

Controlling Banks' and Financial Systems' Exposure to Money Laundering and Terrorist Financing Risks

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1. Background and Introduction

All banks' financial soundness depends primarily on their ability to effectively identify, measure, monitor and control risk. Most financial risks, such as credit, market and interest rate risk, can be measured directly or estimated with reasonable certainty. Industry control measures for these risks are well-developed. However, some risks, such as operational risk,¹ can be more difficult to measure. Nevertheless, these risks can have a materially adverse impact on a bank's financial performance and reputation if not properly controlled.

Bank systems and control weaknesses and failures can cause sizeable losses and impose other costs, such as litigation settlements, damage awards, and regulatory fines; not to mention the direct and indirect cost of a regulatory enforcement action. These occurrences can induce adverse customer reactions, such as abnormal deposit outflows, and negative investor reactions, such as a sustained decline in a bank's stock price, adversely impacting a bank's reputation and franchise value.

Preventing banks from being used to facilitate financial crimes, especially money laundering (ML) and terrorist financing (TF),² is a critical operational risk control priority. Adverse publicity from involvement in illicit activities, even unwittingly, can severely erode public trust and confidence in individual banks, and have spillover effects that can impact public perceptions of financial system integrity more generally. ML- and TF-related control failures can even call into question the competency of a jurisdiction's regulatory oversight. The importance of preventing ML and TF is also evident by the close attention it receives from multiple international standard-setting and assessment bodies, and domestic authorities.

Concerns for effective measures for anti-money laundering (AML) and combating terrorist financing (CTF) and their linkage to financial stability are well-articulated in a 27 March 2015 Factsheet issued by the International Monetary Fund (IMF):³

The international community has made the fight against money laundering and terrorist financing a priority. The IMF is especially concerned about the possible consequences money laundering, terrorist financing, and related crimes have on the integrity and stability of the financial sector and the broader economy. These activities can undermine the integrity and stability of financial institutions and systems, discourage foreign investment, and distort international capital flows. They may have negative consequences for a country's financial stability

and macroeconomic performance, resulting in welfare losses, draining resources from more productive economic activities, and even have destabilizing spillover effects on the economies of other countries. In an increasingly interconnected world, the negative effects of these activities are global, and their impact on the financial integrity and stability of countries is widely recognized. Money launderers and terrorist financiers exploit both the complexity inherent in the global financial system as well as differences between national AML/CFT laws and systems, and they are especially attracted to jurisdictions with weak or ineffective controls where they can more easily move their funds without detection. Moreover, problems in one country can quickly spread to other countries in the region or in other parts of the world.

The Financial Action Task Force,⁴ an independent inter-governmental body charged with developing and promoting policies to protect the global financial system against money laundering and other financial crimes, has summarized sovereign AML/CTF obligations:⁵

Countries should identify, assess, and understand the money laundering and terrorist financing risks for the country, and should take action, including designating an authority or mechanism to coordinate actions to assess risks, and apply resources, aimed at ensuring the risks are mitigated effectively.

Some jurisdictions are also subject to additional domestic laws and regulations, such as the U.S. Bank Secrecy Act, or regional requirements such as those imposed by the European Parliament and the Council of Europe.

This article provides an overview of international standards and assessment processes related to AML/CTF activities of financial institutions and their regulators. Based on our experiences and findings in publicly available regulatory AML/CTF evaluation reports, we also highlight some common AML/CTF program weaknesses where banks may need to place additional focus and resources. We also identify some actions banks and national authorities can take to enhance their AML/CTF oversight activities.

2. International Standards Related to AML and CTF

There are multiple international standards-setters and evaluation bodies covering AML/CTF and related financial crimes prevention, with varying mandates:

- ◆ Financial Action Task Force (FATF)
- ◆ FATF-Style Regional Bodies (FSRBs)
- ◆ The International Monetary Fund and World Bank
- ◆ United Nations

2.1 Financial Action Task Force

FATF, established by the Group of Seven nations in July 1989, serves as the lead organization in providing anti-money laundering guidance to governmental bodies throughout the world. FATF's mandate is "to set standards and to promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and the financing of proliferation, and other related threats to the integrity of the international financial system."⁶ FATF's membership includes 34 countries and two regional organizations. Also, the eight FSRBs⁷ are associate members. The FATF Plenary, the FATF's decision-making body, meets three times per year.

