Improving Global AML/CTF Supervisory Effectiveness

1. Introduction

Effective supervision is not an exact science & cannot be strictly defined, or considered as something that can be taken *"off the shelf"* and is expected to work & operate effectively, repeatedly and without many years & cycles of operation. It is for most countries a journey, which starts with legacy regulators & regulations, updated to reflect AML/CTF global standards rules & regulations, or even with newly installed regulators and coverage of sectors new to regulation. In time, regulation & regulators can evolve from a relatively basic coverage & limited capabilities for licensing and authorisations, supervision & sanctions, to more effective approaches where experience & confidence is gained, & a focus on technical compliance via an audit style approach can evolve into a more risk based understanding of the ML/TF threats & how these are being addressed & where the regulator has a positive influence/impact on the regulated sector, & even on other AML/CTF stakeholders.

GCFFC Experts (former senior supervisors and supervised) have identified **10 key enablers** for success in terms of effectiveness supported by **40 key takeaways**, that aim to support existing and future supervisors as they journey towards improving effectiveness. Supervisors may find themselves at different stages of maturity and benefit from some or all of these enablers and takeaways, which helps them continue their own journeys.

2. 10 Key Enablers and 40 Key Takeaways

The 10 key enablers focus on key areas where improvements in supervisory effectiveness could result in the biggest gains, in many countries. As Supervisors consider where improvements are still needed, 40 key takeaway's have been summarised in detail in a separate paper, with explanations and commentary. The summary of the key enabler and key takeaways are summarised below. The more detailed explanation and summaries is available to Supervisors on request.

1. Political Support and Operational Independence

- 1.1. Genuine Political leadership on tackling ML/TF is essential with appropriate governance, inviting supervisors to actively contribute to the wider AML/CTF effort and support for supervision, in terms of political support and ensuring operational independence. Political support can be demonstrated also in practice in terms of budgets and resources, promoting co operation between agencies and information sharing, including also internationally, where appropriate.

- 1.2 If the Supervisory system is combined with other agencies, including AML/CTF country leadership and or FIU activities, supervisors should still work and co operate with prudential and or conduct supervisors and ensure all supervisors enjoy operational independence.

- 1.3 With political support and operational independence must also come transparency responsibility and accountability.

2. Supervisory Coverage & System

- 2.1 Sectors mandated by FATF, such as FI's, DNFBP's and VASP's should be fully included without exception, so as to comply fully with FATF R15 & R22? Once included, supervisory coverage & effective supervision as required by R26 & R28 should be carried out. NPO's should only be subject to AML/CTF type supervision or oversight to the extent they fit the more limited definition in R8 being the relatively small segment of the NPO population that represents genuine ML/TF risk. Supervisors, should show leadership here to help balance to focus on the true Ml/TF risks without imposing unnecessary burdensome conditions on the entire sector, and to promote productive engagement including PPPs as further described in 6 below.

- 2.2 Additional sectors beyond those mandated by FATF should also be considered (if included in Country NRA's or Sector ML/TF Risk Assessments, though the level of coverage from supervisors can be risk based.

- 2.3 Whatever supervisory system is in place, & their is no ideal one system fits all approach, the system should be such where clear roles and responsibilities are allocated, with adequate coverage from one or more agencies, and where more than one or more agencies have responsibility for any sector, system effectiveness is likely enhanced through relevant AML/CTF and Sector knowledge and expertise in place and a spirit of co operation, collaboration and information sharing being demonstrated. It should be noted that countries are expected to apply the Basel Core Principles of Supervision (CP) to AML supervisory requirements, so to the extent that these are not followed, good reasons should be available.

3 Risk Based Supervision - ML/TF Risk Assessments

- 3.1 Supervisory ML/TF Risk Assessments are the result of the combination of two risk assessments, the Sector and the Entity Risk Assessment.

- 3.2 The Sector Risk Assessment is usually carried out periodically as part of a Country's National AMl/CTF Risk Assessment. Supervisors should be fully involved in this process. In most countries, Banks (particularly the largest Banks) are often considered as presenting the highest risks within the finance sector, with other financial service providers are also often risk rated on the basis of inherent risk and vulnerabilities. Other regulated sectors such as Casinos, DNFPb's and VASP's are also usually included in the National AML/CTF Risk Assessment.

- 3.3 The Entity Based Risk Assessments (for the purposes of classifying entities as higher, medium or lower risk), should be based on a methodology that establishes the inherent ML/TF risks of the entity, including by applying the appropriate sector risk rating (from the Sector Risk Assessment).

