Risk out of Risk: the self-referential dynamics of risk-creation in Anti-Money Laundering

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The aim of this study is to explore the way Financial Institutions and Financial Intelligence Units deconstruct and personalise their Money Laundering (ML) and Terrorist Financing (TF) risks. Specifically, this study examines the application of the Risk Based Approach (RBA) and aims to explore how it drives risk interpretation and deconstruction processes within the wider ML and TF prevention system.

Review of existing literature indicates that the majority of studies deliver descriptive and almost anecdotal assessments of the existing Anti-ML (AML) and Countering the Financing of Terrorism (CFT) frameworks. Furthermore the belief that the RBA helps reduce risk is unquestioned throughout the AML/CFT industry: this has an impact on the way risk is perceived, represented and handled, thereby leading to a misalignment between key AML and CFT stakeholders such as Financial Institutions, Regulators and Financial Intelligence Units. An implication of this misalignment is the impact on the (lack of) effectiveness of institutions in their fight against ML and TF.

The research looks at the decision-making process relating to the application of the RBA when interpreting, deconstructing and prioritising ML or TF risks. It aims to develop a 2nd order cybernetics description of ML risks and reflect on how external dangers are being converted into risks; these, in their turn and through further decisions, generate additional dangers that are being fed back into the overall ML and TF prevention system. The theoretical grounding for this research is based on Niklas Luhmann's Systems Theory and can be placed in the tradition of second-order cybernetics. The research applies Luhmann's systems theoretical treatise on risk to the domains of AML and CFT. The theory also informs data collection and supports the research on deconstructing risk assessments, communications and AML/CFT decision-making processes.

A case study research design of two Financial Intelligence Units (FIUs) based in Western Europe and the Baltics has been conducted, analysing how AML/CFT decisions are related to previous decisions, existing structures, as well as reconstructing the sequence of communication that not only leads to a specific decision but also justifies it to relevant stakeholders. Procedurally, the work focused on decisions made by FIUs and institutions that aim to prevent and combat Money Laundering and Terrorism Financing such as Banks and Regulators, looking at Suspicious Activity Reporting and exploring the

decision-making process relating to risk based regulatory requirements. The purpose was understanding how are risks assessed, prioritised and, where relevant, discarded? What further risk/danger distinctions is made based on those decisions, and what are some of their unintented consequences (e.g. how are risks re-inserted into the system)?

In order to complete the case study, the researcher performed structured and unstructured interviews with relevant organizational members and observed day-to-day AML/CFT operations, behaviours and interactions. In addition, the study looked at internal reports (such as audits, Management Information, risk matrices and assessments), internal policies and procedures, training, regulation, government and industry reports as well as consultation documents written in conjunction with relevant stakeholders.

The originality of this work lies in the application of Luhmann's risk framework to deconstruct and analyse ML and TF risks, as well as understanding the impact of the RBA. More specifically, the research aims to analyse empirical data to recursively think about how ML and TF risks are being deconstructed, reconstructed and communicated within institutions that prevent and combat ML and TF. The conclusions are considered against Luhmann's systemic analysis of risk expecting to extend Luhmann's framework in the field of risk deconstruction. In addition, this study enhances risk representation and communication in the domain of AML/CFT.