

## RISK MANAGEMENT VS ISSUE MANAGEMENT IN THE ANTI-MONEY LAUNDERING AND COUNTER TERRORIST-FINANCING (AML/CFT) CONTEXT

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### Abstract

*This article aims to examine the Risk-based Approach (RBA) widely advocated in the standards of the Financial Action Task Force (FATF) in the implementation of policies and measures for the prevention and countering of money laundering and the financing of terrorism (ML/TF). The article points out arguments why this approach could not be applied to all cases because, in specific situations, ML/TF should be considered as already occurring acts/issues and not only potential risks. The article's conclusions are based on the understanding that risks should be managed with different approaches than issues. Still, due to the FATF's requirements for unification in using RBA across all FATF standards, many countries have difficulty achieving high ratings on the relevant Immediate Outcomes 7 and 8, which should be treated as dealing with already emerging issues and not risks. The article offers an alternative reading in this direction and can serve many institutions engaged in preparing policies for the prevention and counteraction of ML/TF.*

**Keywords:** Risk-based Approach; standards; money laundering.

### MAIN CONCEPTS AND WHY ISSUE MANAGEMENT DIFFERS FROM RISK MANAGEMENT

Risk represents future uncertain events or conditions that might occur and influence the environment. Risks have different levels of probability, impact, and severity. Usually, risks are related to the occurrence of adverse events, but in some instances, these events could have a neutral or even positive impact/consequences on the environment or processes that are under monitoring.

Many different definitions have been proposed to explain the concept of risk. The international standard definition of risk is the "effect of uncertainty on the predefined objectives." Financial Action Task Force (FATF) defines risk<sup>2</sup> as a function of three factors: threat, vulnerability, and consequence.

FATF defines a threat as a person or group of people, objects or activities with the potential to cause harm to, for example, the state, society, the economy, etc. In the money laundering and

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<sup>2</sup> [https://www.fatf-gafi.org/content/dam/fatf-gafi/reports/National ML TF Risk Assessment.pdf.coredownload.pdf](https://www.fatf-gafi.org/content/dam/fatf-gafi/reports/National_ML_TF_Risk_Assessment.pdf.coredownload.pdf)

terrorist financing (ML/TF) context, this includes criminals, terrorist groups and their facilitators, their funds, as well as past, present and future ML or TF activities<sup>3</sup>.

Similarly, the FATF determines the concept of vulnerabilities, as used in risk assessment, comprises those things that the threat can exploit or that may support or facilitate its activities. In the ML/TF risk assessment context, looking at vulnerabilities as distinct from threats means focusing on, for example, the factors that represent weaknesses in anti-money laundering and counter-terrorism financing (AML/CFT) systems or controls or certain features of a country. They may also include the features of a particular sector, technology products/services, or a financial product or type of service that makes them attractive for ML or TF purposes<sup>4</sup>.

Consequence refers to the impact or harm that ML or TF may cause and includes the effect of the underlying criminal and terrorist activity on financial systems and institutions, as well as the economy and society, more generally. The consequences of ML or TF may be short or long-term in nature and also relate to populations, specific communities, the business environment, or national or international interests, as well as the reputation and attractiveness of a country's financial sector<sup>5</sup>.

Effective risk management entails a good understanding of risks. Otherwise, misinterpretation of their nature, source, severity, or likelihood could lead to missed opportunities for risk mitigation and, in some cases, even the transformation of risks into issues. Risk assessments are good tools for achieving the necessary level of risk understanding.

As stated above, according to FATF, ideally, a risk assessment involves making judgments about threats, vulnerabilities, and consequences. Given the challenges in determining or estimating the consequences of ML and TF, FATF considers it acceptable to incorporate consequences into risk assessments that may not involve particularly sophisticated approaches and that countries may instead opt to focus primarily on achieving a comprehensive understanding of their threats and vulnerabilities. The key is that the risk assessment adopts an approach that attempts to distinguish the extent of different risks to assist with prioritizing mitigation efforts.

