

The BCBS Consultative Document *Sound management of risks related to money laundering and financing of terrorism* has, as its stated aim, “to describe how banks should include money laundering (ML) and financing of terrorism (FT) risks within their overall risk management.” As noted in the document, the BCBS supports the 2012 revised FATF Recommendations<sup>1</sup> and intends to “to support countries’ implementation of the FATF standards with respect to their banks and banking groups.” In addition, the document explicitly refers to the Committee’s consideration of the 2013 FATF guidance paper on AML/CFT measures and financial inclusion (FATF Guidance Paper).

**The Consultative Document is being issued during a period of important change for both the BCBS and the FATF.**

- ***Proportionality and the Risk-Based Approach:*** The 2012 revised Basel Core Principles adopted the concept of proportionality as a central tenet of bank supervision. The 2012 revised FATF Recommendations reinforced the risk-based approach (RBA), placing it in a central role vis-à-vis AML/CFT regulation and supervision. The RBA – a concept similar to proportionality – “allows countries, within the framework of the FATF requirements, to adopt a more flexible set of measures, in order to target their resources more effectively and apply preventive measures that are commensurate to the nature of risks, in order to focus their efforts in the most effective way.”<sup>2</sup> FATF recently referred to the RBA as “a general and underlying principle of all AML/CFT systems.”<sup>3</sup>
- ***Financial Inclusion and the Risks of Financial Exclusion.***<sup>4</sup> The 2012 ministerial decree approving the FATF’s new 8-year mandate explicitly and significantly identified financial exclusion as an ML and TF risk. In 2013, the FATF issued a revised guidance paper on AML/CFT measures and financial inclusion,<sup>5</sup> stating that FATF’s full endorsement of the RBA “means that both countries and financial institutions are expected to understand, identify and assess their risks, take appropriate actions to mitigate them and allocate their resources efficiently by focusing on higher risk areas. The greater recognition of a risk-sensitive approach to implement AML/CFT measures – including in particular an approach that takes into consideration the risks of financial exclusion and the benefits of bringing people into the formal financial system – will be a key step for countries that wish to build a more

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<sup>1</sup> Referred to in the Consultative Document as the “FATF standards.”

<sup>2</sup> FATF Recommendations, p. 8.

<sup>3</sup> FATF Guidance Paper, p.9.

<sup>4</sup> Financial exclusion on a global basis refers to the estimated 2.5 billion adults who are not served by the formal financial sector and instead save, borrow and conduct other financial transactions in the untraceable informal cash economy.

<sup>5</sup> The FATF issued earlier guidance on AML/CFT and financial inclusion in 2011.

inclusive financial system.”

In late 2012, the BCBS, through the Basel Consultative Group, launched a workstream on financial inclusion. The workstream is working (i) to identify how the proportionality principle is being applied to prudential regulation and supervision of banks and other deposit-taking institutions engaged in serving poor and low-income customers and (ii) to provide guidance on the opportunities and challenges that supervisors of such institutions will face.

**These fundamental developments within the BCBS and the FATF are scarcely reflected in the Consultative Document.** The document refers to the RBA only a handful of times and the primary focus is on the AML/CFT treatment of higher-risk customers. There is essentially no guidance in the document on application of the RBA to lower-risk customers, products and services. Although emphasis on high-risk activities and customers is essential to implementation on the RBA, the FATF Ministers recognition of financial exclusion as an ML/TF risk demands appropriate risk-based treatment of lower-risk activities and customers.

**The Consultative Document should include guidance to support supervisors in the proper and effective implementation of a RBA with respect to lower-risk activities and customers.** This guidance will help to ensure effective use of limited supervisory resources and to minimize the risk that supervisors and financial institutions will impose inappropriate AML/CFT requirements that present obstacles to lower-risk initiatives essential to reducing financial exclusion. Without such guidance, many supervisors will be reluctant to take an independent approach to address lower-risk scenarios. As noted by the FATF, “applying an overly cautious approach to AML/CFT safeguards can have the unintended consequence of excluding legitimate businesses and consumers from the financial system.”<sup>6</sup>

**In the Annexes hereto, there are proposed additions, deletions and modifications of select paragraphs of the Consultative Document.** These proposals address: (i) the application of the RBA to lower-risk customers, products and services (Annex 1), (ii) the training of supervisors with respect to lower-risk lines of business and customer categories (Annex 2), and (iii) third party agents (Annex 3). Certain other critical issues (profiling, ongoing monitoring, group policies and differences in home and host country rules) require more significant changes to the Consultative Document to reconcile the concerns of the BCBS with those of the FATF. We have therefore not proposed language changes with respect to these matters, but we are available to engage in further discussions on any or all of the issues.

