



RISK BASED ASSESSMENT AND CUSTOMER DUE DILIGENCE – THE USE OF TECHNOLOGY (AI, NLP, DLT AND API)

CFATF RESEARCH DESK
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ACRONYMS



AI- Artificial Intelligence

NLP- Natural Language Processing

DLT - Distributed Ledger Technology

API - Application Programming Interface

VASPs - Virtual Asset Service Providers





What is a Risk Based Approach (RBA)



- Under a RBA, consideration is given to the nature and extent of Money Laundering (ML) and Terrorist Financing (TF) a jurisdiction is exposed to.
- Implementation of appropriate measures is conducted in proportion to the level of risk in the jurisdiction's specific circumstances.
- Stronger measures are applied in higher risk situations and simplified measures in lower-risk situations.



Understanding ML/TF risks



ML/TF risks can be broadly understood on two levels:

- (1) At the whole-of-reporting entity level
- (2) In relation to particular customers and business relationships.

In line with an organisation's risk assessment, a range of risk-based systems and controls must be applied when dealing with particular customers, including:

- procedures to verify customers' identity and for ongoing due diligence;
- understanding the nature and purpose of the business relationship with different customer types;
- understanding the control structure of non-individual customers (i.e. underlying beneficial ownership information);
- understanding risks arising from changes in the nature of the business relationship, control structure, or beneficial ownership of your customers;
- ongoing monitoring of transactions and business relationships with the assessed level of ML/TF risks.



Purpose of the RBA (1)



The purpose of the RBA is to allow governments, Financial Institutions, DNFBPs and VASPs within the framework of the FATF requirements, to adopt a more efficient allocation of resources to combating ML and TF by identifying and assessing the risks faced and determine those which are greater and which are lesser.

This should result in more effective implementation overall, by focusing resources and attention where they will have the biggest impact on the highest risk sectors and activities.



Purpose of the RBA (2)



“The risk-based approach should be the cornerstone of an effective AML/CFT system, and is essential to properly managing risks”. (FATF, 2014)

“Nevertheless, despite FATF Guidance, the FATF Strategic Review of the 4th Round of Mutual evaluations concluded that many jurisdictions continue to apply largely rule-based systems.”



The Private Sector and the RBA



The private sector continues to struggle to adopt the risk-based approach, preferring a costly and defensive approach to AML/CFT. A robust knowledge and awareness of risks, which allows for the capacity to mitigate and address risks proportionately is crucial to the effective implementation of FATF Standards.

According to the FATF, the traditional, rule-based approach has led to defensive compliance, rather than the application of different mitigating measures to different levels of risk. A defensive box-ticking application of the AML/CFT approaches to risk, is inefficient and burdensome, and more importantly does not reflect the real ML/TF threats to the institutions. A better approach would be to apply a genuine risk-based approach.



Benefits of the RBA



An article by AUSTRAC highlighted the benefits of utilising this approach which include:

- more efficient and effective use of resources;**
- minimising compliance costs and burdens on customers;**
- greater flexibility to respond to new and emerging risks as money laundering and terrorism financing methods change.**



FATF's report on the Opportunities and Challenges of New Technologies for AML/CFT- produced in July 2021



Source: OPPORTUNITIES AND CHALLENGES OF NEW TECHNOLOGIES FOR AML/CFT (fatf-gafi.org)

“Defensive AML/CFT frameworks are the result of regulatory or operational uncertainty and/or lack of trust in the strategies and mechanisms applied. Public and private sectors alike may lack trust in their own risk assessments because of their incomplete understanding of reality, lack of information and data, and lack of resources and tools to carry out solid, up-to-date and comprehensive risk assessments.”

However, if there is a greater capacity to collect, process and share data among stakeholders, this could result in significant advantages as it would promote a more dynamic risk-based approach.



Use of technology (1)



The application of machine learning and other AI based tools which allow for real-time, quick and more accurate data analysis may offer the solution to the issues identified above.

Such tools can partially or fully automate the process of risk analysis, allowing it to take account of a greater volume of data, and to identify emerging risks which do not correspond to already-understood profiles.

Such tools can also offer an alternative means of identifying risks - in effect acting as a semi-independent check on the conclusions of traditional risk analysis.