In that sense, FATF recommends that all jurisdictions use a Risk-based Approach (RBA) when implementing measures to tackle ML/TF. The risk-based approach is central to the effective implementation of the FATF Standards. An RBA means that countries, competent authorities, and the private sector identify, assess, and understand the ML/TF risk to which they are exposed and take the appropriate mitigation measures in accordance with the level of risk. It is clear that FATF Standards could only go to this level of granularity and cannot define further the appropriate mitigation measures and the ways for their selection. In some jurisdictions, this is subject to a more general and strategic vision in the policy responses, while in others, measures are selected following rather reactive approaches to a single issue/risk management or only looking at the recommendations included in the Mutual Evaluation Reports (MERs) produced by FATF and the other FATF Style Regional Bodies

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<sup>3</sup> Same as above.

<sup>4</sup> Same as above.

<sup>5</sup> Same as above.

(FSRBs). In the case of Bulgaria, the relevant FSRB is the Council of Europe MONEYVAL Committee<sup>6</sup>.

The flexibility of the RBA allows for more efficient use of resources, as reporting entities, countries and competent authorities can decide on the most effective ways to mitigate the ML/TF risks they have identified. It enables them to focus their resources and take enhanced measures in situations where the risks are higher, apply simplified measures where the risks are lower and exempt low-risk activities. Implementing the risk-based approach should avoid the consequences of inappropriate de-risking behaviour.

However, following the definition of risks, if the negative consequence has already occurred, it is no longer a risk but rather an issue. Issue management should be different from implementing a risk-based approach with risk mitigation measures.

Issue management refers to the identification, addressing and resolution (in whole or partial) of issues. Problems can involve different categories of failure or unwilling results. In this case, the issue is that ML/TF has already occurred. For example, when the crime has been committed, competent authorities should start investigating and prosecuting it to achieve conviction and possibly confiscation and repatriation of the criminal assets. While before the crime occurs, authorities can only put barriers in front of the criminals to integrate their resources into the legitimate financial system of the country.

In this example, issue management covers identifying, tracking, analyzing, and working to resolve and prevent future/occurring issues. Therefore, the AML/CFT process should be divided into two main sections:

1. Risk management – this represents the preventive measures applied by:
  - a. The private sector (e.g. customer due diligence, client risk assessment, identification of the ultimate beneficial owner, etc.),
  - b. Supervisors (e.g. on-site and off-site inspections, training, etc.),
  - c. Financial intelligence units (e.g. strategic analysis and operational intelligence gathering before their dissemination),
  - d. Policymakers (e.g. issuance of legislation and AML/CFT policies) and
  - e. Other competent authorities (within their AML/CFT efforts outside the investigation and prosecution processes).

2. Issue management – activities the competent authorities conduct once the crime has occurred (investigation and prosecution). Policymakers could also assist the issue management by providing competent authorities with the necessary resources and tools.

Although the two concepts seem similar, they are not quite the same. We explained that with risks, there is usually a general idea in advance that there is a cause for concern. An issue tends to be less predictable and can arise without warning. Even if there are indications for the issue's occurrence, it can happen despite the preventive measures applied by the competent authorities.

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<sup>6</sup> <https://www.coe.int/en/web/moneyval/home>

In the AML/CFT context, the two topics are interconnected; each provides information and serves to finetune the other.

In that sense, the FATF does not require the application of an issue management but instead includes it as part of the general RBA.

### **RESIDUAL RISK AND ITS RELEVANCE.**

Overall, every risk assessment and risk mitigation cycle should be followed by evaluating the residual risk. It refers to the level of risk that remains after the risk mitigation process. According to a definition provided by Stanford University, residual risk is the risk remaining after leadership's response to the risk – design of appropriate processes and controls and implementation of the same<sup>7</sup>. Therefore, the residual risk in AML/CFT, by definition, should be acceptable for jurisdictions, and they should apply an RBA until they achieve the desirable (predefined) residual risk.

The residual risk will play a more and more substantial role in the AML/CFT area, as it provides a realistic overview of the effectiveness of the risk mitigation measures and future risk prioritization. The residual risk could sometimes remain similar to the initially measured risk levels or even increase. However, this does not necessarily mean the risk mitigation measures were ineffective. On the contrary, they could have been effective, but changing the environment while applying risk mitigation measures could result in higher levels of risk.

The issue management could generally be informed by the risk assessments and, at the same time, provide data for them as well. This means that the residual risk could serve well to finetune the issue management process and vice versa.