- 3.4 Supervisors may wish to consider the following:

  - 3.4.1 whether their entity risk ratings should be informed by the results from the entities own ML/TF risk assessment. Whilst an entities own risk assessment is required to be completed by the entity based on supervisory guidance and so should be consistent with the supervisors view on what data should be collected by the entity and what areas should be measured for the entity to determine its own inherent and residual ML/TF risks, no two entity risk assessments will be calibrated to a common basis and will present real reliance challenges for supervisors, without such a common standard being applied.

  - 3.4.2 whether to include an impact or size factor as a "dominant" or "determinative" risk factor, as this will distort the final results, producing ratings more useful to prudential supervisors rather than AML/CTF supervisors.

  - 3.4.3 whether to use additional information sought from entities and for example also from agencies such as the FIU where available, on the quality of reporting and co operation from reporting entities, which could be taken into consideration to assess the entities overall Ml/TF risk rating.

  - 3.4.4 If there are material differences in risk ratings from the entity's own risk assessment end from the supervisory risk assessment, these should be understood and resolved.

- 3.5 Supervisors should ideally use residual ML/TF risk ratings, provided the supervisor is confident that the rating can be evidenced and is fully justified, in particular by the independent testing of systems and controls, and the assessment of the quality of management. Where confidence levels are low, inherent risk is more likely used.

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- 3.6 Supervisors should ideally update entity risk assessment annually, (entity risk profiles) particularly in case of major changes and or events, except for lower risk entities. Sector risk assessments will usually be carried out periodically as part of a Country's National AML/CTF Risk Assessment.

4. Supervisory Plans

- 4.1 Supervisory plans should be risk based and intensify supervisory activities based on the risk ratings determined under the supervisory risk assessment.

- 4.2 Applying resources to supervisory tasks including the supervisory inspection plan should be based on ML/TF risks and not on available resources, though resources will always be limited to some degree and risk based decisions will need to be made.

- 4.3 Where populations of high risk are very large, these should be further segmented so as to prioritise the very highest risks. The highest risk segments should not receive all the supervisory attention but a risk based balance made across all risk categories

- 4.4 Whilst the traditional supervisory approach of onsite inspections and testing has been a mainstay of supervisory plans, particularly for higher risk rated entities, and whilst their is merit in one to one meetings and face to face interviews, in particular with key position holders, AML/CFT risk and control design and effectiveness can be assessed using data requests and technology by supervisors to assess entity risks and responses and to compare entities to identify Red flags, outliers and other Resuits from data analytics.

- 4.5 Whilst the traditional supervisory approach of annual inspections and testing has also been a mainstay of supervisory plans, particularly for higher risk rated entities, advanced reporting and continuous or perpetual assessments where action is taken where triggers are pulled may be more effective and efficient.

- 4.6 Supervisory responsibility for effective supervision cannot be delegated to external audits, though their work can be relied upon, in circumstances where genuine reliance is reasonable.

- 4.7 Supervisory plans should consider broader levels of engagement with those where high intensity of supervision has been determined, to further increase co operation, feedback and capacity building, including for example, a supervisory college, including representatives from all appropriate supervisory agencies, the FIU, foreign supervisors with branches in their jurisdictions etc.

- 4.8 Supervision should also apply and appropriate intensity applied to new regulated entities and to entities being liquidated.

- 4.9 Supervisors should consider providing annual reports, including objectives, metrics and results of their activity, and the impact of supervision on their supervised sectors.

5. ML/TF Risk Tolerance

- 5.1 Supervisors should understand it is not possible to expect a zero tolerance approach to either ML/TF risks for supervised sectors and or entities. Applying a zero tolerance requires there to be no business activity. Even supervisory risk assessments do not envisage a zero residual risk result even for low risk entities with strong controls. As such supervisors should seek to understand an entities tolerance for ML/TF risk, assess it's reasonableness and that it's AML/CTF programme is managed so as to stay within a reasonable tolerance, bearing in mind its own risk assessment of the entity. Being outside tolerance at any given time should be identified by the entity Itself, for example in case of a control failure or weakness but fixed and the entity brought back into tolerance within a reasonable period, once the remediation is completed. Supervisors should always be informed of these cases, and should assess levels of reporting and remediation in its overall assessment of the entity, whether positive or negative.

6. Co Operation & Collaboration

- 6.1 Whatever supervisory system is in place, co-operation, collaboration, co ordination, knowledge and information sharing is essential amongst all key stakeholders, which applies domestically but also has relevance internationally. Some systems will require or expect more formality than others to document collaboration, knowledge and information sharing which may be necessary but should not be an excuse not to do this, or used to hinder it.

