing number of future researches should be in this direction and that competent institutions activate a systematic collection of data and opinions coming from the regulated, in order to effectively support the necessary harmonization process between AML/CFT international measures and the specific, often problematic, national contexts.

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