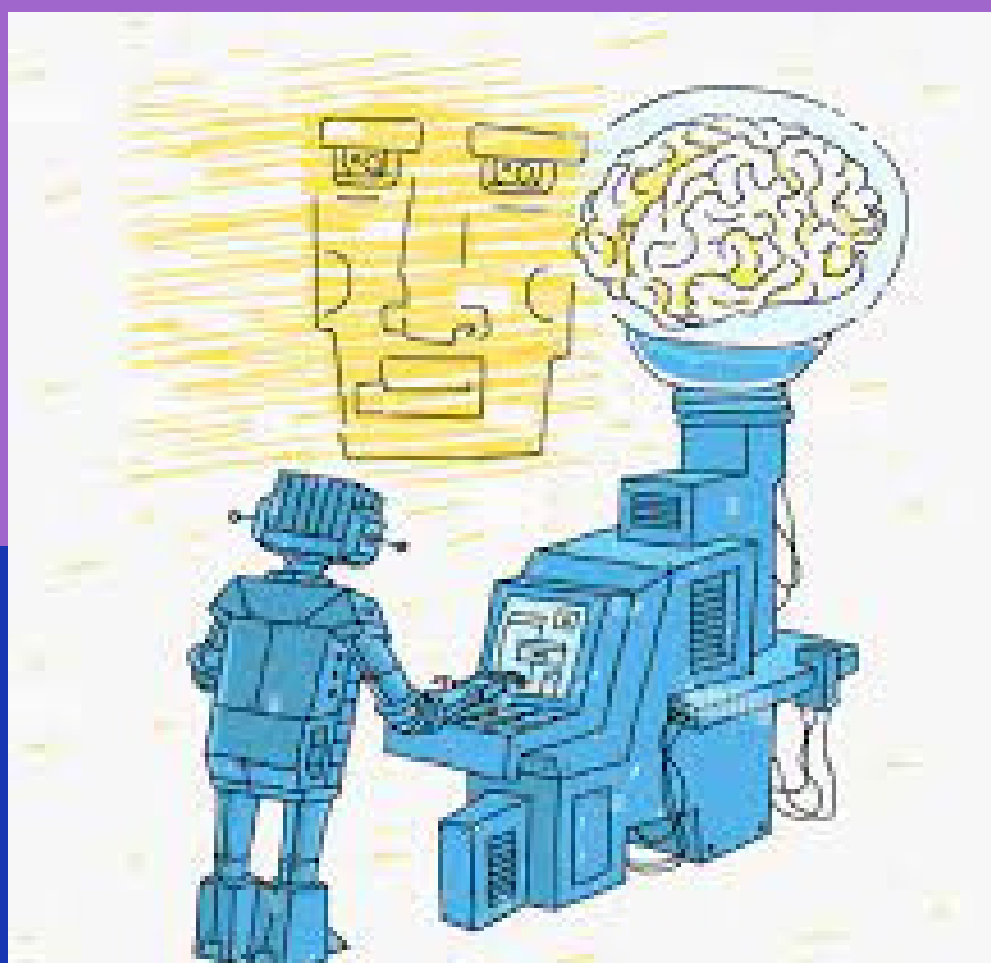


Use of technology (2)

The FATF's Report states that the application of machine learning and other AI based tools can offer a solution to the costly phenomenon of defensive compliance that much of the private sector adopting a rule-based approach struggles to shake. This is because AI and machine learning tools allow for real-time, quick and more accurate data analysis – all of which saves time and cost in compliance programs.



AI can automatically monitor transactions and reduce the need for initial human review



The FATF recommends the use of AI-enhanced transaction monitoring as it can allow regulated entities to comply with greater speed, accuracy, and efficiency. AI and machine learning are especially useful when applied to big data to strengthen ongoing monitoring, distinguish normal from suspicious activity in real-time, and filter cases that require additional investigation.

Machine learning, which is the currently the best-known form of AI, also provides the ability to automate the process of risk analysis partially or fully by analysing a greater volume of data and identifying emerging risks. This can increase the degree of confidence when applying risk-based measures.



