A Conceptual Framework to Assess the Risk of Money Laundering in Designated Non-Financial Institutions in Emerging Market Economies

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Abstract

The scale of money laundering has increased recently due to various reasons. The global economic volatility brought on by geopolitical tensions, disruptions in international trade as well as misuse of emerging technologies are some of the main causes. Within this challenging environment, money launderers may exploit opportunities beyond traditional financial institutions (Akartuna, E., et al, 2023). Non-financial institutions represent a major share in many economies and have become increasingly vulnerable to such criminal activities. The Financial Actions Task Force (FATF), the global policy setter on combating money laundering, terrorist financing and financing of proliferations, has recognised the vulnerable areas and several higher risk non-financial institutions. They are named as Designated Non-financial Businesses and Professions (DNFBPs). However, the focus of country authorities on the risk emanating from the DNFBP sector is far less than the Financial sector. It provides greater opportunities to exploit such sectors for money laundering purposes, especially during periods of global unrest and economic uncertainties. This is confirmed by the worldwide poor evaluation results by the FATF on risk identification and implementation of Anti-Money Laundering and Anti-Terrorist Financing (AML/CFT) control measures in the DNBFP sector. This could be due to the lack of proper assessments of money laundering threats and vulnerabilities, i.e., the money laundering risk of the sector. One major impediment in applying regular approaches to assess risk in the DNFBP sector is insufficient data availability. This case is more critical in emerging and developing economies. In this study, I propose a conceptual "bottom-up approach" for DNFBPs to assess Money Laundering and Terrorist Financing (ML/TF) risks, considering the lack of data and informality prevailing in the sector. Within this conceptual framework, an index is proposed to assess vulnerability, and the index will allow authorities to evaluate preliminary risk levels. Further, this will help the sector to allocate required resources to combat higher ML/TF threats. In addition, based on this framework, I have identified six main challenges that affect the proper control of illegal activities in the DNFBP sector, namely, 1) lack of regulatory requirements and supervisory concerns, 2) lack of awareness of corporate management of firms and lack of technology in firms, 3) primitive state of businesses, 4) political interventions, 5) lack of government support and 6). structural issues, such as the sector not being well established in the country. Moreover, these align with factors discussed often in the country mutual evaluation report by FATF. Finally, I discuss a case study to elaborate how Sri Lanka has successfully faced such challenges during its period of introducing and implementing the FATF requirements in the country's Non-financial sector.

Keywords: *money laundering, AML/CFT measures for DNFBPs, assessment of ML/TF risks, index, FATF Recommendations, emerging market economies, economic crisis in Sri Lanka*

JEL Classification: *G 28, K 42*

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1. Introduction

Money launderers exploit opportunities elsewhere than formal financial institutions. They capitalise vulnerabilities in the Non-financial sector. Recent literature highlights that money launderers prefer Non-financial sectors (Shamloo, B., et al, 2024). This is mainly due to the perception of having weaker controls compared to formal financial institutions The scale of such Money Laundering (ML) through Non-financial sector activities has increased substantially in recent years. This may be due to recent developments in digital transformation, remote business operations, and economic disruptions. These have created new opportunities for financial crimes, including ML and Terrorist Financing (TF). They provide additional avenues for wrongdoers like money launderers through non-financial businesses. Due to stringent controls in Financial Institutions, and the possibility in tracing their transaction records, these wrongdoers have shifted from financial businesses to non-financial businesses. These activities have been increased during the Covid-19 pandemic and unusual times like economic uncertainties. Shifting regulatory priorities, weak monitoring and evaluation by authorities during times like pandemic encourage the increase in criminal activity corruption and money laundering (Ilahi and Widowaty, 2021).

There are opportunities for wrongdoers to exploit any business or any professional service for the process of converting dirty (illegally earned) money to appear as clean money. The FATF, as the global policy setter on combating money laundering, countering terrorist financing, and proliferation financing, has recognised several high-risk non-financial institutions. Some of their activities have been highlighted as attractive to money launderers and terrorist financiers. Therefore, such businesses and professions are named by the FATF as DNFBPs. These non-financial institutions in any country are more or less exposed and vulnerable to money laundering, terrorist financing, proliferation financing and other related financial crimes. Accordingly, the FATF has made it a requirement for every country to identify preventive measures to combat such financial crimes that could be carried out by misusing those non-financial institutions. Out of 40 Recommendations of the FATF in the global fight against money laundering, terrorist financing, and proliferation financing, Recommendations 01, 22, 23, and 28 are specifically applicable to DNFBPs (FATF 2012-2025). Also, there are several guidelines from the FATF on evaluating and assessing money laundering, terrorist financing, and proliferation of financing risks of different sectors.

However, it has been a challenge and an observed lack of available tools for jurisdictions to evaluate the overall country risk emanating from the DNBFP sector. Most guidelines on assessing risks for the Non-financial sector have qualitative approaches. A quantitative perspective is a gap that needs to be filled. However, the situation in the Financial sector is different as in most cases, it is a more formal, regulated market segment compared to non-financial businesses and professions. Hence, the Financial sector has some quantitative mechanisms to identify, analyse, and evaluate the overall money laundering risk of the sector in a proper manner than the Non-financial sector. Therefore, when it comes to countries' understanding of ML risk emanating from Financial segments, it is always better than their understanding of such risks emanating from the Non-financial sector.

Accordingly, in this study, I propose a conceptual framework for DNFBPs to assess Money Laundering and Terrorist Financing (ML/TF) risks, considering the lack of data and informality prevailing in the sector. Within this framework, an index is proposed to assess risk, and the index will allow authorities to evaluate preliminary risk levels. The study aims to introduce a conceptual framework to create an index to assess the preliminary risk of money laundering in Non-financial businesses and professions. One major impediment in applying regular approaches to the DNFBP sector is insufficient data availability in this sector in the emerging and developing world. Therefore, the commonly used top-down approach to assess ML risk of the sector may not be appropriate for this sector. Accordingly, in this paper, I propose a bottom-up approach to develop an index for the DNFBP sector to assess its overall ML risk.

This paper also explores challenges that, especially emerging economies, experience when ensuring non-financial institutions' compliance under the three core FATF Recommendations on combating money laundering, terrorist, and proliferation financing. Identification of these challenges will support overcoming such challenges and effective implementation of anti-money laundering and counter terrorist financing requirements for the Non-financial sector of countries. Challenges for Non-financial sectors are studied under the six main categories for this study.

