An Index to Evaluate Risk of Money Laundering in Designated Non-Financial Institutions, Challenges Faced by Emerging Market Economies and a Case Study for Sri Lanka

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Abstract

With the recent economic downturn amidst the spread of COVID-19 and its containment measures globally, the scale of money laundering activities has increased substantially. Under these trying conditions, money launderers exploit opportunities beyond financial institutions into non-financial institutions. The Financial Actions Task Force (FATF), the global policy setter on combating money laundering, has recognized the vulnerable areas and has identified several higher-risk non-financial institutions named designated non-financial businesses and professions (DNFBPs). However, it appears that the focus of country authorities on the risk emanating from the DNFBP sector is far less than the financial sector. This could be due to the lack of proper assessments of money laundering vulnerabilities of the sector. One major impediment in applying regular approaches to assess vulnerability in the DNFBP sector is insufficient data available in emerging and developing economies. Therefore, this study proposes a bottom-up approach for DNFBPs considering the lack of data and informality prevailing in the sector. This index will allow authorities to evaluate preliminary risk levels and further study the sector to allocate required resources to combat illegal activities. Further, this study has identified six main challenges hindering the proper control of illegal activities in the DNFBP sector, namely, regulatory and supervisory concerns, lack of awareness of corporate management of firms and lack of technology, primitive state of businesses, political interventions, lack of government support and structural issues. Finally, a case study of Sri Lanka has been discussed to elaborate on how Sri Lanka has faced such challenges while implementing the FATF requirements relevant to combat money laundering in the country's non-financial sector.

Keywords: *non-financial institutions, emerging market economies, FATF, money laundering, risk*

1. Introduction

Money launderers exploit opportunities elsewhere than financial institutions. With the economic downturn amidst the spread of COVID-19 and its containment

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measures globally, the scale of such money laundering activities through non-financial institutions is expected to have increased substantially. The Financial Actions Task Force (FATF), the global policy setter on combating money laundering, countering terrorist financing and proliferation financing, has recognized several high-risk non-financial institutions and termed them as Designated Non-financial Businesses and Professions (DNFBPs).

Non-financial businesses such as casinos, real estate agents, dealers in precious metals and precious and semi-precious stones, and professional service providers such as lawyers, notaries, accountants, and trust & company service providers (sometimes referred to as Gatekeepers) are designated as DNFBPs. According to the FATF Recommendations, these businesses and professions should take specific measures to deal with higher-risk situations to eliminate such unlawful activities. These DNFBPs are prone to commit money laundering activities due to several reasons, such as less regulations and restrictions than financial sectors, large values involved in transactions that support many criminal proceeds that can be laundered easily misusing such transactions, etc. Therefore, FATF Recommendations 22, 23 and 28 require countries to apply specific requirements of conducting customer due diligence, retaining customer and transaction records for a stipulated period, reporting money laundering suspicions to the country's AML competent authority. Further, the country's AML competent authority must supervise DNFBPs on their compliance with AML measures enacted in the country.

However, a lack of available tools to evaluate the overall country's money laundering risk emanating from the DNBFP sector has been observed. Most of the guidance provided in this regard has qualitative approaches such as interviews, professional views, judgements, etc. Accordingly, this study attempts to fill the void by introducing a framework to create an index to assess the preliminary risk of money laundering in DNFBPs. Further, this paper explores challenges faced by emerging economies to ensure non-financial institutions' compliance under the three core FATF recommendations. Moreover, as a practical illustration, the study presents how Sri Lanka has overcome the identified challenges in introducing the compliance culture into its DNFBPs.

2. Literature Review

The risk-based approach is central to the FATF standards (FATF Guidance, National Money Laundering and Terrorist Financing Risk Assessment-Feb 2013). The core aspects in this regard are identification, assessment and understanding the money laundering risk. Hence, countries need to have proper tools to identify, assess and understand the money laundering risk in a country. FATF requires countries and jurisdictions to understand the sources and methods of money laundering to develop effective anti-money laundering program (ML & TF Risk Assessment strategies - FATF-GAFI 2008). As per the FATF Recommendation 1, financial institutions as well as DNFBPs should be able to identify, assess and take appropriate actions to mitigate or control risks (FATF 2012) which is conducted more qualitatively by most of the countries based on professional judgements, experts' opinions, etc. (Ferwerda & Reuter, 2018). However, there are many disadvantages of identifying and assessing money laundering risk through qualitative methods such as over or underestimate the money laundering risk, and they may have a different opinion on a business nature and its operations (Ferwerda & Kleemans, 2018). The financial sector and non-financial sector of a country have a somewhat similar set of global standards to be complied with as per the global requirement of anti-money laundering (FATF, 2020). As recommendations earlier have focused on controlling drug trafficking and misusing financial institutions to launder drug proceeds, these global standards are well established in the financial sector compared to the non-financial sector (Muller, Kalin & Goldsworth, 2007).

