Assessing the risk of money laundering: research challenges and implications for practitioners

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Introduction

Over the past 12 years, the concept of *risk* has become central to the anti-money laundering (AML, hereinafter) debate worldwide. All the actors involved in the prevention of money laundering — governments, law enforcement agencies, public authorities, banks and professionals — have been asked to shift from a *rule-based* paradigm to a *risk-based* approach, allocating their AML efforts where the risk of money laundering is higher.

The key reference of this risk-based approach (RBA) is the first of the 40 Recommendations issued by the Financial Action Task Force (FATF). FATF Recommendation 1 provides that AML measures should be “*commensurate with the risks identified*” (FATF 2012, pg. 31): higher money laundering risks require enhanced measures, lower risks allow for simplified ones. Consequently, AML resources (e.g. processes, people, investigations) should be deployed according to the estimated risk.

The RBA is a very innovative paradigm. For the first time, public and private institutions are advised not to comply blindly with the law but to evaluate where and when to take action. This innovation has found a lot of success among regulators and policy-makers. Since its introduction in the late 1990s by the FATF, the RBA has inspired the AML legislation of most countries worldwide, including the United States and most European countries. The Directive 2015/849 (or 4th EU AML Directive) and the forthcoming 5th AML Directive devote an entire section to the RBA. However, its success goes beyond geographical scope. The RBA is applied by both governments and private companies, namely all the *obliged entities* which are subject to AML legislation: banks, insurances, professionals, notaries, casinos, real estate agents, high value dealers, among others.

All these actors should carry out an assessment of how money laundering risks distribute across areas, sectors, products and clients. The FATF and, in the EU, the 4th AML Directive

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require countries to improve the understanding of where risks are. In the last 5 years this recommendation has brought in a proliferation of so-called AML *National Risk Assessments* (NRA), such as in Italy (2014, under update), the United States (2015), Japan (2015), Switzerland (2015), the United Kingdom (2015) and Germany (2016) (for a complete overview on NRAs see Veen and Ferwerda 2016). At the EU level, even a *supranational* risk assessment exercise was carried out (European Commission 2015) and is currently under revision. The result is a patchwork of diverse exercises, often generic, difficult to compare and not always relevant for investigators and practitioners.

Similarly, banks, professionals and other obliged entities, in order to respond to AML regulatory requirements, have developed methodologies to assess the money laundering risk of their clients as part of their *customer due diligence* (CDD) process. These methods often rely on automated systems based on algorithms and on (at least declared on paper) the latest scientific advances, such as machine learning and artificial intelligence. Banks, in particular, have invested millions of euro in costly models and IT tools which remain black boxes; difficult to interpret, test and validate (Savona and Riccardi 2017).

Despite the centrality at policy and regulatory level, the issue of money laundering risk and risk assessment have been ignored for years in academic literature. In this field, practitioners have gone far beyond what researchers have produced. The result is that most of the available money laundering risk assessment exercises — produced both by governments and obliged entities — rely on poor theoretical and methodological frameworks and on weak empirical evidence.

The lack of dialogue between practitioners and academic researchers has opened a wide space now occupied by consulting and IT companies who, over the years, have imposed their risk assessment ‘standards’ on obliged entities. The consequence is that, despite the innovative principle intrinsic to the RBA, the actors required to apply it end up carrying out ritual risk assessments just because they are required to by law: the same ‘compliance culture’ which the introduction of the RBA sought to turn over. Only improving the quality of research in this area could improve the quality of the ML risk assessment produced by practitioners, and bring the RBA back to its original spirit.

This special issue

This Special Issue goes in this direction and aims to fill the above research gap. It groups together empirical and theoretical contributions from the latest academic research on this topic. It provides a critical review of the concept of money laundering risk, of how the risk is currently assessed and it suggests some alternative approaches to produce risk metrics which on the one hand could complement NRAs, and on the other hand could support the daily activity of AML practitioners.

The first contribution by Ferwerda and Reuter (2018) is a critical review of current national risk assessments. The authors focus on two recent NRAs, the Italian and Swiss, which from a methodological perspective represent the benchmark. A comparison of the two exercises is presented, confronting the methodological approaches, the theoretical assumptions and the results. The authors also discuss the pros and cons of the FATF conceptualization of money laundering *risk* and suggest some inputs on how to improve NRA exercises.

Second, Riccardi, Milani and Camerini (2018), starting from the FATF risk definition, elaborate a methodology to produce a composite indicator of ML risk at the sub-national level,

and apply it to the 110 Italian provinces. The authors propose a methodological approach which is transparent, empirically-backed, replicable over time and across geographic areas, and which could complement current NRAs. Beyond presenting the main results of the application in Italy, the authors discuss how such indicators could be useful both for policy-makers and for practitioners involved in CDD activities, while stressing the limits of such approach.

In the same vein, Ferwerda and Kleemans (2018) propose a methodology to assess the risk of money laundering across business sectors, and test it in the Netherlands. Their application reveals that casinos, hotels and the art sector have the highest money laundering risk in the Dutch economy. The authors describe the theoretical and empirical assumptions of their model, and they validate the results referring to experts' opinions and to police/judicial evidence provided by Dutch public authorities.

Hopkins and Shelton (2018) first provide a critical review of the two waves of NRA carried out in the United Kingdom in 2015 and 2017, discussing the strengths and the weaknesses of the institutional approach; and second propose an alternative methodology which, operationalizing the risk of money laundering as defined by FATF in a range of variables, could lead to the production of a composite indicator of ML risk across the 43 police areas of England and Wales.

Finally, Soudijn (2018) focuses on the sources that can be used for carrying out assessments of money laundering risk. In particular, he discusses the opportunity to use past police reports to identify how ML techniques (or typologies, in FATF taxonomy) evolve over time, to assess how ML risk can change in the future. He tests this idea by looking at 12 years (2005 to 2017) of Crime Pattern Analyses on Money laundering, i.e. reports periodically issued by the Dutch police, and by collecting cases and interviews on money laundering. The author also discusses the downsides of using such approach, questioning to what extent the evolution of ML techniques are a result of a change in criminals' behaviour as opposed to variations in the research methodology.

The contributions contained in this Special issue can benefit a wide range of stakeholders. Firstly, AML practitioners in both the public and private sector can find useful scientific references and inputs to develop CDD methodologies or risk assessment exercises. Secondly, researchers in the field of money laundering, economic and financial crime, and also that of corruption and organised crime, can find sound empirical exercises to support the *risk* paradigm studies increasingly advocated in their respective fields.

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