Further, as a practical illustration, the study presents how Sri Lanka has overcome some of the the identified challenges in introducing the AML/CFT compliance culture into its non-financial businesses and professions. As Sri Lanka was twice delisted by the FATF's close monitoring list which is commonly referred as the "Grey List" and FATF's positive evaluation on the progress made by Sri Lanka for the recommended actions by the International Co-operation Review Group (ICRG) process were the leading factors to select Sri Lanka for this case study (FATF-Improving Global AML/CFT Compliance: On-going Process - October 2019, CBSL, 2020).

Accordingly, the rest of the paper is organised as follows: Section 2 discusses the DNFBP sector considered for money laundering purposes, while Section 3 briefs on non-compliance by countries as reflected in FATF records. Section 4 describes the methodology of the analysis. Section 5 provides a broad conceptual framework and an index to assess the risk of money laundering in Non-financial institutions, including a literature review on related indices for Financial institutions. Section 6 discusses challenges faced by emerging economies to minimise risk in the DNFBP sector, while Section 7 considers a case study for Sri Lanka. Section 8 states policy implications, and Section 9 concludes the study.

2. Designated Non-financial Businesses and Professions

Non-financial businesses such as casinos, real estate agents, dealers in precious metals and precious and semi-precious stones, as well as the specified activities of professional service providers such as lawyers, notaries, accountants, and trust & company service providers (sometimes referred to as Gatekeepers) are designated as non-financial businesses and professions under the scope of AML/CFT by the global policy setter. The FATF has labeled these non-financial businesses and professions as attractions to money launderers and terrorist financiers. According to the FATF Recommendations, these businesses and professions should take specific preventive measures when dealing with high risk situations to eliminate such unlawful activities and attraction. Also, it should be noted that these requirements are even more compelling for the Financial businesses of a country.

2.1 Use of the Non-financial sector by money launderers and terrorist financiers

Suitable control measures for ML were originally introduced for the Financial sector of the countries by the global policy setters, as the Financial sector is highly misused mainly by drug traffickers. This was in 1990, Then, as it was observed that Financial sector was misused not only for laundering the proceeds from illegal drug trafficking, but it was also misused for laundering proceeds of other crimes, and for financing terrorism, terrorist activities as well as their organisations. The FATF therefore introduced some global standards on preventing ML as well as some additional recommendations on preventing TF in 2001 and 2003 FATF (2012-2025)With the introduction of those strict controls, criminals gradually started moving from the Financial sector to Non-financial sector due to the latter's lack of such strict controls.

Also, the value of transactions in Non-financial businesses is relatively higher than in the Financial sector. For example, the value of land, the price of a gem, winning price of a casino game, etc. Hence, the amount of criminal proceeds that can be laundered easily by misusing such transactions, more than depositing them or investing large amounts in a financial product, is high. In the Non-financial market, there are professional service providers who may be misused by criminals to hide their real identity under the former's professional reputation or goodwill.

In these Non-financial markets there are fewer regulations compared to Financial markets. In most countries, Non-financial markets are not properly regulated. This makes it easy for criminals to enter and exit these businesses and professions without a considerable cost. Value can be easily stored for a long time in non-financial assets such as lands, buildings, gems, and jewelry without rapid changes compared to the value of financial assets such as deposits, stocks, securities, bills, and bonds.

In doing business with these segments, criminal proceeds can be easily moved from one place to another without being caught by legal authorities. For example, criminal proceeds can be invested in a gem, and it can be easily carried across borders. Tax payment requirements can be skipped by purchasing luxury goods such as jewelry, watches, compared to purchasing financial products. Criminal proceeds can be layered into different categories easily when they are spent purchasing goods such as gems, jewelry, watches, antiques, or any other luxury items rather than directly using financial institutions to save or transfer those funds into other financial institutions, accounts, or investing them in financial products. Non-financial markets, institutions, professional service providers, and goods are appealing to criminals who aim to launder their proceeds mainly due to the above-mentioned factors.

3. Technical Compliance with FATF Recommendations and the Effectiveness of AML/CFT Frameworks

The FATF periodically assesses whether countries have accomplished these international standards to prevent money laundering, terrorist financing and proliferation financing effectively. The FATF assesses the effectiveness of establishing its Recommendations separately for the Financial sector and the Non-financial sector. Accordingly, the technical accuracy of a country's AML/CFT framework for the DNFBP sector is assessed through the three core FATF Recommendations, which were mentioned above. Comparing the soundness of implementing FATF Recommendations to prevent ML, TF and PF, it appears that many countries have established these Recommendations more successfully in the Financial sector than in their Non-financial sector. Analysing the FATF mutual evaluation reports, Omar and Johari (2015) revealed that lack of awareness and poor enforcement by regulators are key concerns for the low level of compliance with the FATF Recommendation applicable to DNFBPs segments in such countries.

Table 1 summarises the country's technical evaluation on the successful implementation of the core AML/CFT Recommendations for DNFBPs. It shows that only 12 out of 156 countries have successfully introduced customer due diligence measures as per FATF Recommendation 22 and have achieved the best rating at the level of "Compliant". More critically, it shows that only 14 out of 156 countries have been able to make successful arrangements to monitor the compliance of DNFBPs sectors by a relevant competent authority as per the requirement of Recommendation 28. Recommendation 23 requires Non-financial institutions to report suspicious transactions to a competent authority which is also a very critical FATF requirement, and it is also at a very low level in terms of implementation. Only 16 countries have been able to achieve a rating at the high level of Compliant. Further, a considerable number of countries belong to the rating levels of "Partially" or Non-Compliant" for all three core compliance requirements, which is an indicator that most of the countries are struggling to implement these technical requirements as expected by the FATF. However, it should be highlighted that a considerable number of countries belong to the category of "Largely Compliant," which could be considered as an improvement and an indicator that countries are gradually attempting to onboard their DNFBP segments into the national framework of combating money laundering. Hence, an index-based money laundering risk assessment framework would be a timely requirement to support these countries and jurisdictions.