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<sup>6</sup> FATF Guidance Paper, p.5.

Annex 1

**Proposed References to RBA and Lower Risk Products and Services**

The following texts are quoted from the draft paper. **The suggested additions are highlighted in yellow. Suggested deletions are highlighted in red and have a line through the text.**

Paragraph 3: “The Committee supports the adoption of the standards issued by the Financial Action Task Force (FATF). In February 2012, the FATF released a revised version of the *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation* (the FATF standards), to which the Committee provided input. In March 2013, the FATF also issued Financial Inclusion Guidance, which has also been considered by the Committee for these guidelines. The Committee’s intention in issuing this paper is to support countries’ implementation of the FATF standards with respect to their banks and banking groups, by exploring complementary areas and leveraging the expertise available in both organisations. Therefore, these guidelines are intended to be consistent with and to supplement the goals and objectives of the FATF standards, **including the application of a risk-based approach.**” The Committee has included cross-references to FATF standards in this document in order to assist banks in complying with national requirements based on the implementation of those standards.”

Paragraph 5: “The inadequacy or absence of sound ML/FT risk management can increase the exposure of banks to serious risks, especially reputational, operational, compliance and concentration risks. Recent developments, including robust enforcement actions taken by regulators and the corresponding direct and indirect costs incurred by banks due to their lack of diligence in applying appropriate risk management policies, procedures and controls, have highlighted those risks. These costs and damage could probably have been avoided had the banks maintained effective risk-based AML/CFT policies and procedures. **However, sound ML/FT risk management involves taking a risk-based approach. The FATF Guidance Paper (para 39) notes the “potentially negative consequences if the controls designed for standard risks and higher risks are also applied to situations where the risks are lower.<sup>7</sup> This ‘over-compliance’ approach by regulators and financial institutions could exacerbate financial exclusion risk, thereby increasing overall ML/TF risk. Regulators/supervisors should play a role and provide further guidance when institutions overestimate ML/FT risks or adopt overly-conservative control measures.<sup>8</sup>”**

Para. 12: “In accordance with the updated *Core Principles for Effective Banking*

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<sup>7</sup> De Koker and Symington *Drivers of conservative compliance responses in the South African financial services industry* Cenfri/FinMark Trust (2011).

<sup>8</sup> Chatain, P.L., Preventing Money Laundering and Terrorist Financing: A Practical Guide for Bank Supervisors, The World Bank, Washington, DC; De Koker, L. and Symington, J. (2011).

*Supervision* (2012), all banks should be required to “have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the banking sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities”. This requirement is to be seen as a specific part of the banks’ general obligation to have sound risk management programmes in place to address all kinds of risks, including ML and FT risks. ~~Therefore~~, ‘Adequate policies and processes’ in this context requires the implementation of other measures in addition to CDD rules. ~~These measures should also be proportional and risk-based, informed by and compliance with the banks’ own risk assessment of ML/FT risks.~~ The reference to “strict” CDD rules does not mean that enhanced due diligence measures are to be applied without consideration of the specific risks to be mitigated but rather that the CDD rules should be based on informed analysis, reflecting a principled risk-based approach that addresses both higher and lower risks. As stated in the BCBS *Due Diligence for Banks* (2001) para 20, ‘It is important that the customer acceptance policy is not so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged.’ This document sets out guidance in respect of such measures. In addition, other guidelines (see paragraph 7 above) are applicable or supplementary where no specific AML/CFT guidance exists.”