### **IS THE INCLUSION OF ISSUE MANAGEMENT AS PART OF THE RISK-BASED APPROACH (RBA) APPROPRIATE IN THE AML/CFT CONTEXT?**

FATF probably considers that all possible manifestations of ML/TF are risks, and jurisdictions should be aware of them at any given time so that they should never become real issues with unexpected occurrences. However, the reality does not necessarily follow that understanding, and many new ML/TF techniques occur without being anticipated by the jurisdictions. For example, several years ago, before the broad application of artificial intelligence (AI) or virtual assets, no jurisdiction could have expected that deep fake or dark web would become tools for ML/TF and create new types of ML/TF schemes. They became recognized risks when it was noticed as a money laundering practice in several jurisdictions. Nonetheless, when these jurisdictions identified the two ML/TF tools, they were not risks for them but rather issues. Moreover, the RBA could only be implemented when the competent authorities have already detected ML/TF and, therefore, have the necessary information from existing cases. It is unclear but highly probable that there are ML/TF techniques that remain undetected and, hence, cannot even be included as part of this risk mitigation approach. Once they are uncovered, they should first be treated as issues and could even remain as such.

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<sup>7</sup> <https://ocro.stanford.edu/enterprise-risk-management-erm/key-definitions/definition-residual-risk>

Issue management requires more resources and their prompt application. This means jurisdictions' preparation level to tackle ML/TF issues should be higher. The more countries learn about the issues, the better prepared they will be to address them in the future. Therefore, in this context, issues might become risks or inform risks in the subsequent phases of the assessments. An important caveat is that not all issues should be mitigated.

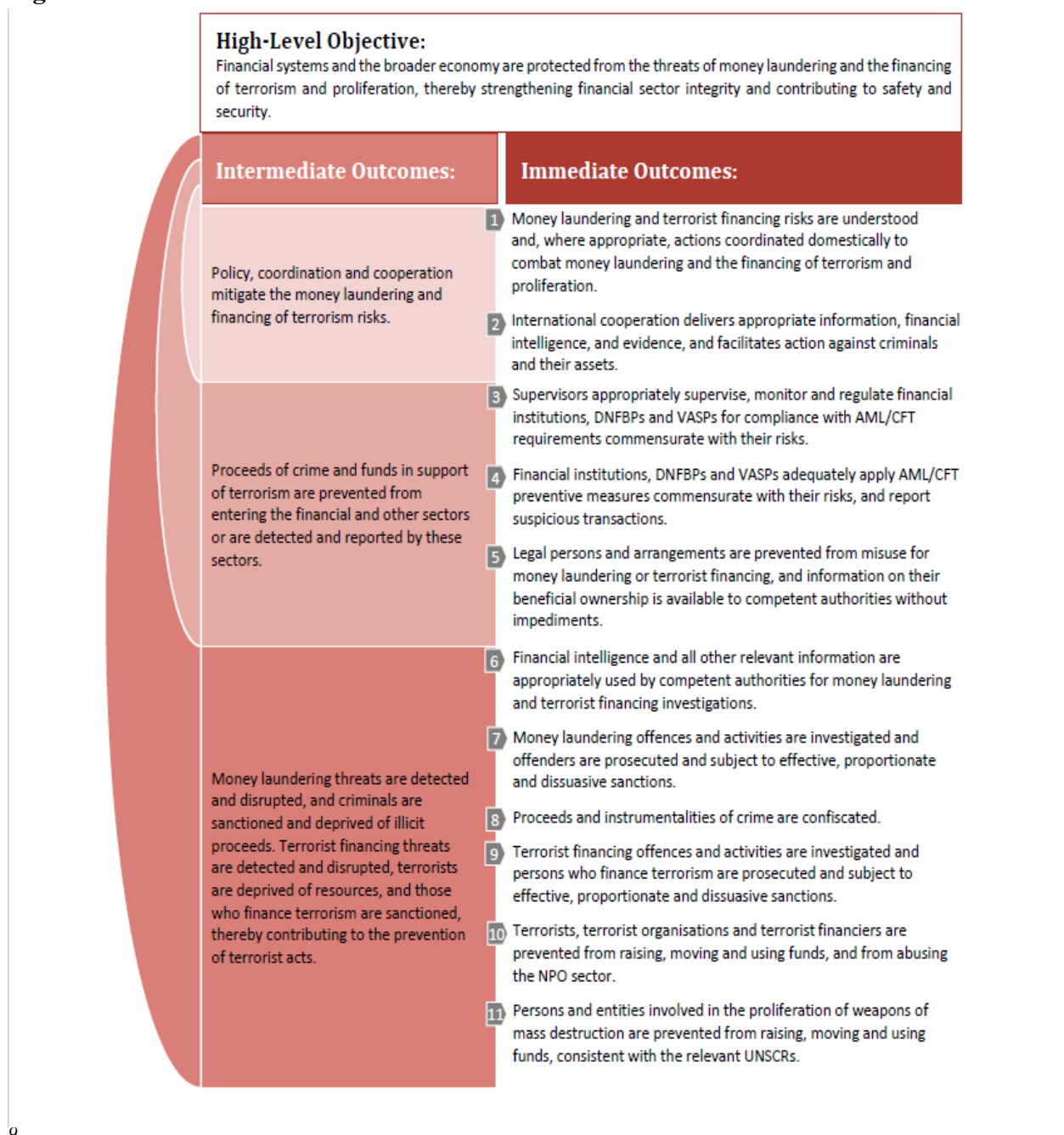
Another essential question is whether or not countries should allocate such substantial resources to be always available for issues management. In the case of ML/TF, there is a perception that these types of crime cannot be avoided but can only be mitigated. It means that whatever countries do, ML/TF cannot be eradicated but just kept in acceptable proportions. In some instances, especially where the society feels the consequences of the crime (e.g. fraud, terrorist financing, laundering of the proceeds of human trafficking or drug trafficking) directly, the issue management response should be much more rapid, more robust and direct. In other instances, where the crime is less evident for the society (e.g. tax evasion, trade-based money laundering, etc.), the issue management could happen through alternative means, like applying crime disruption strategies.