Table 1: Level of technical compliance by countries for the 3 core FATF Recommendations on DNFBPs

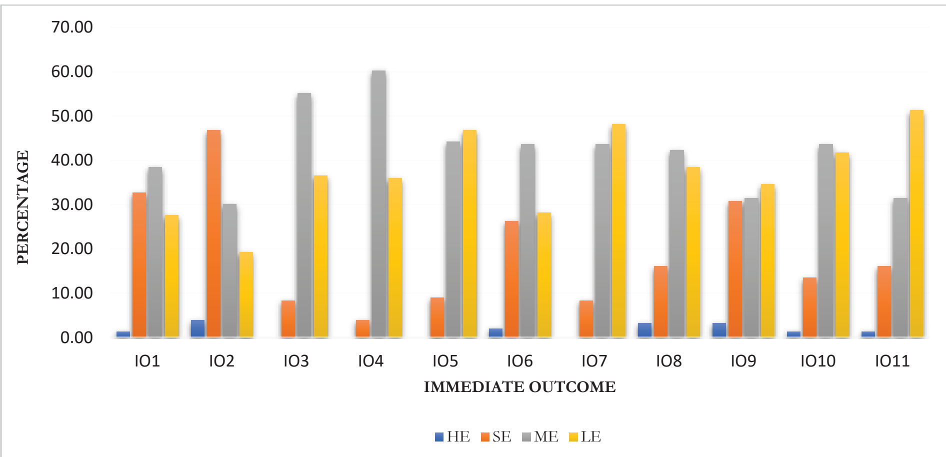
Level of Assessment	No. of Countries Assessed at each Recommendation relevant to DNFBPs			Definition
	Rec 22 DNFBP Customer Due Diligence	Rec 23 DNFBP Other Measures	Rec 28 Regulation & Supervision of DNFBPs	
C	12	16	14	C: Compliant
LC	74	83	54	LC: Largely Compliant
PC	58	47	69	PC: Partially Compliant
NC	12	10	19	NC: Non-Compliant
Total	**156**	**156**	**156**	Total: No. of Countries

Source: Consolidated assessment ratings of FATF, Oct 2024

The ultimate goal of implementing the technical requirements is to practically contribute to every economy to combat ML successfully by preventing detecting and disrupting ML threats and vulnerabilities, as well as supporting the prosecution of criminals and prescribing the proscription of illegally acquired wealth and proceeds. Hence, the FATF assesses the effectiveness of implementing technical requirements in controlling ML attempts using the legal economic framework. Most countries experience difficulties in achieving a good assessment level in this regard compared to achieving a good assessment level at technical compliance, as explained above. The effectiveness in implementing AML measures is assessed by the FATF through "Immediate Outcomes".

The following Graph 1 shows FATF's assessment of the effectiveness of the countries in applying the FATF Recommendations on combating ML and TF. The statistics show that the effectiveness of most countries is at low to moderate levels. However, it should be analysed carefully as these effective outcomes, which have been named as Immediate Outcomes, were not separately assessed for DNFBP sectors; it was a combination of effectiveness measures taken by a country for Financial institutions as well as designated non-financial businesses and professions. However, the FATF updated their standards at the end of 2024 as well as, followed by the evaluation methodology in June 2025. Now there is a separate Immediate Outcome (IO-4) to assess the country's effectiveness separately for implementing preventive measures for their DNFBP segment. The FATF with its regional bodies such as Asia Pacific Group on Money Laundering (APG), has now implemented a new round of country assessment. In future this study can be updated to analyse the assessment outcomes for DNFBPs separately under the new FATF methodology. There are 11 Immediate Outcomes as depicted in Figure 1 below.

Figure 1: Effectiveness of AML/CFT measures of the countries as per FATF Evaluation



Source: FATF

HE	High level of effectiveness
SE	Substantial level of effectiveness
ME	Moderate level of effectiveness
LE	Low level of effectiveness

The 11 Immediate Outcomes, which have been shown in the above graph are then recategorised into 3 key "Intermediate Outcomes". The first Intermediate Outcome is to assess the effectiveness of the country's policy, coordination, and cooperation, and mitigate the ML and TF risks. If a country does not show proper policy coordination or cooperation with other institutions and arrangements, it indicates that such countries' policies do not effectively contribute to combating ML, terrorism and proliferation financing. The second Intermediate Outcome is to assess the country's

effectiveness in preventing proceeds of crime and funds in support of terrorism from entering the Financial and other sectors or being detected and reported by these sectors. Although the rules and measures are in place, if they are not supportive of effectively preventing or controlling the proceeds of crimes and financing of terrorism, the ultimate goal is not fulfilled. The third Intermediate Outcome is for assessing how countries' ML threats are detected and disrupted, and criminals are sanctioned and deprived of illicit proceeds, TF threats are detected and disrupted, terrorists are deprived of resources, and those who finance terrorism are sanctioned, thereby contributing to the prevention of terrorist acts (FATF, 2020).

For example, under the old methodology IO-4 referred to the effectiveness of financial institutions, and DNFBPs adequately applying AML/CFT preventive measures commensurate with their risks and report suspicious transactions. Most countries belong to the rating level of "moderate" or "low" for this Immediate Outcome, which shows that the private sector institutions are not adequately applying preventive measures, with the understanding of risks and reporting of suspicious activities by them not at sufficient levels. It is common that in most countries, especially in the Non-financial sector, they do not properly understand their ML and TF risk exposures, and hence, no preventive measures are taken. Further, reporting suspicious activities to the competent authority is at very low levels, especially in Non-financial sectors. It is obvious that the financial institutions are much ahead compared to non-financial businesses and professions in assessing ML/TF risks, applying preventive measures, and reporting suspicious transactions. E.g. In Sri Lanka, the dominant sector in reporting suspicious transaction is the Banking sector (FIU Annual report, 2024). However, this effectiveness was not separately assessed under the old FATF methodology. This issue has been now fixed by the FATF. But, when we refer to the particular country's assessment report published by the FATF, it is clear that the effectiveness of the Non-financial sector is far below the Financial sector.

This scenario demonstrates that countries face more challenges in achieving effectiveness than technically complying with AML/CFT measures, and especially the effectiveness of DNFBPs is behind the well-established Financial institutions. Therefore, it is worth discussing the reason for it being a challenge for most countries, especially developing economies.

Accordingly, it is an obligation of every country to facilitate the requirements to ensure that their designated non-financial businesses and professions comply with the above-discussed requirements. For this, countries should ensure that their Non-financial institutions are properly incorporated into the AML/CFT regime of the country. Most countries are struggling in identifying and assessing ML/TF/PF risk of institutions and sectors dure to various reasons. The FATF requires countries to apply risk-based approaches, identify higher risk Non-financial institutions and closely monitor them under a proper AML/CFT/CPF legal framework.

4. Methodology

This study proposes a conceptual framework for DNFBPs to assess ML/TF risks. One major impediment in applying regular approaches to the DNFBP sector is its insufficient data availability in the emerging and developing world. Therefore, the commonly used top-down approach may not be appropriate for this sector. Accordingly, in this paper, I propose a bottom-up approach for the DNFBP sector to assess the overall risk in the sector. A simple index is proposed based on the bottom-up approach. This paper also explores challenges, which emerging economies face in ensuring non-financial institutions' compliance under six main categories.