Para. 14: “A bank should develop a thorough understanding of the inherent ML/FT risks present in its customer base, products and services offered (including products under development or to be launched) and the jurisdictions within which it or its customers do business. This understanding should be based on specific operational and transaction data and other internal information collected by the bank as well as external sources of information such as national risk assessments and country reports from international organisations. Policies and procedures for customer acceptance, due diligence and ongoing monitoring should be designed and implemented to adequately control those identified inherent risks. ~~A risk-based approach – as articulated by FATF – involves designing policies and procedures that reflect the variation in risks presented by different products, services and customers.~~ Any resulting residual risk should be managed in line with the bank’s risk profile established through its risk assessment. This assessment and understanding should be able to be demonstrated as required by, and should be acceptable to, the bank’s supervisor.”

Para. 15: “Effective ML/FT risk management requires proper governance arrangements such as described in relevant previous publications of the Committee.<sup>15</sup> In particular, the requirement for the board of directors to approve and oversee the policies for risk, risk management and compliance is fully relevant in the context of ML/FT risk. The board of directors should have a clear understanding of ML/FT risks ~~of the different types of products (including those under development), services and customers and the importance of adopting a risk-based approach.~~ Information about ML/FT risk assessment should be communicated to the board in a timely, complete, understandable and accurate

manner so that it is equipped to make informed decisions.”

Para 23: “The chief AML/CFT officer should also have the responsibility for reporting suspicious transactions. The chief AML/CFT officer should be provided with sufficient resources to execute all responsibilities effectively and play a central and proactive role in the bank’s AML/CFT regime. In order to do so, he/she must be fully conversant with the bank’s AML/CFT regime, its statutory and regulatory requirements and the ML/FT risks arising from the business, including the different risks associated with different customers, products and services in order to take appropriate (i.e., proportionate) risk mitigation measures in relation thereto.”

### Customer Acceptance

Para. 30: “A bank should develop and implement clear customer acceptance policies and procedures to identify the types of customer that are likely to pose a higher risk of ML and FT pursuant to the bank’s risk assessment.<sup>179</sup> For enhanced CDD used in higher risk situations ~~When assessing the risk~~, a bank should consider all relevant factors such as a customer’s background, occupation (including a public or high-profile position), source of income and wealth, country of origin and residence (when different), use and purpose of accounts, linked accounts, business activities or other customer-oriented risk indicators before determining what is the level of overall risk and the appropriate measures to be applied. Consistent with the FATF Recommendations, for lower risk situations, simplified measures may be permitted, such as permitting verification of the identity of the customer after the establishment of the business relationship (e.g., if account transactions rise above a defined monetary threshold)<sup>10</sup> or not requiring an address or identification number.”

Para. 31: “Such policies and procedures should require basic due diligence for all customers and enhanced due diligence as the level of risk associated with the customer increases. For example, the application of ~~basic~~ simplified account-opening procedures may be appropriate for lower-risk accounts (e.g., accounts with low transaction and balance limits) or for an individual who expects to maintain a small account balance and use it to conduct routine retail banking transactions. It is important that the customer acceptance policy is not so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged. The FATF *Financial Inclusion Guidance*

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<sup>9</sup> Text of footnote 17: “The FATF standards also include useful guidelines on how the bank may effectively implement a risk-based approach (see in particular Recommendation 1).”

<sup>10</sup> “It is essential to distinguish between identifying the customer and verifying identification. Customer identification entails the gathering of information on the (future) customer to identify him/her. *At this stage, no identification documentation is collected.* In contrast, the verification of the customer identification requires checking reliable, independent source documentation, data or information that confirms the veracity of the identifying information that was obtained during the identification process” (italics added). FATF Guidance Paper, para. 66.

provides useful guidelines on application of the risk-based approach that should be considered when designing AML/CFT procedures ~~that are not overly restrictive to the financially or socially disadvantaged~~. Enhanced due diligence may be essential for an individual planning to maintain a large account balance and conduct regular cross-border wire transfers or an individual who is a politically exposed person (PEP). In particular, such enhanced due diligence is required for foreign PEPs. Decisions to enter into or pursue business relationships with higher-risk customers should entail enhanced due diligence measures, such as approval to enter into or continue such relationships, being taken by senior management. The bank's customer acceptance policy should also define circumstances under which the bank would not accept a new business relationship or would terminate an existing one."