In April 1990, FATF published "The Forty Recommendations of the Financial Action Task Force on Money Laundering" (known as the *40 Recommendations*), which provided a comprehensive plan of action to combat money laundering. The *40 Recommendations* were revised in 1996 and 2003.

The FATF's mandate was expanded in 2001 to combat terrorist financing, which resulted in publication of a supplemental document containing eight (later expanded to nine) Special Recommendations known as the *IX Special Recommendations* covering terrorist financing risks.

The *40 Recommendations* and the *IX Special Recommendations* were collectively known as the *40 + 9 Recommendations*. FATF completely revised the *40 + 9 Recommendations* on 15 February 2012, issuing *The FATF Recommendations* (subtitled "International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation"). The IX Special Recommendations have been subsumed into the new 40 recommendations contained in *The FATF Recommendations*. In February 2013, the FATF also published a methodology for assessing technical compliance with *The FATF Recommendations*.⁸

2.1.1 *The FATF Recommendations, February 2012: The Global Standards for AML/CTF*

The following briefly summarizes the main requirements of *The FATF Recommendations*:

Recommendations 1-2: *Anti-Money Laundering and Countering the Financing of Terrorism Policies and Coordination*

Countries should understand and assess the applicable ML and TF risks they face. A key authority should be designated in every country to effectively coordinate and manage the risks involved. Countries should also ensure all authorities involved in AML/CFT policies and activities are able to effectively cooperate with one another.

Recommendations 3-4: Money Laundering and Confiscation

Money laundering should be criminalized, as outlined in the Vienna (1988) and Palermo (2000) Conventions. Countries should also adopt measures to ensure money laundering proceeds and other property is appropriately frozen and confiscated by the government.

Recommendations 5-8: Terrorist Financing and Financing of the Proliferation of Weapons of Mass Destruction

Countries should criminalize terrorist financing and proliferation of weapons of mass destruction and should implement targeted financial sanctions to comply with UNSC resolutions. Also, countries should review the effectiveness of current laws associated with entities susceptible to terrorist financing abuse, such as charities and non-profit organizations.

Recommendations 9-23: Financial and Non-Financial Institution Preventative Measures

Countries should ensure that domestic financial institution secrecy laws do not limit implementation of any of *The FATF Recommendations*. Guidance is also included for financial institutions in conducting adequate customer due diligence (CDD) for certain customers and transactions:

1. Verifying identity using reliable, independent documents or information.
2. Identifying beneficial owners.
3. Purpose and intent of the business relationship.
4. Conducting due diligence on the customer and scrutiny of transactions throughout the course of the relationship.

Financial institutions should be required to retain records of transactions for five years and CDD information for at least five years after the relationship has ended. Additional measures should be required for higher-risk customers and activities such as politically exposed persons, correspondent banking, money transfer services, new technologies, and wire transfers. Recommendations also address financial institutions' reliance on third parties in performing CDD requirements, foreign branches and subsidiaries, and operating in higher-risk countries.

Other recommendations include requirements for the reporting of suspicious transactions and the confidentiality of suspicious transaction reports (STRs). In addition, special CDD recommendations exist for designated non-financial businesses and professions (DNFBPs) including casinos, real estate agents, dealers in precious metals and stones, independent legal professionals, accountants, and trust and company service providers.

Recommendations 24-25: *Transparency and Beneficial Ownership of Legal Persons and Arrangements*

These recommendations cover transparency and beneficial ownership information for legal persons and legal arrangements. Countries should take measures to prevent the misuse of legal persons and arrangements such as bearer shares, nominee shareholders, nominee directors, and express trusts. Such measures should allow financial institution access to information regarding beneficial ownership and control, settlors, trustees, and beneficiaries.

Recommendations 26-35: *Powers and Responsibilities of Competent Authorities and Other Institutional Measures*

Recommendations 26-28 contain guidance concerning the regulation and supervision of financial institutions, casinos and other DNFBPs. Supervisors should have the power to impose a range of appropriate disciplinary actions. Other recommendations address the establishment of financial intelligence units (FIUs) and the responsibilities and powers of law enforcement agencies and investigation authorities. Countries should have appropriate measures in place to detect cross-border transportation of currency or negotiable instruments. Countries maintain comprehensive statistics regarding the effectiveness of their AML/CFT systems. In addition, supervisors and other authorities should establish guidelines and feedback designed to assist financial institutions and DNFBPs. Countries should ensure there are appropriate sanctions and actions applicable not only to financial institutions and DNFBPs, but also to directors and senior management of such organizations.