5. Conceptual Framework to evaluate the risk of money laundering in Non-financial institutions

As discussed above, countries are required to implement FATF Recommendations as per the risk-based approach. Every country should have a proper understanding of the ML risk of each sector of its economy. The following section discusses literature related to available indices for the Financial sector for this purpose and proposes a conceptual framework for an index to evaluate Non-financial sector risk.

5.1 Literature Review

A risk-based approach is central when it comes to applying AML measures. Every country is required to identify, assess and understand their ML risk properly. It is an essential foundation to efficient allocation of resources to mitigate these risks as per the FATF standards (FATF, 2012-2025). This approach has been highlighted in scholarly work as well. The concepts of risk assessment and risk management became key elements in the recent definition of AML regulation (Pellegrina and Masciandaro, 2008). The core aspects in this regard are identification, assessment, and understanding of ML risk. Hence, countries need to have proper frameworks, mechanisms, processes and tools to identify, assess, and understand the ML risk of a country. FATF requires countries and jurisdictions to understand the sources and methods of money laundering to develop an effective AML programme (ML & TF Risk Assessment strategies- FATF-GAFI 2008). ML risk is mainly divided into 3 core areas: the country's ML threat, vulnerability, and consequences (FATF Guidance, national Money Laundering and Terrorist financing Risk Assessment-Feb 2013). As it is hard to assess the consequences, ML risk is assessed based on threats and vulnerabilities. Once the risk is properly identified, countries can determine whether to apply enhanced AML measures or simplified measures (FATF Guidance, National Money Laundering and Terrorist Financing Risk Assessment 2013). Further, as resources are lacking, risk assessment can be used to determine an efficient allocation of resources for essential areas. Hence, the national AML policy can be effectively and efficiently applied to the high-risk sectors through the Risk Based Approach (RBA).

Lyeonov, S., et. Al, (2020) propose econometric and intellectual data analysis techniques to quantify money laundering risks in banks. While this approach is well-known and adopted by countries through their legal systems, the mechanisms, methodologies and tools available to carry out the process are still a gap and they significantly differ from what is established in their financial institutions.

In most countries, financial institutions benefit from established mechanisms, quantitative methods and risk assessment tools. Pellegrina and Masciandaro (2008) discuss the measurable compliance indicators and risk-based regulation. Also, as mentioned above, Lyeonov, S., et. Al, (2020) propose econometric and intellectual data analysis techniques to quantify ML risks in banks. It discussed the possibility of assessing ML risk with structured data set and helped regulators to move beyond qualitative judgements.

However, risk identification and assessment of designated non-financial businesses are conducted more qualitatively by most countries based on professional judgements, experts' opinions, etc (Ferwerda and Reuter, 2018). Especially in the designated non-financial businesses and professions, typologies, professional judgements, and experts' opinions are involved in understanding the risk level of ML, which may not provide a clear picture of the real ML risk. Lack of quantitative data is a major concern in this regard. However, there are many disadvantages of identifying and assessing ML risk through qualitative methods, such as experts' opinions. This is because such judgments, opinions, and views may over or underestimate ML risk, and they may have different opinions on a business' nature and its operations. (Ferwerda and Kleemans, 2018). Hence, quantitative analysis is a requirement especially for DNFBPs.

Some countries have tried hybrid models in assessing money laundering risks in their Non-financial sectors. The French AMF (2019) has introduced a mixed method of qualitative and quantitative in mapping threats and vulnerabilities to calculate ML risk scores. The FATF guidance of Risk-Based Supervision (2021) highlights the requirements for countries the supervisory authority to adapt structured framework that is sensitive to identified risk to monitor institutions across Financial as well as Non-financial sectors. As per these requirements, every country needs a proper framework and an index for risk assessment and thereby widens their risk understanding.

The Financial sector, as well as the Non-financial sector of a country, has a somewhat similar set of global standards to be complied with as per the global requirement of AML (FATF, 2020). FATF Recommendation 26 requires risk-based supervision of financial institutions, whilst Recommendation 28 requires the risk-based supervision or monitoring of DNFBPs (FATF Risk-based Supervision Report, March 2021). As recommendations earlier have been more focused on controlling drug trafficking and misuse of financial institutions to launder drug proceeds, these global standards are well established in the Financial sector compared to the Non-financial sector (Muller, Kalin and Goldsworth, 2007). However, with the introduction of control measures to the Financial sector, the Non-financial sector became more attractive for ML. However, after assessing the risk of misusing the Non-financial sector, the FATF has recommended developing and maintaining a good understanding of ML/TF risks at all sectoral levels as well as entity level based on sound risk assessment of inherent risks and quality of mitigation measures and informed by national ML/TF risk assessment (FATF Risk-based Supervision Report, March 2021). Accordingly, countries are required to have clear tools for identification, analysis, and evaluating money laundering risk of Financial as well as Non-financial sectors. The FATF has issued sectoral guidelines.

However, it is the country's responsibility to have a proper tool to assess its own ML risk based on these guidelines. The Financial sector has different tools in this regard and data are readily available than in the Non-financial sector, and different research has introduced various tools to assess ML risk of financial institutions (Lyeonov, S., et. Al, 2020). In the FATF assessment, it has been revealed that most of the countries belong to non-compliant or partially compliant categories for applying AML measures for the Non-financial sector (Choo K K, 2012). Conducting regular risk assessment is a compliance requirement as per the global standards (e.g. countries conduct National Risk Assessments regularly and most of times depend on qualitative information when it comes to risk assessment of DNFBPs), most research has highlighted that an effective methodological tool is essential to carry out impartial, comprehensive, and adequate ML risk assessment (Dmytrov and Medvid, 2017).

In order to understand their own ML risk, Non-financial businesses and professions need to identify and assess the following aspects: client base, the jurisdictions in which they operate, types of delivery channels they have and effectiveness of the risk controls already in place (FATF Guidance for a risk-based approach-Accounting profession, 2019). Hence, introducing a framework with a quantitative method for assessing ML risk of DNFBPs should focus on such criteria.

As discussed above, AMF of France (2019), has a methodology for sector risk assessment. This introduced a risk matrix, which is a combination of threats and vulnerabilities. As per the report, in a particular sector, if the threat and vulnerability are higher, then that sector has a higher risk of ML compared to a sector that has a higher level of threat and a moderate or lower level of vulnerability. However, to apply this matrix, countries should have identified clearly the threat and vulnerability factors of each sector.