FATF assesses countries against the effectiveness of the applied AML/CFT measures provided in eleven Immediate Outcomes (*see the picture below – source FATF Methodology*<sup>8</sup>)

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<sup>8</sup> <https://www.fatf-gafi.org/content/dam/fatf-gafi/methodology/FATF%20Methodology%2022%20Feb%202013.pdf>

Figure 1.



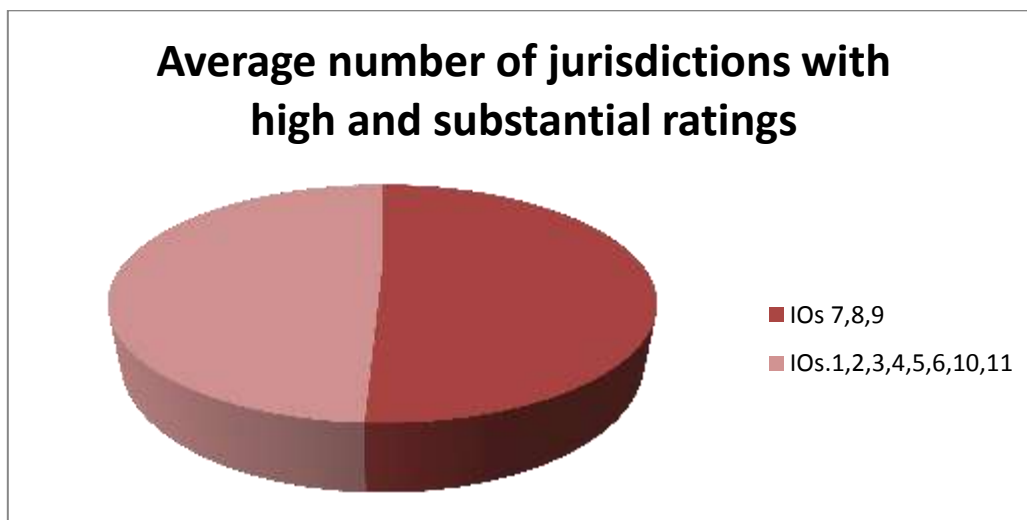
When talking about issues management, we could easily relate these to the following FATF Immediate Outcomes (IOs):

- Immediate Outcome 7 – money laundering offences investigation and prosecution
- Immediate Outcome 8 – confiscation of the proceeds and instrumentalities of crime
- Immediate Outcome 9 – terrorist financing offences investigation and prosecution

<sup>9</sup> See above.