### **Customer and beneficial owner identification, verification and risk profiling**

Para. 32: "The FATF standards require banks to identify the customers and verify their identity ~~when establishing business relations or carrying out transactions above USD/EUR 15,000 or that are wire transfers~~, unless the country has determined ~~through a risk assessment that (i) a particular financial institution or types of activities (and customers associated with the activities) may~~, is carried out on an occasional or very limited basis ~~and there is a low risk of ML or TF or be exempted because~~ (ii) there is a proven low risk of ML or FT (occurring in strictly limited and justified circumstances) related to a particular type of financial institution or activity.<sup>11</sup>"

Para. 33: "A bank should establish a systematic procedure for identifying and verifying its customers and, where applicable, any beneficial owner(s). Generally, ~~subject to possible exemptions for low risk and possible simplified measures for lower risk of ML/TF~~, a bank should not establish a banking relationship, nor carry out any transactions, until the identity of the customer has been satisfactorily established and verified ~~in accordance with any prescribed documentation requirements~~ FATF Recommendation 10. Consistent with BCP 29 and the FATF standards, the procedures should also include ~~the identification of the beneficial owner and~~ the taking of reasonable measures to verify the identity of the beneficial owner. A bank should also verify that any person acting on behalf of the customer is so authorised, and should verify the identity of that person."

Para. 35: "While the customer identification and verification process is applicable at the outset of the relationship or before an occasional banking transaction is carried out, a bank should use this information to build an understanding of the customer's profile and behaviour. The purpose of the relationship or the occasional banking transaction, the level of assets or the size of transactions of the customer, and the

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<sup>11</sup> The FATF Guidance Paper states that "In most jurisdictions, the current exemptions or limitations on applying AML/CFT requirements to certain financial activities are essentially based on a 'perception' of low risk because of the activity's size or nature (e.g., leasing, factoring, life insurance) with little or no evidence to support the risk ranking. Only a few jurisdictions have undertaken risk assessments before exempting a sector." (para. 57)

regularity or duration of the relationship are examples of information typically collected, although where ML/TF risks are lower, a risk-based approach could mean that the bank would collect on limited information (e.g., transaction activity).<sup>12</sup> Therefore, a bank should also have policies and procedures in place to conduct due diligence on its customers sufficient to develop customer risk profiles either for particular customers or categories of customers. These profiles will facilitate the identification of any account activity that deviates from activity or behaviour that would be considered “normal” for the particular customer or customer category and could be considered as potentially suspicious or unusual. Customer risk profiles will assist the bank in further determining if the customer or customer category is higher-risk and requires the application of enhanced CDD measures and controls. The profiles should also reflect the bank’s understanding of the intended purpose and nature of the business relationship/account, sources of customer funds or income and wealth, expected level of activity and type of transactions, and other similar considerations. Any information collected on customer activity or behaviour should be used in updating the bank’s risk assessment.”

Para. 36: “To verify customer identity, a bank should obtain customer identification papers, comply with FATF Recommendation 10 and use reliable, independent source documents, data or information as well as any information and documentation obtained as a result of CDD conducted on the customer. This could include copies of or records of official documents (eg passports, identity cards, driving licences), account files (eg financial transaction records) and business correspondence, including the results of any analysis undertaken such as the risk assessment and inquiries to establish the background and purpose of the relationships and activities.”

Para. 37: “A bank should also obtain all the information necessary to establish to its full satisfaction the identity of their customer and the identity of any person acting on behalf of the customer and of beneficial owners. While a bank is required to both identify its customers and verify their identities, the nature and extent of the information required for identification and verification purposes will depend on the assessed risk assessment to be mitigated, including the type of applicant (personal, corporate, etc), and the expected size and use of the account. The specific requirements involved in ascertaining the identity of natural persons are usually prescribed in national legislation. For enhanced customer due diligence in the case of a higher-risk scenario, a bank should also obtain all the information necessary to establish to its full satisfaction the identity of their customer and the identity of any person acting on behalf of the customer and of beneficial owners. If the relationship is complex, or if the size of the account is significant, additional identification measures may be advisable, and these should be determined based on the level of overall risk. For lower-risk scenarios, simplified measures could be applied,

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<sup>12</sup> As stated in Interpretive Note to Recommendation 10 of the FATF Standards, instead of collecting specific information on the purpose and intended nature of the business relationship, the purpose and intended nature would be *inferred* from the type of transaction or business relationship (para. 21).

requiring banks to obtain information *reasonably required* to establish to its *reasonable satisfaction* such identities. Higher-risk customers will require the application of enhanced due diligence to verify customer identity. If the relationship is complex, or if the size of the account is significant, additional identification measures may be advisable, and these should be determined based on the level of overall risk.”