Although the Non-financial sector has been identified as a higher risk sector, there is a gap of a quantitative index that tailors to the assessment of its ML risk. Most existing studies either focus on the Financial sector or rely on qualitative typologies and analyses of perceptions (Pellegrina & Masciandaro, 2008; Lyeonov et al., 2020; Ferwerda & Reuter, 2022; and Ferwerda & Kleemans, 2019). This is the case of most emerging countries where the lack of data is a common problem. This gap underscores countries to need for a bottom-up approach, that facilitates firm level even preliminary data for risk scores. Such a framework is suitable for any country having data constraints.

5.2 The Conceptual Framework

This paper provides a framework for countries to understand the preliminary money laundering risk of their DNFBP sector. Having a better understanding of the ML risk of each sector helps in applying suitable AML measures for the sector according to its identified risk. This is the whole purpose of the risk-based approach, which has been introduced by the FATF. This framework will support countries when conducting their National Risk Assessments (NRAs), as DNFBPs is a core sector under private business segments, which countries are required to identify, assess, and understand the ML risk.

However, one major impediment in applying regular approaches to the DNFBP sector is insufficient data availability in this sector in the emerging and developing world. Therefore, the commonly used top-down approach may not be appropriate for this sector. Accordingly, in this paper, I propose a bottom-up approach to develop an index for the DNFBP sector, to assess the overall ML risk in the sector. The advantage of the bottom-up approach in this context is that the information comes directly from the grassroots level, i.e., firms in the relevant sector.

Interviews, expert opinions, and professional judgements are the core methods used in these ML risk assessments. However, there are many disadvantages of relying on those qualitative measures, such as the over- or underestimation of risks, areas unknown or unseen even to experts or professionals, as well as subjective expert judgment.

As recommended by the FATF through its guidelines, to assess ML risk properly, a combination of quantitative and qualitative assessment is proposed in this study. Hence, this conceptual framework can be complemented by purely qualitative methods, which are being used by the countries presently. This framework can be used by countries to have their own quantitative analysis in identifying, assessing, and understanding the ML risk of DNFBPs.

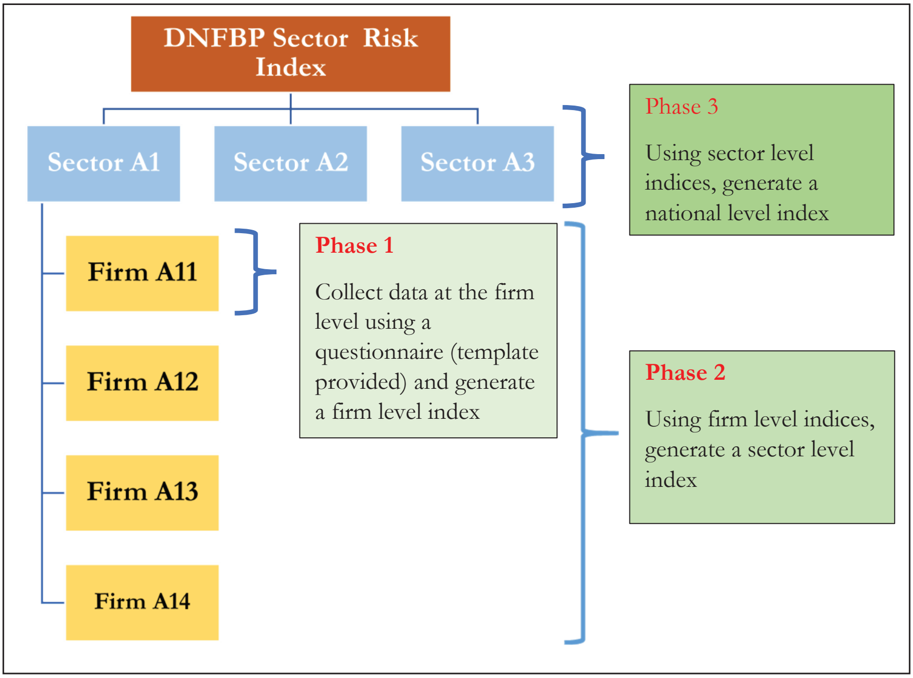
In selecting variables, attention was given to the variables that make a business or a professional service provider in the DNFBP sector attractive for money laundering.

In this framework ML threat is not collected from firms; however, the threat has to be considered by relevant authorities as per the records of proceeds of crimes, the number of reported suspicious transaction activities, number of investigations and prosecutions and any other information and statistics of crimes relating to this sector.

5.3 Bottom-up approach to calculate a risk index for the DNFBP Sector

The proposed approach consists of three phases as discussed below. The graphical depiction of the framework is given in Figure 2.

Figure 2: An Approach to Calculate DNFBP Sector Risk Index



Phase 1

This is the firm-level data collection and index calculation phase. Grassroots level data are to be collected from firms (businesses and professions) in each sector to assess the risk of each firm and the sector. If there are many firms in a sector, a random sample of around 20-30% of firms based on the size of the firm (using the annual turnover) could be used to collect data. A sample template to collect data is given in Figure 3. This template is not an exhaustive list, but an indicative one, and could be revised or modified according to the country and sector requirements. To select risk criteria, a country can ML typology, case studies, convicted money laundering cases, NRA reports of other countries, and other relevant criminal and judicial reports.

The main risks considered in the questionnaire are, as per FATF guidelines, the customer base of a firm, currently available types of products and services as well as delivery channels, geographical locations of a firm, and strength of prevailing AML control measures.

Accordingly, based on firm-wise data, using the template and scores given in the template, the firm-wise risk index is calculated.