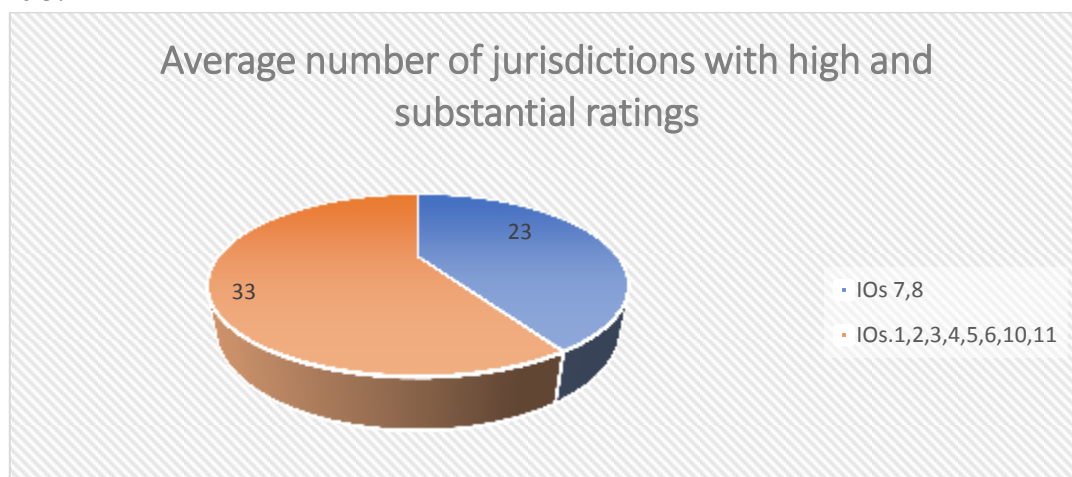
Interestingly, an overview of the mutual evaluation (ME) process and the consolidated assessment ratings<sup>10</sup> shows that these three IOs (7, 8 and 9) are rated similarly compared to the other eight IOs. The average number of high ratings (substantial and high effectiveness) given to jurisdictions for the three IOs is 34, meaning that, on average, 34 jurisdictions received these high ratings, while for the other eight IOs, the number is 33.

**Figure 2.**



However, suppose we remove IO.9, where ratings are given based on the ability of the country to conduct terrorist financing investigations and prosecutions, as in most cases, there are none or a minimal number of actual cases. In that case, the average result for IO.7 and IO.8 is 23, compared to 33 for all other IOs.

**Figure 3.**



<sup>10</sup> <https://www.fatf-gafi.org/en/publications/Mutualevaluations/Assessment-ratings.html>

It is complicated to prove a direct link between these results and the fact that the FATF does not explicitly consider issue management for these three or even two IOs. However, it is clear that countries have specific difficulties with their effective application in practice.

In the case of Bulgaria, this correlation is less evident as the country was assessed with low and moderate levels of effectiveness in all IOs. Nonetheless, a close look at the latest 2022 MONEYVAL Mutual Evaluation Report of Bulgaria<sup>11</sup>, IO. 7 and IO. 8, assessed with low effectiveness, show that while the ratings here are a bit irrelevant for comparison purposes (to outline the more critical negative role of these two respective IOs), the language used in the report provides more clarity.

A direct statement from the report (on pages 77 and 78, IO.7) stipulates that *"It is a particular feature of the Bulgarian AML regime that the major recipient of FIU disseminations is the Financial Security Directorate of the State Agency for National Security (FSD-SANS) which is not a law enforcement authority (LEA) itself, rather a security agency with vast databases and analytical capacities. The FSD-SANS would normally not prepare their ML cases for being directly reported to the prosecutor - instead of which, most of their cases are forwarded to Ministry of Interior (MoI) bodies for gathering more information beforehand. While all stakeholders agreed that the FSD-SANS input gives an important added value to the quality of ML cases being prepared, the subsequent involvement of multiple bodies in the process to build up a ML criminal investigation may duplicate the efforts and unnecessarily increase the time it takes for verifying a ML suspicion before finding it suitable for an investigation."*<sup>12</sup>