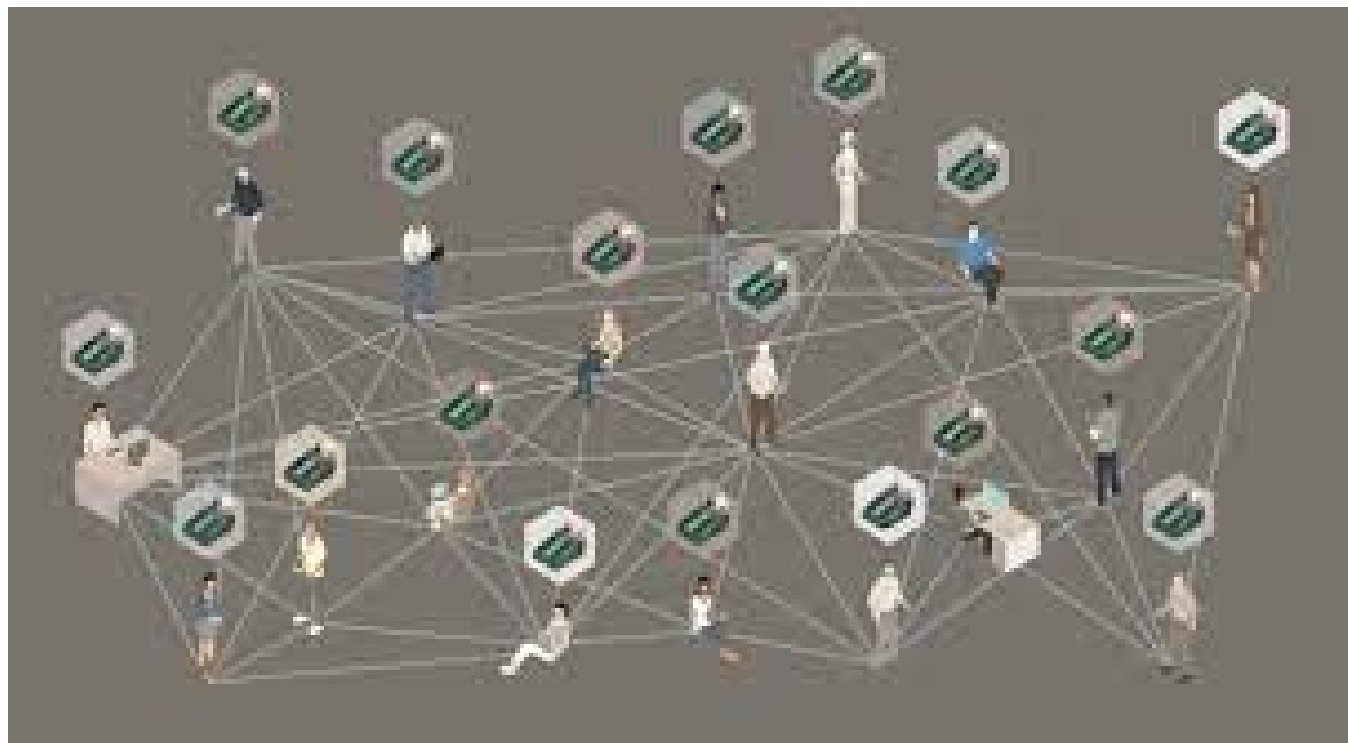
Natural Language Processing and fuzzy matching tools overcome data quality issues and help reduce false positives in AML

The FATF describes Natural Language Processing (NLP) as a branch of AI that enables computers to understand, interpret, and manipulate human language. NLP uses fuzzy logic, a logical technique that takes imprecise or approximate (fuzzy) data and processes it using multiple values to produce a useable (but imprecise) output.

Applying NLP and fuzzy matching tools to AML compliance alleviates to an extent those issues associated with poor data quality (such as incomplete or distorted data) and false positives and negatives to be efficiently reduced.



Distributed Ledger Technology may improve the traceability of transactions



The FATF puts forward the use of Distributed Ledger Technology (DLT) owing to its several potential benefits, including:

- The ability to make identity verification easier by improving transaction traceability on a cross border and even global basis.
- Increased monitoring possibilities because transactions could be managed via a single ledger and shared among several institutions across jurisdictions, or via interoperable ledgers.
- Improved management of customer due diligence requirements as well as greater cost effectiveness and a more accurate, quality-based data pool.

The FATF further acknowledges that DLT continues to pose challenges and raises significant concern from an AML/CFT perspective and thus its use needs to be closely monitored and further considered.



Digital solutions for customer due diligence will streamline onboarding processes



Applying new technologies, including digital ID and client screening/matching onboarding tools, can facilitate more streamlined onboarding processes adapted to the risk, context, and individual which can facilitate more effective compliance and also improve customer experience.

Client screening and matching tools benefitting from NLP and advanced fuzzy matching tools allow elements of identification to be differentiated, like similar names. They can also overcome language differences and identify cross-references with adverse media information and different databases.



Application Programming Interfaces are essential to AML/CFT efforts



For AML/CFT, APIs (Application Programming Interfaces) can connect KYC software to monitoring tools or risk assessment tools to customer risk profiles which can generate alerts and even alter risk classifications as behaviour changes.

APIs are particularly important in helping financial institutions overcome the difficulty of integrating many different - and often incompatible - systems, including specialised tools and legacy technologies created by different developers.



Technology implementation challenges for AML can be overcome



The FATF report acknowledges the adoption of new tech may come with regulatory or operational challenges and the need for clear support from FATF and national competent authorities for innovation in AML/CFT is paramount to increase private sector interest, investment and trust in new technologies.