Figure 3: A Sample Template for Risk Assessment Index- Firm-wise

ML Risk assessment for Company X for the Year 2025

Risk	Criteria	Response	Score	Possible highest marks	Rating
Inherent Risks	**Customer Risk:**	Yes	0		
	Local	No	1		
	Foreign				
	PEP				
	Listed/ Designated				
	Kown Criminals				
	Customers relating to Adverse news-media				
	Source of funds is clear/ not clear				
	Purpose of transaction is given/ not given				
	NPO/ NGO				
	Legal persons				
	Dealing with third parties and brokers				
	Customers from war areas/ Zones				
	Customers from sanctioned countries				
	Customers from listed countries				
	Products and Services Risk:				
	Cash intensive payment methods				
	Hi-tech products				
	Non-Face to face delivery				
	Anonymity can be maintained				
	Geographical location Risk:				
	Located in a high crime area				
	Located in an export, import zone				
	Located in a tax-free zone				
	Located in a capital city				
	Located among many informal business area				
	Delivery Channel Risk				
	Non-face to face delivery/onboarding				
	Use of agents				
	Use of third parties				
Other Factors	**Size of the business**				
	Small				
	Medium				
	Large				
	Licensing Requirement				
	Yes				
	No				
	Business Registration				
	Yes				
	No				
	Availability of Company Service Providers				
	Auditor				
	Yes				
	No				
	Service of a Company Secretary				
	Yes				
	No				
	Service of an Accountant/ firm				
	Yes				
	No				
	Service of a Law firm				
	Yes				
	No				
	Target Market				
	Provincial				
	National				
	International				
	Operates on Cash Basis				
	Yes				
	No				
	Other				
	Paying Taxes				
	Yes				
	No				
Controls	**AML/ CFT Controls**				
	Availability of AML/ CFT Policy				
	ML/TF/PF risk assessment				
	Availability of Reporting mechanism for suspicious transactions				
	Policies for record keeping				
	Availability of recruiting policy for human capital				
	Availability of CDD mechanism				
	Availability of screening designated persons				
	Mgt is knowledgeable about AML requirements company controls and the policy				
	No. of AML/CFT training provided for Compliance and non-compliance staff				
	Availability of fit & proper requirements				

Phase 2

At this phase, the sector-wise risk index is calculated using the index generated for each firm in Phase 1. In this calculation, the annual turnover of the firm is considered to determine its size. Accordingly, the sector-level index is calculated as follows:

$$I_{Ai} = \sum_{j=1}^{n} I_{Aij} \frac{T_{Aij}}{\sum_{j=1}^{n} T_{Aij}},$$

where I_{Ai} is the index for the i^{th} sector, i = 1…m. There are *m* sectors in the economy. I_{Aij} is the index for the j^{th} firm in the i^{th} sector, j = 1….n. T_{Aij} is the annual turnover of the j^{th} firm in the i^{th} sector.

Phase 3

In this phase, the overall risk index is calculated using the index generated for each sector in Phase 2. Accordingly, the overall money laundering risk for the DNFBP sector is given by:

$$I_{DNFBP} = \sum_{j=1}^{m} I_{Ai} \frac{\sum_{j=1}^{n} T_{Aij}}{\sum_{j=1}^{m} \sum_{j=1}^{n} T_{Aij}},$$

6. Challenges faced by emerging economies in implementing the FTAF Recommendations

Campa (2020) explains that ML/TF cannot be fought in isolation. Governments, the public sector, as well as the Private sector, all have a role to play. Specifically, these international measures on combating ML have been originally designed and introduced to protect the misuse of Financial sectors and financial institutions such as banks, non-bank financial institutions, insurance companies, and currency exchangers from ML activities. This was mainly due to their high-risk exposure, which originated with the possibility of misusing those entities as vehicles to clean dirty money earned through illegal drug selling. With the introduction of these control measures for financial institutions, drug dealers and other criminals started to shift from financial institutions to Non-financial sectors such as businesses and professional services, mainly due to their minimal or sometimes no controls at all to limit such illicit efforts. The FATF requires DNFBPs to adopt some similar controls relevant to financial institutions and deal with their customers with special care. Accordingly, DNFBPs are required to question the source of funds involved in a particular transaction. Since then, it has become a requirement for countries to make sure that their DNFBPs take appropriate measures to detect ML exposures and have proper controls to mitigate such identified risks. This was named as the application of the "Risk Based Approach" by DNFBPs. Under the Risk Based Approach, FATF requires governments to ensure that their DNFBPs assess their ML and TF related risks and take measures to mitigate risks based on their risk assessments.

However, from the introduction of these requirements today, most countries, especially in the developing world, are still struggling to introduce and implement these requirements in their non-financial businesses and professional sectors. Most countries have found it challenging when it is compared with the introduction and implementation of such measures in their financial segments due to various reasons. In analysing the reasons to find out why they experience it as a real challenge; the following facts stand out. Similar challenges have been identified and discussed in various country AML/CFT mutual evaluation reports (for example see Lao PDR (2023), Vietnam (2022),

Those facts can be classified under six categories as follows:

I. Structural Issues
   a. The Non-financial sector is comparatively less structured and governed than the financial sector.
   b. In most countries, non-financial institutions belong to the informal sector of the economy.
   c. Lack of knowledge on repercussions of ML: cascading impact of ML from the DNFBPs to the Financial segment, reputational damages, fines, imprisonment, etc.
   d. No taxation policies implemented properly.

II. Regulatory Requirements and Supervisory Concerns
   a. There are no regulators or proper regulations to guide these entities.
   b. In some countries, there is no business registration process for these non-financial businesses.
   c. No licensing is required to enter or exit from the markets.
   d. There are no centralised databases to access information about non-financial institutions.
   e. Some of these entities are not administered by specific laws and regulations.
   f. Designated non-financial entities are not used to operate under proper compliance.
   g. The scope of AML/CFT is limited only to specified activities. Hence, the application is limited and hard for authorities to monitor.
   h. These sectors are regulated/managed under multiple institutions. No single ministry or authority that handles the operations relevant to these sectors.

III. Lack of Awareness of Corporate Management of Firms and Lack of Technology in Firms
   a. The level of understanding and the knowledge of the management as well as employees, is comparatively lower than that of Financial institutions.
   b. Lack of resources compared to Financial institutions.
   c. Technological developments are used minimally.
   d. Some entities are operated from generation to generation (family based), and they do not want to change the way they operate.
   e. No standard business accounting and auditing practices in those entities.
   f. Lack of resources to be employed on compliance matters.

IV. Primitive State of Businesses
   a. Most of the businesses are highly cash-incentive.
   b. Some of the businesses are conducted online, with no physical space to contact, and there are no mechanisms to register online businesses.
   c. The cost of implementing compliance would be high for small firms.
   d. Most of the non-financial businesses are budding businesses that are vulnerable to different types of risks.
   e. Sometimes these entities are not directly exposed to laundering money; however, they are used to make transactions more complex or to add another layer to the process of money laundering, and hence it is not easy to identify their vulnerabilities.
   f. No bookkeeping, accounting, or auditing practices.

V. Political Interventions
   a. Politically appointed ruling parties do not want to disturb these businesses by imposing rules and regulations and become unpopular among those who run the businesses.
   b. There are instances that these informal businesses are owned by money launderers or criminals themselves and influence political parties not to regulate.