- 6.2 Supervisors should engage in regular outreach to the supervised sectors to explain supervisory expectations and encourage feedback through engagement and consultation with the supervised sector, and in particular with private sessions with MLROs.

- 6.3 Supervisors can play an important role in promoting so called public partnerships, including by convening and leading and/or contributing and/or supporting financial information sharing partnerships to improve overall ML/TF effectiveness. Ideally supervisors should be present in public and private sector PPP's recognising they provide support by their presence and can add legitimacy. Supervisors can also play an important role in engaging with financial privacy and data protection supervisors to ensure activities are necessary and proportionate.

- 6.4 Supervisors can also play an important role supporting innovation and the use of new technology and/or supporting industry platforms to improve the effectiveness/or efficiency in combating ML/TF, without promoting particular platforms which still require the implementation of adequate systems and controls.

7. Impacting & Influencing Behaviour

- 7.1 Supervisors should consider implementing senior manager regimes or making individuals responsible and accountable where evidence exist that appropriate culpable behaviour can be shown, and not just focus on action against entities themselves, and consider incentives such as using capital models to reward and penalise those with effective risk based AML/CTF programmes and those that don't as well as using sanctions tools such as fines and penalties when warranted. Using capital models to penalise entities as well as imposing fines and penalties can lead though to double jeopardy and should be avoided.

- 7.2 Whilst some supervisors and or supervisory regimes favour imposing large fines and penalties on entities, in relevant cases, others take a different view, with arguments in favour and against. Where administrative fines and penalties are available to supervisors these should be the preferred route if considered appropriate and necessary with transparency and due process, in preference to other sanctions, particularly using the threat of criminal sanctions to persuade entities to agree to voluntary settlements. Where criminal violations exist those individuals responsible should be prosecuted.

- 7.3 In some countries, the ability to consider levying meaningful fines and penalties is limited due to environment factors.

- 7,4 The use of best practice practice guides, establishing standards and training for senior officers holders, can raise their performance and support them to succeed and to avoid failure through not knowing what good enough looks like.

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8. Building & Retaining Essential Capabilities

- 8.1 Supervisors need to ensure knowledge capital is acquired and retained, as well as human, financial, social and other resources. A challenge relating to remuneration, pay scales and comparisons for ANL/CTF supervisors, versus other co parable public sector professionals and private sector professionals should be acknowledged and addressed.

- 8,2 Supervisors should explore the opportunities available to them from technology, data, and data analytics to modernise the supervisory approach ("SupTech").

- 8.3 Supervisors would benefit either from a professional standards body able to train and certify supervisors, as well as an Egmont style body for regulators. Resources are available to supervisors including for example from FATF training Centres. Innovative hiring models including tempura ray secondment models or exchange programmes should be considered and traditional ethical considerations addressed.

9. Environmental Factors

- 9.1 Supervisors and supervision does not operate in a vacuum. They operates within a broader public/private space within countries which have diverse challenges and opportunities impacted by domestic environmental factors, which can have a material impact on their work and how effective they can be.

- 9.2 Environmental factors will impact the effectiveness of supervision as well as of other agencies and so these should be identified and born in mind when evaluating a country's overall ML/TF effectiveness. The FATF Methodology currently requires assessors to consider a number of these structural elements, and other contextual factors, to reach a general understanding of the context in which the country's AML/CFT system operates, though these issues are seldom assessed in practice, and/or fail to be reflected in terms of outcomes, and/or even where reports make reference to these structural elements assessors often omit analysing how these types of shortcomings impact on the assessment of each individual immediate outcome. Given the relevance these structural elements and contextual factors may play in explaining why levels of effectiveness may be higher or lower than expected, for assessing immediate outcomes 3 and 4, the FATF's methodology ought to require assessors to weigh their impact.

- 9.3 The fight against ML/TF should ideally be a policy of State, bringing together all political forces irrespective of which one may be exercising power at a particular time and so the most important environmental factor is likely to be genuine political support and political will to achieve success. Nevertheless, additional important "environmental factors", also play a significant role in overall effectiveness in combatting money laundering and terrorism finance whether that be for supervisors or for any of the agencies involved.

- 9.4 These include:

  - Corruption and criminality including ML/TF

  - Institutional weakness, instability & the rule of law

  - A capable, independent, and efficient judiciary

  - Exclusion and informality including authoritarian abuses

10. Supervisory Maturity

- 10.1 Supervisory responses, will reflect country factors, in terms of political, economic and social development, as well as Ml/TF risk and due consideration should be given to the the relative supervisory response as well as the absolute response.

- 10.2 Supervisory progress can be assessed not simply against a common checklist, but against these country factors and as against progress over time.

- 10.3 An example of a Supervisory Maturity Model is set out below in Appendix 1.