Accordingly, countries must have straightforward tools in identifying, analyzing, and evaluating the money laundering risk of financial and non-financial sectors. The FATF has issued sectorial guidelines. However, it is the country's responsibility to have a proper tool to assess its own money laundering risk based on these guidelines. The financial sector has different tools in this regard, and data are readily available compared to the non-financial sector, and various tools have been introduced to assess the money laundering risk of financial institutions (Lyeonov, Żurakowska-Sawa, Kuzmenko & Koibichu, 2020). In the FATF assessment, it has been revealed that most of the countries belong to non-compliant or partially compliant categories for applying AML measures for the non-financial sector (Choo, 2012). As conducting an NRA is a compliance requirement as per the global standards, most researchers have highlighted that an effective methodological tool is essential to carry impartial, comprehensive and adequate money laundering risk assessment (Dmytrov & Medvid, 2017). Client base, the jurisdictions in which they operate, the effectiveness of the risk controls already in place (FATF Guidance for a risk-based approach-Accounting profession, 2019) are the factors to be considered in this regard.

3. Index to Evaluate Vulnerability of Money Laundering in DNFBPs

This paper provides a framework for countries to understand the preliminary money laundering risk of their DNFBP sector. One major impediment in applying regular approaches to the DNFBP sector is insufficient data available in this sector in the emerging and developing world. The advantage of the bottom-up approach used in this paper, in this context, is that the information is collected directly from the grass-root level, i.e., firms in the relevant sector. As recommended by the FATF through its guidelines, a combination of quantitative and qualitative assessment is proposed in this study to assess money laundering risk properly. Hence, this framework can be complemented with purely qualitative methods used by the countries presently. In selecting variables, attention has been given to variables that make a business or a professional service provider in the DNFBP sector exposed to money laundering. In this framework, the money laundering threat is not collected from firms. However, such threat has to be considered by relevant authorities.

4. Approach to Calculate a Vulnerability Index to DNFBP Sector

Phase 1: Grass-root level data are to be collected from firms (businesses and professions) in each sector to assess the vulnerability of each firm and the sector. If many firms exist in a sector, a random sample of around 25 percent of firms based on the firm size (using the annual turnover) could be used to collect data. A template to collect data is proposed in this study, which is not an exhaustive list, and could be revised as per the country and sector requirement. For example, a country can use money laundering typologies, case studies, convicted money laundering cases, NRA reports of other countries and other relevant criminal and other judicial reports to select risk criteria. The principal vulnerabilities considered in the questionnaire are, as per FATF guidelines, the firm's customer base, currently available types of products and services, delivery channels, geographical locations of a firm, and strength of prevailing AML control measures. Accordingly, based on firm-wise data, a firm-wise index is calculated using the template and scores given in the template.

Phase 2: A sector-wise index is calculated using the index generated for each firm in Phase 1. In this calculation, as a proxy to determine the firm size, the annual turnover of the firm is considered. Accordingly, the sector level index is calculated as follows:

$$I_{Ai} = \sum_{j=1}^{n} I_{Aij} \frac{T_{Aij}}{\sum_{j=1}^{n} T_{Aij}},$$

where I_{Ai} is the index for the i^{th} sector, $i = 1 \ldots m$. There are m sectors in the economy. I_{Aij} is the index for the j^{th} firm in the i^{th} sector, $j = 1 \ldots. n$. T_{Aij} is the annual turnover of the j^{th} firm in the i^{th} sector.

Phase 3: The overall index is calculated using the index generated for each sector in Phase two. Accordingly, overall vulnerability for the DNFBP sector is given by:

$$I_{DNFBP} = \sum_{j=1}^{m} I_{Ai} \frac{\sum_{j=1}^{n} T_{Aij}}{\sum_{j=1}^{m} \sum_{j=1}^{n} T_{Aij}},$$

5. Challenges in Implementing the FTAF Recommendations

Campa (2020) explains that ML/TF cannot be fought in isolation. Governments, the public sector, as well as the private sector have a role to play in this regard. These international measures on combating money laundering have been originally designed and introduced to protect the misuse of financial sectors and financial institutions such as banks, non-bank financial institutions, insurance companies and currency exchangers for money laundering activities. However, the FATF requires DNFBPs to gradually adapt some of the similar controls relevant to financial institutions and deal with their customers with special care. From the introduction of these requirements so far, most countries, especially the developing world, are still struggling to introduce and implement these requirements to their non-financial businesses and professional sectors. It is identified that most countries have found it challenging when it is compared with the introduction and implementation of such measures to their financial segments due to reasons such as structural issues, regulatory requirements and supervisory concerns, lack of awareness of corporate management of firms and lack of technology in firms, primitive state of businesses, political interventions, and lack of government support.