VI. Lack of Government Support
   a. Little support from some governments to the relevant authorities in introducing these measures.
   b. Micro finance sectors are not well-supported by governments through regulations.

When a country is attempting to introduce compliance measures to unregulated sectors, the above-mentioned matters are the issues that have to be overcome.

7. The Case of Sri Lanka

Sri Lanka is a founding member of APG, the FATF-style regional body for the Asia-Pacific region (FIU, 2021). Extending its best support to the international effort on combating ML and TF, Sri Lanka established its AML/CFT legal framework and the institutional setup, including an AML/CFT regulator, the Finance Intelligence Unit Sri Lanka (FIU-Sri Lanka) in 2006. Through the FIU-Sri Lanka, Sri Lanka has been monitoring its financial sector compliance on AML/CFT measures to mitigate ML and TF risks of the country since 2006. However, the Non-financial sector was not brought under the same roof till 2018 due to some of the factors discussed under the challenges of implementing anti-money laundering and countering the financing of terrorism in this article.

In 2015, Sri Lanka was evaluated by its international peer reviewers as a country that needs to further improve its AML/CFT measures for the financial sector, as well as introduce the same measures for the non-financial sector. Hence, Sri Lanka was in the list of FATF's closely monitored countries (which is well-known as the Grey List) as a jurisdiction with identified AML/CFT deficiencies during its last mutual evaluation in 2015. Introducing an effective AML/CFT regime for higher risk DNFBPs was a major action (among others), that Sri Lanka had to immediately attend to, in order to come out the said list. Accordingly, Sri Lanka had to expedite its process of including its DNFBPs into the country's national AML/CFT regime.

In introducing AML/CFT measures for designated non-financial businesses and professions in Sri Lanka, the FIU-Sri Lanka has taken several important steps which have ultimately benefited from the effective implementation of AML/CFT measures for the Non-financial sector in Sri Lanka. Those series of actions taken by the FIU-Sri Lanka were well acknowledged by the APG, the international reviewers, as well as the FATF at its plenary conducted in 2019 and announced that Sri Lanka's delisting from the Grey List due to its satisfactory performances in attending the given "Action Plan" by the FATF. Today, Sri Lanka has effectively implemented a supervision mechanism for the DNFBPs under its risk-based supervision strategy and has taken several key corrective measures for identified non-compliances in the AML/CFT frameworks of those institutions including imposing of financial penalties and issuing severe warnings.

The following section explains such actions taken by the FIU-Sri Lanka in introducing AML/CFT measures for DNFBPs.

A separate division for regulating designated non-financial businesses and professions

First, the FIU-Sri Lanka formed a separate division for the supervision of designated non-financial businesses and professions at the FIU-Sri Lanka. Then capable staff were allocated to the division to attend to different sectors of the DNFBPs. Providing staff with several local as well as international training courses has contributed to the success. The tasks assigned for this division were conducting studies on DNFBP sectors, issuing rules and regulations, outreaching and educating the relevant markets, and implementing supervising DNFBPs.

Market studies on designated non-financial businesses and professions

The DNFBP supervision division of the FIU-Sri Lanka conducted market studies to identify the functions of different markets and professions. These studies have been helpful to identify the size of the industries, key market players in different markets, market mechanisms and practices, as well as relevant rules and regulations prevailing in those markets. Also, the studies have been helpful to build up a continuous rapport with stakeholders and make them aware of the anti-money laundering and countering the financing of terrorism regime of the country. Further, these studies have been helpful in understanding ML and TF possibilities and vulnerabilities of each market. Support, dialogues, interviews, sharing of information by officials of relevant ministries, public institutions, regulators, self-regulatory bodies, industry associations and private sector institutions as well as published reports on these markets and their operations were useful in this exercise.

Drafting and issuance of AML/CFT rules and regulations

Once the market operations and mechanisms are understood to some extent via the aforesaid market studies, the FIU-Sri Lanka drafted customer due diligence rules covering all DNFBPs. Once drafted, they have been referred to relevant stakeholders of each market, such as regulators, authorities, licensing bodies, unions, and some large-scale private sector businesses and professional firms, industry associations as well as chambers, to get their comments and concerns on the draft rules. Then the rules were issued after attending to those entities' concerns within the scope of the legal requirements.

Continuous Engagement with Government on DNFBP Regulation

The FIU- Sri Lanka, with support from the Central Bank, has actively engaged with government authorities to advocate for the establishment of dedicated regulatory bodies for various DNFBP segments. At the time, sectors such as casinos and real estate lacked centralized oversight, creating challenges for effective coordination under AML/CFT requirements. These efforts have yielded tangible results, including the establishment of a regulatory authority for gambling and ongoing initiatives to introduce similar arrangements for the real estate sector.

Awareness and Outreach

A massive countrywide awareness campaign was carried out after the issuance of the customer due diligence rules. In conducting such a massive awareness campaign, support has been received from all the designated Non-financial sector related stakeholders such as regulators, authorities, unions, industry associations and chambers, as well as immense support was received from the DNFBP Working Group, which represented each DNFBP sector. This massive awareness campaign included seminars, meetings, presentations, newspaper articles, web notices, banners, workshops, training sessions, and one-on-one meetings, etc. The compulsory training workshops for the newly appointed compliance officers are being carried out on a regular basis. The training workshops consist of practical sessions such as "assessing institution's money laundering and terrorist financing risks", "preparing anti-money laundering and countering the financing of terrorism policies and procedures", "conducting customer due diligence", "customer risk profiling", "retention of records", "screening of designated persons and entities by UNSCRs" as well as "reporting suspicious transactions by DNFBPs". All the training materials are uploaded and communicated through the FIU-Sri Lanka website to the market. For this, a separate space was designed on the FIU-Sri Lanka website, and DNFBPs are directed to refer to the materials available there.

Registering designated non-financial businesses with the FIU-Sri Lanka by appointing Compliance Officers

After issuance of the CDD Rule, along with the awareness campaign, the FIU-Sri Lanka invited through different media the relevant DNFBPs to appoint their Compliance Officers for AML/CFT matters and inform the appointment details of the Compliance Officer to the FIU-Sri Lanka through a given format, which was named as "Compliance Officer Declaration Form". Once the Declaration Form is received, it is entered into the FIU-Sri Lanka database, and the institution is contacted to inform them of the acceptance of the appointment if the compliance officer is qualified as per the requirements (The compliance officer should be a senior management level officer). In this process, institutions are instructed to copy the declaration form to the Compliance Officer for his knowledge.