To help secure this support, FATF highlights that interpretability and explainability of tools for AML/CFT is key. Not only do regulated entities need to explain and remain responsible for their operations, but supervisors themselves must be able to understand the models used by AI tools to determine their accuracy and relevance.



Technologically active AML supervisors are integral to new tech adoption



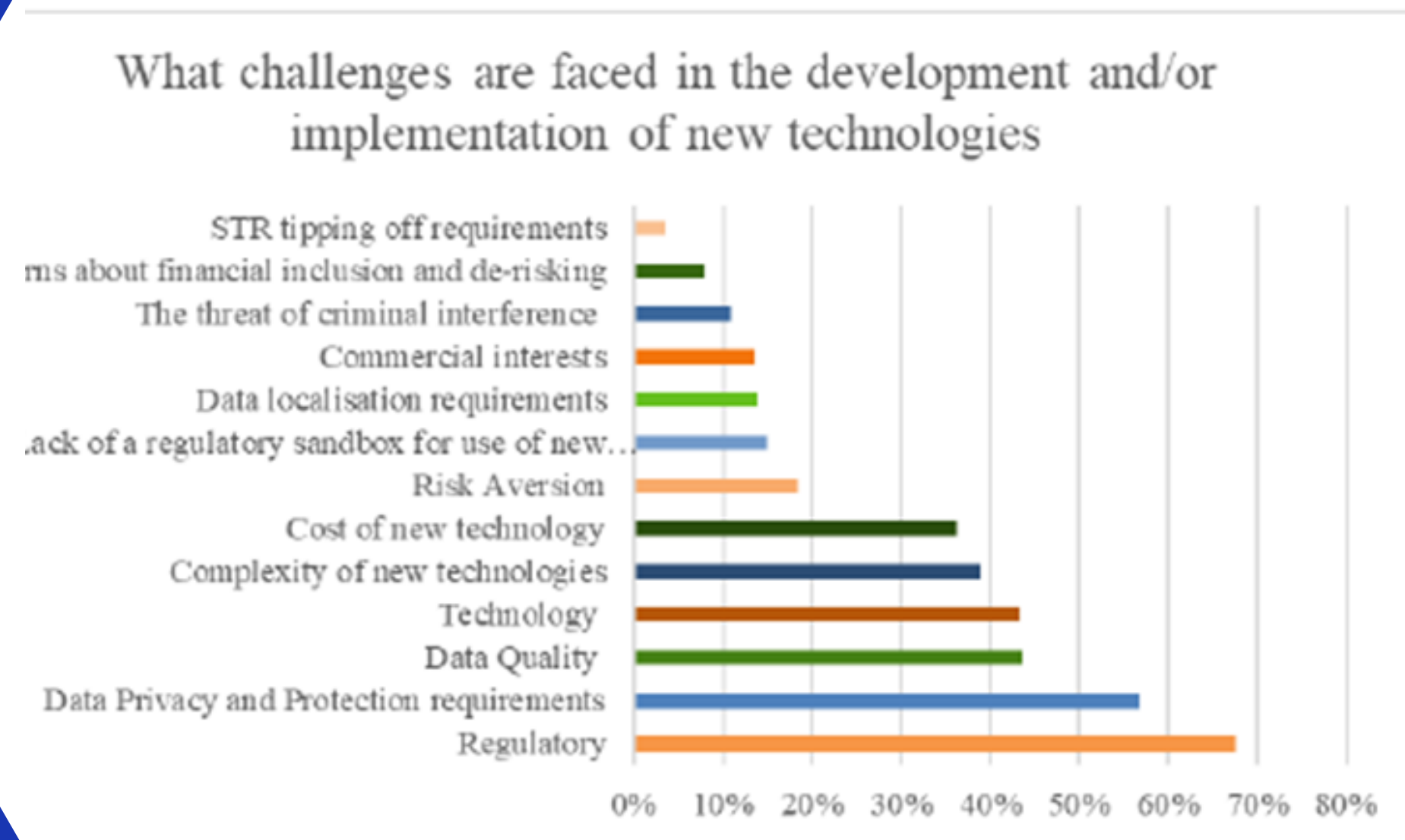
The FATF acknowledges that if it, along with supervisors, shows more active support for new technologies then this would help respond to the outstanding risk and trust concerns expressed by regulated entities. The role of “technologically active supervisors” (supervisors willing to engage with technology developers), as is already the case in many jurisdictions, therefore becomes integral to new tech adoption.

The FATF also acknowledges the need for greater collaboration between supervisors and regulated entities, specifically in the form of ongoing exchanges and cooperation rather than at specific events.



Challenges in the Development and/or Implementation of New Technologies

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Thank you!



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