The clear criticism is related to the duplication of efforts in what we call "the issue management phase." Moreover, one of the tools used by the Bulgarian system to achieve effective issue management, the Criminal Procedure Code (CPC), is also heavily criticized (page 54, IO. 7): *"Extremely formalistic and bureaucratic features of the CPC pose unreasonable obstacles for the pre-trial authorities particularly as the strict and narrow deadlines and other procedural constraints are concerned."* *"Neither LEAs nor the prosecutorial authorities consider ML a priority and there are absolutely no mechanisms in place to prioritize any sorts of ML cases. All criminal cases are distributed randomly and dealt with equally."*<sup>13</sup>

One statement, however, makes a specific outline of the lack of issue management policies and procedures (page 54, IO. 7): *"The characteristics of ML offences investigated and prosecuted do not appear commensurate with the identified ML risks of the country, particularly as the composition of the respective predicate crimes is concerned. Most of the ML cases are related to fraud and have been generated by the reporting regime under the Law on Measures against Money Laundering (LMML), with almost no ML cases occurring in relation to high-scale corruption or organized criminality. There are no mechanisms or policies in place to achieve any significant changes in this field."*<sup>14</sup>

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<sup>11</sup> <https://rm.coe.int/moneyval-2022-1-mer-bulgaria/1680a70913>

<sup>12</sup> Same as above.

<sup>13</sup> Same as above.

<sup>14</sup> Same as above.



Therefore, authorities and policymakers should be able to benefit from the findings of this research to navigate their efforts for more effective issue management. As mentioned below, the response concerning issue management should slightly differ from the one related to risk management.

The Mutual Evaluation Report itself uses language that guides in the abovementioned direction (on page 5, Executive Summary): *"Bulgaria's ability to develop national AML/CFT policies to mitigate ML/TF risks is inhibited by the areas of risk understanding that require further improvement. Challenges exist in relation to inter-agency cooperation between LEAs, which is particularly hindered by the lack of necessary tools."*<sup>15</sup>

As stated above, following the FATF approach, MONEYVAL generally recognizes all IOs as relevant to risk management, but the emphasis on the lack of tools for LEA cooperation is specific more to the issue mitigation. A further example in that direction is provided in the following paragraph, talking about the lack of statistics, specifically mentioning again areas of issues where ML/TF have already occurred. *"The lack of comprehensive statistics limits the authorities' understanding and their abilities to react to risks. Statistical data for evaluating the use of financial intelligence, investigation and prosecution of ML and TF and related predicate offences, confiscation and international cooperation are particularly limited."*<sup>16</sup>

## HOW DOES RISK AND ISSUE MANAGEMENT REFER TO PRACTICAL MEASURES?

Countries could use the risk-based approach in many different ways. Here are some of them:

- To identify gaps or opportunities for improvement in AML/CFT policies, procedures, and processes.
- To develop new risk mitigation policies and achieve lower residual risk exposure. Applying an RBA will be essential for the overall effectiveness of this process. Below, we will explain how this should relate to the risk management process.
- Support informed decisions about risk appetite and implementation of control efforts, resource allocation, and technology application.
- Ensure that policymakers possess the necessary awareness to target the remediation efforts.

Issue management should be considered in a similar direction. Nonetheless, issue management should be more related to identifying areas where jurisdictions should directly deploy resources to tackle specific ML/TF offences. For example, issue management measures will determine the number of police and/or customs officers necessary to investigate trade-based money laundering (TBML) and their specific level of knowledge, training, and technical equipment to be efficient.

Another example could be given concerning implementing different methodologies and guidance papers. While supervisors, for example, are expected to provide such documents to their supervised entities regularly, the police won't need such reports that often and can focus

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<sup>15</sup> Same as above.

<sup>16</sup> Same as above.

on the crime investigation instead. In any case, no supervisory authority can directly tackle ML/TF offences, so their issue management measures should be much more limited.

A noticeable assumption here is that risk management requires a more policy-oriented response with somehow limited direct interventions to tackle the ML/TF crime. In comparison, issue management could be considered the reverse.

Despite all the above, crime will exist no matter what. In a nutshell, in the AML/CFT context, issues are most likely unavoidable for their occurrence, but the negative consequences stemming from them could be mitigated through effective investigation, prosecution and confiscation processes. These are the high-level issue management strategies that all jurisdictions should effectively apply. However, their proportions, intensity, resource allocation and timelines should differ based on the specific context of each jurisdiction.