Workshop to train Compliance Officers

Once the Compliance Officer's appointment is acknowledged, the Compliance Officer is called for a free-of-charge awareness workshop that is conducted by the FIU-Sri Lanka. There, the Compliance Officer is given comprehensive training on a risk-based approach and all the AML/CFT measures to be taken, including conducting institutional ML/TF risk assessment and drafting the AML/CFT Policy. Every compliance officer is informed to go through this training session. The FIU-Sri Lanka conducts this workshop quarterly. During the COVID-19 pandemic, it was conducted as a webinar. During the workshop, Compliance Officers are equipped with the required materials, such as Acts, regulations, rules, guidelines, directions, red flag indicators and other instructions, as well as samples and templates of documents. Higher management persons, such as Chief Executive Officers or Managing Directors of DNFBPs, are also invited to these workshops as their understanding of these matters is important to carry out the compliance officer's task effectively. An international-level training on counter-proliferation financing measures has been provided for Compliance Officers of identified DNFBPs in Sri Lanka.

Supervision of DNFBPs

DNFBPs are supervised under two different scenarios. First, the high risk DNFBPs are entered into the annual supervision plan of the FIU Sri Lanka. To select higher risk DNFBPs, an off-site risk assessment is conducted every year. The required information and statistics for the off-site risk assessment are collected through a questionnaire. A correspondent risk score is calculated in respect of each DNFBP by feeding the information collected through the questionnaire to a Risk Assessment Tool. A risk score for each DNFBP is generated through the Risk Assessment Tool using qualitative and quantitative data. The DNFBPs with higher scores are ranked as higher AML/CFT risk institutions compared to other DNFBP institutions. Once the higher risk DNFBPs are selected, they are examined by an examiner's team, which consists of an examiner in charge, and some other examiners. The examiners are going for the onsite examinations with an informing letter from the director of the FIU-Sri Lanka. Sample transactions are selected for examinations, and examiners meet and discuss with the senior management of the institution during the examination. Employees from different levels are also interviewed during the examination. Once the examination is completed, the examination report on findings is submitted to the Director of the FIU-Sri Lanka through the Head of the DNFBP supervision division within a stipulated time. An examination report consists of three parts: 1. Overview of the institution examined including the current ML/TF risk ratings, 2. Examiner's findings on the inherent money laundering and terrorist financing risk, the control measures, and 3. Examiner's recommendations on corrective measures to be taken. All these procedures are written with specific time frames in the examination manual for DNFBPs of the FIU-Sri Lanka. Corrective actions are then taken based on the examination report by a committee established internally. Other than the risk based onsite examinations, offsite examinations, follow up examinations, spot examinations as well and thematic reviews are conducted from time to time.

Corrective actions on non-compliance

The level of non-compliance assessed during the onsite examination is explained in the onsite examination report. This is a formatted report and annexed to the FIU-Sri Lanka examination manual. The A committee in FIU-Sri Lanka takes corrective action such as providing action plans with timelines to correct deficiencies, issuing warnings, or imposing penalties, considering the examiners' recommendations. Corrective actions are predefined as per the legal requirements and according to the sanction procedures of the FIU-Sri Lanka. The preliminary corrective actions with deficiencies are communicating to the institution, providing a time frame to address non-compliance, conducting follow-up examination for verifying corrective measures taken, communicating the improvements or further deficiencies to the institution. If there are any serious non-compliance or violations, the FIU-Sri Lanka will take strict measures such as issuing warning letters, show cause letters and imposing penalties as per the Financial Transaction Reporting Act, No. 06 of 2006. There are several instances by now, financial penalties have imposed to DNFBPs in Sri Lanka for AMAL/CFT non-compliances. Not only that the FIU-Sri Lanka publishes such instances under the policy of naming and shaming of non-compliant institutions.

Domestic coordination via a Working Group of DNFBPs

At the beginning, the FIU-Sri Lanka worked with an established Working Group for building market relationships with DNFBPs. The DNFBP Working Group consisted of members from the FIU-Sri Lanka, regulatory bodies, licensing bodies, and powerful unions of each industry and profession. The DNFBP Working Group was useful in building up market awareness on the AML/CFT requirements, recognising market trends, changes, and behaviours. This Working Group was effective as a communication channel.

More access to information

A separate email facility, phone lines, and web space in the FIU-Sri Lanka website have been provided for DNFBP institutions to communicate with the FIU-Sri Lanka. All the important messages are passed through the email communication as well as through the FIU-Sri Lanka website. All the relevant regulatory bodies and other key stakeholders, such as self-regulatory bodies, unions, and licensing authorities, have also given a space on their websites to provide communications related to the FIU-Sri Lanka to their relevant institutions.

8. Policy Implications

The result of this study has several policy implications. First, this conceptual framework to evaluate vulnerabilities in the DNFBP sector allows authorities to evaluate preliminary risk levels and act accordingly. Once the ML risk of the DNFBP sector is assessed, policymakers can introduce enhanced measures for higher risk sectors whilst simplified control measures for lower risk sectors. Accordingly, the authorities could allocate required resources optimally to combat illegal activities.

Further, the main challenges that I have identified in the study could be explored further by policymakers to overcome such challenges. Finally, the case study on Sri Lanka could be considered as a guide to initiate and strengthen action on combating ML in the DNFBP sector.

9. Conclusion

Applying AML/CFT measures for DNFBPs under the national AML/CFT regime is a challenging task especially when there are no regulatory bodies, licensing mechanisms, or properly developed market and market practices. When markets become informal, bringing the institutions operating under such arrangements into a compliance framework is a real challenge. The FATF has recognised several higher risk non-financial institutions and named them DNFBPs that are and can be exploited for such illegal activities. However, it appears that the focus of country authorities, especially of emerging market economies, on vulnerabilities emanating from the DNFBP sector is far less than the financial sector. This is confirmed by the worldwide poor evaluation results on introducing AML/CFT compliance requirements for DNFBPs by countries under the mutual evaluations of the FATF.

In this study, I proposed a conceptual framework and an index to assess the preliminary risk of ML in non-financial businesses and professions. The approach I propose is a bottom-up approach considering the lack of data and informality prevails in this sector. This index allows authorities to evaluate preliminary risk levels and further study the sector to allocate required resources to combat illegal activities. Further, I discussed the case study of Sri Lanka, which inspired the computation of the proposed index, to elaborate how the country has successfully faced those challenges during its period of introducing and implementing the FATF requirements to its non-financial segment. In addition, in this study, I identified main challenges that affect the proper control of illegal activities in the DNFBP sector.

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