6. The Case of Sri Lanka

Sri Lanka has been monitoring its financial sector compliance on anti-money laundering and countering the financing of terrorism measures for an extended period; however, the non-financial sector was not properly brought under the same roof until recently due to some of the factors discussed under the challenges of implementing anti-money laundering and countering the financing of terrorism in this study. By 2017, Sri Lanka was evaluated by its international peer reviewers under the FTAF's country assessment procedures as a country that needs to improve its anti-money laundering and counter the financing of terrorism measures further for the non-financial sector. Accordingly, Sri Lanka had to expedite the effective inclusion of its DNFBPs into the country's national anti-money laundering and countering the financing of the terrorism regime. In introducing anti-money laundering and countering terrorism measures for designated non-financial businesses and professions in Sri Lanka, the FIU-Sri Lanka has taken several necessary steps that have ultimately benefited effective implementation of anti-money laundering countering the financing of terrorism measures for the non-financial sector in Sri Lanka.

The FIU-Sri Lanka established a separate division for regulating and supervising designated non-financial businesses and professions for AML/CFT purposes. First, market studies have been conducted separately on each designated non-financial businesses and professions to understand the nature of operations and the market sizes. Then FIU-Sri Lanka has drafted and issued AML/CFT rules and regulations for DNFBPs. Parallelly, a countrywide awareness campaign has been carried out with the issuance of rules. The awareness campaign has been conducted with the support of all the designated non-financial sector related stakeholders such as regulators, authorities, unions, and chambers, as well as from the newly formed DNFBP Working Group, which represents members from each DNFBP sector. Outreaching sessions such as seminars, meetings, presentations, newspaper articles, web notices, banners, workshops, training sessions and one-on-one meetings have been fruitful in this regard. Registering designated non-financial businesses and professionals in each sector has been initiated.

Currently, the FIU-SL supervises DNFBPs for compliance with issued rules and regulations and, corrective actions are taken on non-compliance such as not appointing a compliance officer, no CDD is conducted, no written AML/CFT policy is available, and no proper records are kept. Forming the Working Group for implementing these requirements has been a fact to be highlighted here, which has been very useful in many ways. Further, different facilities have been made available to access more information, such as a separate email facility, phone lines and webspace on the FIU-SL website. In addition, the relevant regulatory bodies and other key stakeholders such as self-regulatory bodies, unions and licensing authorities have made available spaces in their websites to provide communications related to the FIU to their relevant institutions. A memorandum of understandings has been signed with relevant authorities or regulatory bodies to make the inter-agency cooperation more effective. Introducing an effective anti-money laundering and countering the financing of terrorism regime for higher risk DNFBPs was one of the major actions among other actions that helped Sri Lanka to come out from the list of FATF's closely monitored countries (which is well-known as the Grey List).

7. Conclusion and Policy Implications

FATF has recognized several high-risk non-financial institutions and named DNFBPs that can be exploited for such illegal activities. However, it appears that the focus of country authorities, especially of emerging market economies, on vulnerabilities emanating from the DNFBP sector is far less than the financial sector.

In this study, a framework was proposed for an index to assess the preliminary risk of money laundering in non-financial businesses and professions. The proposed approach is a bottom-up approach considering the lack of data and informality prevailing in this sector. This index allows authorities to evaluate preliminary risk levels and further study the sector to allocate required resources to combat illegal activities. In addition, this study identified the main challenges that affect the proper control of illegal activities in the DNFBP sector. Finally, a case study of Sri Lanka was discussed to elaborate on how Sri Lanka has faced those challenges during its period of introducing and implementing the FATF requirements to the country's non-financial segment.

The results of this study have several policy implications. First, the proposed framework to evaluate vulnerabilities in the DNFBP sector allows authorities to evaluate preliminary risk levels and act accordingly. Second, once the money laundering risk of the DNFBP sector is assessed, the policymakers can introduce enhanced measures to higher risk sectors whilst simplified control measures for lower-risk sectors. Accordingly, the authorities could allocate required resources optimally to combat illegal activities. Further, the main challenges identified in the study could be explored by policymakers to overcome such challenges. Finally, the case study on Sri Lanka could be considered as a guide to initiate and strengthen action on combating money laundering in the DNFBP sector.

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