3. Conclusion

Effective supervision is not easy, and takes time and whilst “pre conditions”, “environmental factors” and “supervisory arrangements” play a significant role, true effectiveness can only be achieved, over time by adopting and improving a countries risk based supervisory processes and achieving gains and avoiding or overcoming setbacks along the way. This journey can only be successfully travelled alongside knowledgeable, skilled, experienced, cooperative, collaborative and committed supervisors. Many countries will only achieve success by recognising that strategy comes second to culture and that “culture eats strategy for breakfast”. Where cultural change is involved in any endeavour, careful thought and consideration is needed to chart the course to future success.

Achieving success in improving supervisory effectiveness, produces additional positive outcomes. The interconnected nature of all involved stakeholders means that improvements in effectiveness by one individual stakeholder will lead to improved effectiveness in others, and by so doing raise overall levels of effectiveness. As many stakeholder groups reflect on their strengths and weaknesses and the actions that are needed to close gaps and improve effectiveness, so should supervisors. Whilst Bank and Fi supervisors have more advanced techniques and DNFBP supervisors need to catch up including supervisors of VASPs, the challenge of all supervisors is to move from rules based and then to risk based supervisory approaches and to encourage effective ML/TF risk based preventative measures in the regulated sector.

The GCFFC Experts:

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Appendix 1 - Example of Supervisory Maturity Model

GCFFC - Key Enablers to further improve Supervisory Effectiveness - Maturity Model

No	Maturity Levels	Level 1 - Basic	Level 2- Technical	Level 3 - Programme	Level 4 - Influencing	Level 5 - Effective
Pre Conditions / Continuing Conditions for Supervisory Effectiveness						
1	Political Support & Operational Independence	Little/No genuine Political Support/Operational Interference/Political Appointees of leaders		--------------------------->		High Political Support - Cross Party/Operational Independence/Merit Based Leaders appointed
2	Environmental Factors	Lower levels for Rule of Law, Independent Judiciary, Higher levels of Corruption, Institutional Instability, Exclusion & Informality		--------------------------->		Higher levels for Rule of Law, Independent Judiciary, lower levels of Corruption, Institutional Instability, Exclusion & Informality
Coverage and Systems						
3.1	Coverage & Systems	Supervision focus on main Banks & other main FI types; Mainly Prudential; Focus on Safety & Soundness		--------------------------->		Supervision of Banks, FI's, Casinos, VASPs & DNFBPs; Prudential & Conduct; Focus on addressing ML/TF risks.
3.2	Systems & Arrangements	Legacy supervisory system/ arrangements, with little co operation with other supervisors and/or FIU		--------------------------->		Bespoke supervisory system, with co operation and collaboration with other supervisors and FIU embedded
Risk Based Supervision						
4	Risk Based Assessments	Irregular Sector Risk Assessments and/or Entity/ Group Assessments do not generate accurate Supervisory Plans		--------------------------->		Regular Sector Risk Assessments and Entity/Group Assessments generate accurate Supervisory Plans
5	Risk Based Intensity	Levels of Supervisory Intensity insufficiently inadequate based on factors other than ML/TF risk (inherent)		--------------------------->		Levels of Supervisory Intensity sufficiently adequate based on ML/TF risk (residual) factors
6	Risk Appetite	Zero Tolerance for AML/CTF Compliance Risk, auditing controls against strict interpretation of regulations & apply best practices as standards		--------------------------->		Reasonable Risk Appetite for ML/TF risks, includes looking beyond technical compliance to what an effective AML/CTF programme means
Influencing and Impacting Behaviours / Co operation / Essential Capabilities						
7	Impacting and Influencing Behaviour	Little/No Accountability for AMI/CTF breaches - No material impact on supervised sectors - More interested in protecting the reputation / image of the country		--------------------------->		Supervised Sectors are accountable for material AML/ CTF breaches (TIC - Actual ML/ TF & Overall programme effectiveness) - Material impact on supervised sectors
8	Co Operation & Collaboration	Supervisors are siloed and rarely engage with other regulators (national or international), or FIUs, not engaged in PPPs, ignore innovation and new IT, and fail to address information sharing & privacy challenges		--------------------------->		Supervisors proactively engage with other regulators (national and international), FIUs, PPPs, supporting innovation and new IT, addressing information sharing & privacy whilst retaining safeguards
9	Essential Capabilities	Human capital, resources, knowledge, technology support, data collection and usage, & professional career pathways are limited and a recurring challenge		--------------------------->		Human capital, resources, knowledge, technology support, data collection & usage, & professional career pathways have been strategically considered and support overall effectiveness