FIUs, required by Recommendation 29, serve as countries' central authority for receiving and analyzing suspicious transactions reports (STRs) and "...other information relevant to money laundering, associated predicate offences and terrorist financing, and for the dissemination of the results of that analysis."⁹ "Financial institutions and their directors, officers and employees should be prohibited by law from disclosing the fact that (an STR) or related information is being filed with the FIU."¹⁰

Recommendations 36-40: *International Cooperation*

These recommendations contain guidance to foster international cooperation. For example, countries should take steps to become party to official international gatherings such as the Vienna Convention, the Palermo Convention and the Terrorist Financing Convention (1999). Mutual legal assistance processes should be established to promote efficient information sharing, freezing of assets and confiscation, extradition, and other methods such as a Memorandum of Understanding.

2.1.2 FATF Lists of “High-risk and Non-cooperative Jurisdictions”

The FATF Plenary publishes two documents twice a year identifying jurisdictions that have “strategic deficiencies with respect to AML/CTF compliance.” The most severe designation, “High-risk jurisdiction,” means that FATF believes “its members and other jurisdictions (need) to apply counter-measures to protect the international financial system from the on-going and substantial money laundering and terrorist financing...risks emanating from (these) jurisdictions.” There are two countries identified on the most recent High-risk jurisdiction list published in February 2015. “Non-cooperative jurisdictions” have “strategic AML/CFT deficiencies... (and) have not made sufficient progress in addressing the deficiencies or have not committed to an action plan developed with the FATF to address the deficiencies.” FATF identified three Non-cooperative jurisdictions in its most recent declaration in February 2015.¹¹

2.2 FATF-Style Regional Bodies

The FSRBs' primary mandate is to ensure that their member states meet AML/CTF standards issued by the FATF, the United Nations and other relevant authorities.¹² There is no hierarchical relationship between the FSRBs and the FATF.

FSRBs' members commit to a mutual peer review system to determine the levels of compliance with international AML/CFT standards. These peer reviews are referred to as “mutual evaluations.” FSRBs' mutual evaluations utilize *The FATF Recommendations* and the related 2013 assessment methodology,¹³ and may include desk-based reviews of jurisdictions' AML/CFT systems as well as on-site visits by a team of trained experts drawn from other members of the FSRB. Mutual evaluations assess a jurisdictions' technical compliance with *The FATF Recommendations* (i.e., legal and institutional frameworks and powers and procedures of responsible authorities) and the effectiveness of their AML/CTF regimes.

2.2.1 Basel Committee on Banking Supervision (BCBS)

The BCBS first expressed concerns about the need for banks and their regulators to prevent criminal use of the banking system for the purpose of money laundering in 1988.¹⁴ Subsequently, the BCBS issued two publications providing more specific guidance – *Customer due diligence for banks* (October 2001) and *Consolidated KYC management (October 2004)*.¹⁵ Both of these have been superseded by *Sound management of risks related to money laundering and financing of terrorism* (January 2014), which is consistent with *The FATF Recommendations* and “describes how banks should include risks related to money laundering and financing of terrorism within their overall risk management framework,” cautioning that “Failure to manage these risks can expose banks to serious reputational, operational, compliance and other risks.”¹⁶

The BCBS has done extensive work identifying the essential preconditions that need to be in place to have an effective bank supervision program, articulated

in its “Core Principles for Effective Banking Supervision” (known as the Basel Core Principles or BCP).¹⁷ The BCP were originally issued in 1997, and revised in 2006 and 2012, with the latest version containing 29 principles. Principle 29 of the BCP, entitled “Abuse of financial services,” states:¹⁸

The supervisor determines that banks have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 29 lists thirteen “Essential Criteria” against which compliance is assessed.