### **STRATEGIC APPROACHES IN RISK AND ISSUE MANAGEMENT FOR IMPROVED AML/CFT MEASURES**

Both risk and issue management should be applied with a strategic focus on their policy and institutional response. Nonetheless, the strategic approaches should slightly differ in these two scenarios. With risk management, competent authorities and policymakers should look at the prevention of the financial system's integrity, creating barriers to criminals for market entry, improving the transparency of beneficial ownership, better supervisory activities, higher levels of understanding of the risks, etc. Meanwhile, with issue management, competent authorities and policymakers should look at a more significant law-enforcement response. For example, tackling the ML/TF crime by achieving proportionate and dissuasive convictions, confiscating ill-gotten assets, and even delivering greater levels of confidence in the rule of law application.

As previously mentioned, the strategic approaches in the two types of management have common denominators. One is domestic and international cooperation, which is critical for identifying issues and risks, their nature, intensity, materiality, and context.

In the AML/CFT Global Network<sup>17</sup>, international cooperation should be constructive and timely, covering all relevant competent authorities. Collaboration with the private sector is also essential in the information exchange. It can be done *ad hoc* as part of a country coordination mechanism or a public-private partnership (PPP) cooperation mechanism. In the AML/CFT context, PPPs refer to strategic collaborative efforts between private sector representatives and public sector agencies such as financial intelligence units, law enforcement authorities, regulatory bodies, and policymakers to share information and operational and/or strategic intelligence to tackle financial crime.

In many instances, however, these types of cooperation are not efficient. The lack of trust between the exchanging parties, lack of legal power to collaborate, data protection issues, and others are among the reasons for this inefficiency. Therefore, in these instances, issues and risk identification happen late or without the necessary level of coverage and primarily rely on domestic data sources maintained mainly by the public authorities.

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<sup>17</sup> <https://www.fatf-gafi.org/en/countries/global-network.html>

In these cases, strategic information and other relevant data cannot reach their destination and, therefore, cannot be used to build effective policies, which results in a chain of negative consequences.

Even if the information is provided, it must be used correctly by the right players (involved in the policymaking process). As Professor Todor Tanev says in his book "The Political Strategies,"<sup>18</sup> *"When compared to tactical and operational management, strategy proves to be a value-selected ideal for the distant future, the common sense of which is being further developed in socially constructed, more specific meanings that finally reach the state of end goals of strategic importance. All this creates the basis for a positive attitude towards the uncertainties used as opportunities rather than risks that should be avoided."* Therefore, a strategic approach should include a much more holistic view involving a wide range of information, data, analysis, tools, and players working together to achieve a predefined goal.

## CONCLUSIONS

The FATF experts probably considered all the abovementioned nuances and decided to compile the risk and issue management into one process called the "risk-based approach." However, there is some evidence that a new analysis could be necessary for the future, especially if the authorities look at the limited resources available to address risks and issues and the need for prioritization in an accurate strategic policy response.

For example, if they take into consideration a single risk or issue. Each one of them could be mitigated through four or five alternative ways. However, due to their limited resources, the competent institution could apply only two or three of them in the specific case.

How should they select? Probably, based on the intensity of the mitigation measure, its timelines for application, expected results, etc. In other words, there should be objective criteria for selecting mitigation measures, and the best way to choose is to have as much preliminary data as possible, including risk and issue management results, residual risk measurement, etc. The more precise jurisdictions are with their assessment of these categories, the better strategic approaches in the selection of mitigation measures they will be able to apply.

In general, a better understanding of risks and issues should lead to a better mitigation response and, therefore, decrease the level of issue manifestation. This is because, in theory, risks should, at one point, turn into issues if they are inevitable/inherent or not well addressed. Hence, all government policies should eventually be related to efforts to limit ML/TF cases and, where they occur, to convictions and confiscation. This will not only provide a general society perception of the proper application of the rule of law but will also make the country's financial system more resilient to infiltration of criminal assets. However, the nature and specificity of the risk or issue management tools could defer. In such a context, comprised of complex theories, a better understanding of the difference between risk and issue management could lead to more targeted strategic approaches in policymaking.

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<sup>18</sup> 2003, Tanev, "The political Strategies", Sofia, 2008.

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