Annex 2

**Proposed Amendments Regarding the Role of Supervisors**

The following texts are quoted from the draft paper. The suggested additions are highlighted in yellow. Suggested deletions are highlighted in red and have a line through the text.

Para. 84: “Higher-risk **and lower-risk** lines of business or customer categories may **each** require specialised expertise and additional procedures to ensure ~~an~~ effective review. The bank’s risk profile should also be used in determining the frequency and timing of the supervisory cycle. Again, banks dealing with higher risk profiles may require more frequent review than others. Supervisors should also verify whether banks have adequately used their discretion with regard to applying AML/CFT on a risk-based approach. They should also evaluate the internal controls in place and how banks determine whether they are in compliance with supervisory and regulatory guidance, and prescribed obligations. The supervisory process should include not only a review of policies and procedures but also, when appropriate, a review of customer documentation and the sampling of accounts and transactions, internal reports and suspicious transaction reports. Supervisors should always have the right to access all documentation related to the transactions conducted or accounts maintained in that jurisdiction, including any analysis the bank has made to detect unusual or suspicious transactions.”

Annex 3

**Proposed Amendments Regarding Policies with respect to Third Parties/Agents**

The following texts are quoted from the draft paper. The suggested additions are highlighted in yellow. Suggested deletions are highlighted in red and have a line through the text.

Para. 19: “A bank should have adequate policies and processes for screening prospective and existing staff **and third parties** to ensure high ethical and professional standards for hiring staff. All banks should implement ongoing ~~employee~~ training programmes for employees **and third parties** so that bank staff are adequately trained to implement the bank’s AML/CFT policies and procedures. The timing and content of training for various sectors of staff will need to be adapted by the bank according to their needs and the bank’s risk profile. Training needs will vary depending on staff functions and job responsibilities and length of service with the bank. Training course organisation and materials should be tailored to an employee’s specific responsibility or function to ensure that the employee has sufficient knowledge and information to effectively implement the bank’s AML/CFT policies and procedures. New employees should be required to attend training as soon as possible after being hired, for the same reasons. Refresher training should be provided to ensure that staff are reminded of their obligations and their knowledge and expertise are up to date. The scope and frequency of such training should be tailored in light of the risk factors to which employees are exposed due to their responsibilities and the level and nature of risk present in the bank.”

Para. 20: “As part of **the second line of defence**, the chief officer in charge of AML/CFT should have the responsibility for ongoing monitoring of the fulfilment of all AML/CFT duties by the bank **(including third parties)**. This implies sample testing of compliance and review of exception reports to alert senior management or the board of directors if it is believed management is failing to address AML/CFT procedures in a responsible manner. The chief AML/CFT officer should be the contact point regarding all AML/CFT issues for internal and external authorities, including supervisory authorities or financial intelligence units (FIUs).”

Para. 24: “**Internal audit, the third line of defence**, plays an important role in independently evaluating the risk management and controls, and discharges its responsibility to the audit committee of the board of directors or a similar oversight body through periodic evaluations of the effectiveness of compliance with AML/CFT policies and procedures. A bank should establish policies for conducting audits of i) the adequacy of the bank’s AML/CFT policies and procedures in addressing identified risks, ii) the effectiveness of bank staff **and third parties** in implementing the bank’s policies and procedures; iii) the effectiveness of compliance oversight

and quality control including parameters of criteria for automatic alerts; and iv) the effectiveness of the bank's training of relevant personnel, including third parties. Senior management should ensure that audit functions are allocated staff who are knowledgeable and have the appropriate expertise to conduct such audits. Management should also ensure that the audit scope and methodology are appropriate for the banks' risk profile and that the frequency of such audits is also based on risk. Periodically, internal auditors should conduct AML/CFT audits on a bank-wide basis. In addition, internal auditors should be proactive in following up their findings and recommendations.<sup>16</sup> As a general rule, the processes used in auditing should be consistent with internal audit's broader audit mandate, subject to any prescribed auditing requirements applicable to AML/CFT measures."