2.3 International Monetary Fund/World Bank

The International Monetary Fund (IMF) and The World Bank conduct periodic assessments of member countries' financial sectors and overall financial stability through their Financial Stability Assessment Program (FSAP).¹⁹ Countries' FSAP results are published in “Financial System Stability Assessment” reports (FSAP Reports) and subsidiary supporting documents, accessible on the IMF's website.²⁰ The FSAP reports provide assessments of countries' observance of international regulatory and supervisory standards issued by the BCBS, the International Association of Deposit Insurers, the International Association of Insurance Supervisors, the International Association of Securities Commissions, the Committee on Financial Market Infrastructures, and the FATF. Since 2000, the IMF has conducted over 70 AML/CTF assessments.²¹ The IMF also provides technical assistance and, in some cases, financial support to assist jurisdictions in enhancing their ability to meet their AML/CTF responsibilities.²²

2.4 United Nations

The United Nations Security Council (UNSC) has authority to issue binding resolutions to Member States.²³ The UNSC has passed various resolutions and has imposed various sanctions against individuals and entities related to the control of money laundering and countering terrorist financing and proliferation. UN Members must take action to uphold the sanctions and resolutions in their jurisdictions. UNSC Committees are established pursuant to each resolution to oversee their implementation.

3. Commonly Observed Weaknesses in Bank AML/CTF Programs

The vast majority of banks have adequate AML/CTF programs. Based on our experience in AML/CTF advisory activities and publicly-available regulatory assessments of banks' AML/CTF programs, the following are recurring areas of weakness in AML/CTF programs:

3.1 Customer Due Diligence (CDD)/Know Your Customer (KYC)

Surprisingly, deficiencies continue to be observed in CDD, the most fundamental AML/CTF process. Weaknesses appear to be in two areas: either the due diligence process is not sufficiently robust and/or it is not properly documented. Due diligence procedures need to be stringent and require analysis to be adequately documented. Before opening accounts or establishing other business relationships, banks should obtain, verify and record information that unquestionably establishes the identities of the new customer(s) and beneficial owner(s), and verification of the source of funds, such as wealth, income, inheritance, etc. Enhanced due diligence should be conducted on customers deemed to present elevated or high-risk.²⁴ Supporting documentation of both initial and on-going customer due diligence should be maintained. FATF Recommendation 11 requires that all records of transactions be retained for five years and any identification data, account files and business correspondence for at least five years after the business relationship has terminated. The identification data and transaction records should be readily available to domestic authorities, such as regulators or law enforcement officials.²⁵

3.2 Suspicious Transactions Reporting

FATF requires that when "...a financial institution suspects or has reasonable grounds to suspect that funds are the proceeds of a criminal activity, or are related to terrorist financing, it should be required, by law, to report promptly its suspicions to the (jurisdiction's) financial intelligence unit (FIU)."²⁶ Some banks have not implemented clear internal procedures to ensure they are consistently meeting their obligations in this area. The threshold for triggering "reasonable suspicion" is a matter of judgment. Employees involved in AML/CTF screening and monitoring activities need to understand this concept. For consistency and quality control, many banks assign the final decision to file an STR to subject matter experts (SME) who are highly trained and experienced in these matters. However, there needs to be procedures, guidance and training as to what types of circumstances trigger reasonable grounds or suspicions, so potential reportable situations can be escalated for SME review and final determination as to STR filing. The filing of STRs should lead to investigations and prosecutions.

3.3 AML/CTF Governance and Oversight

The effectiveness of an AML/CTF program depends on many factors. Proper engagement and oversight by a bank's board of directors, board committees, and senior executive management is an important underpinning to a sound and credible program. The officer charged with primary responsibility for AML/CTF program oversight needs to have sufficient stature within the organization and proper authority. The AML/CTF oversight function needs to be adequately resourced and staffed by trained professionals. Internal audit and other quality assurance reviews should verify the adequacy of the scope, coverage and effectiveness of AML/CTF programs.

4. Achieving Effective Country and Bank AML/CTF Programs

We recommend the following actions to countries and their banks to enhance the effectiveness of their AML/CTF programs:

1. National authorities should periodically conduct stringent self-assessments of compliance with FATF standards and other applicable international standards such as UNSC resolutions. Timely action should be taken to address non-compliance or partial compliance, which could involve changes to existing processes and procedures, or necessitate changes to laws and regulations.
2. National authorities should review IMF FSAP assessments and other published assessments of jurisdictions' compliance with *The FATF Recommendations* and Basel Core Principle 29. This type of benchmarking can assist countries in avoiding weaknesses found in other jurisdictions and identify best/good/sound practices and approaches that might be adopted.
3. Countries should ensure a comprehensive AML/CTF supervision program is in place for banks and other financial services firms that assesses compliance with all applicable international standards and requirements, such as those imposed by the FATF, FSRBs and the United Nations, at regular intervals. Domestic and regional requirements should also be covered.
4. Effective bank compliance depends on a supportive corporate culture that approaches AML/CTF compliance as a key business priority, and not merely a technical compliance matter. Active Board and senior executive management engagement in this area is essential. A supportive "tone from the top" is needed as well as accountability and incentive systems that reinforce the importance of AML/CTF among team members.
5. Banks and AML/CTF oversight authorities need to stay current with methods criminals may use to evade existing laws, or new ways of using banks to perpetrate ML and TF and related criminal activities, referred to as "typologies." The FATF and various other public and private sector bodies publish ML and TF typologies and case studies to alert regulators, law enforcement agencies, financial intelligence units and practitioners to new ML and TF threats.
6. National authorities charged with overseeing AML/CTF compliance and the entities they regulate need to have a strong commitment to organizational training and human capital management that results in the acquisition and retention of talent and expertise to ensure ongoing effective implementation of the preceding recommendations.

5. Conclusion

Countries need to ensure that AML/CTF risks are properly controlled and timely action is taken to achieve full, substantiated compliance with all applicable domestic and international standards. Banks' AML/CTF programs need to be carried out by trained, experienced professionals with sufficient authority and influence in the organization. *The FATF Recommendations* is a benchmark standard that both countries and financial institutions can use as a roadmap in developing and enhancing programs to prevent money laundering, terrorist financing, the proliferation of weapons of mass destruction, and other criminal misuse of the financial system that can undermine financial stability.

The authors are subject matter experts in AML and CTF matters and have worked with numerous clients in establishing effective AML/CTF programs.

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Endnotes

1. The Basel Committee on Banking Supervision defines “operational risk...as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.” (BCBS 2011, p. 3).
2. Various international authorities have defined money laundering and terrorist financing. A concise IMF description (IMF 2015) states: “Money laundering is a process by which the illicit source of assets generated by criminal activity is concealed to obscure the link between the funds and the original criminal activity. Terrorist financing involves the raising and processing of assets to supply terrorists with resources to pursue their activities. (ML and TF) often exploit...vulnerabilities in financial systems that allow for an inappropriate level of anonymity and non-transparency in the execution of financial transactions.”
3. IMF 2015.
4. Information about the Financial Action Task Force is available at their website: www.fatf-gafi.org.
5. FATF 2012, p. 11.
6. FATF 2012.
7. There are currently eight FATF-style regional bodies: The Eurasian Group (EAG), Asia/Pacific Group on Combating Money laundering (APG), Caribbean Financial Action Task Force (CFATF), Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism of the Council of Europe (MONEYVAL), Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), Financial Action Task Force on Money Laundering in South America (GAFISUD), Intergovernmental Action Group Against Money-Laundering in West Africa (GIABA), and Middle East and North Africa Financial Action Task Force (MENAFATF).
8. FATF 2013.
9. Posted at The Egmont Group of Financial Intelligence Units' website at www.egmontgroup.org/about/faqs.
10. FATF 2012, p. 24.
11. Lists of countries that FATF has designated as “High-risk and non-cooperative jurisdictions” and related information are available at www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/

12. For example, in the case of MONEYVAL, an FSRB whose members are 47 European countries, mutual evaluations also assess compliance with standards issued by the European Parliament and Council of Europe.
13. FATF 2013a “sets out criterion for assessing technical compliance with each of the FATF Recommendations” and the “outcomes, indicators, data and other factors used to assess the effectiveness of (their) implementation,” p. 4.
14. BCBS 1988.
15. “KYC” stands for Know Your Customer.
16. Excerpted from the press release accompanying the issuance of BCBS 2014.
17. Basel 2012.
18. Basel 2012, pp. 64-65.
19. See the IMF’s “Financial Sector Assessment Program: Frequently Asked Questions,” updated as of August 7, 2014, available at www.imf.org/external/np/fsap/faq
20. The IMF’s website is www.imf.org.
21. IMF 2015.
22. IMF 2015. UNSC Resolutions and Sanctions
23. UNSC Resolutions and Sanctions related to AML/CTF and proliferation can be accessed at www.un.org/sc/committees/
24. A high risk designation could result, for example, from a customer being domiciled in a higher risk jurisdiction as identified by FATF or payments received from a non-FATF member jurisdiction.
25. FATF 2012, p.15.
26. FATF 2012, p. 19.

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