

REPUBLIC OF AZERBAIJAN

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**THE WAYS OF STRENGTHEN THE PREVENTION
OF THE LEGALIZATION OF CRIMINALLY
OBTAINED FUNDS IN BANKING SYSTEM**

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ABSTRACT

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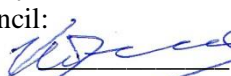
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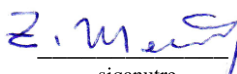
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GENERAL CHARACTERISTICS OF DISSERTATION

Actuality of the subject. In the global world, the risk of anti-money laundering and financing of terrorism is quite high and on this basis, actuality of the investigated study is to demonstrate how banks, as one of the anti-money laundering organizations, can optimize their protection against these risks, to identify ways to strengthen internal control systems, and the impact of anti-money laundering and financing of terrorism on the economy, financial stability and security of countries as well as mechanisms to minimize the social consequences of this.

Failure to protect Azerbaijani banks, financial institutions and the financial system from the risks of money laundering and financing of terrorism can lead to serious social and economic consequences. It also relates to the country's international image and assessment. In countries with weak money laundering and financing systems of terrorism, as well as in countries that do not comply with international standards in this area, investment opportunities, international cooperation, and tourism development are very weak and limited form. Therefore, the establishment and improvement of the system combating financial crimes in the financial institutions in the country, especially banks, and strengthening international cooperation in this area are some of the most important issues of our time.

In general, money laundering is used worldwide to conceal criminal activities such as drug and arms trafficking, financing of terrorism and so on. Banks and financial institutions are more attractive in terms of money laundering. Banks around the world have become the main target of money laundering and financial crimes. Because banks offer a wide range of services that are used to conceal the source of money. According to the International Monetary Fund (IMF) estimates for 2017, the total amount of money laundering is 2-5% of the gross national product worldwide and is between \$ 800 million - \$ 1.5-2 trillion. This is a very high indicator. Therefore, combating financial crimes is one of the most actual problems of our time.

Since the enactment of Law of the Republic of Azerbaijan On the Prevention of the Legalization of Criminally Obtained Funds or Other Property and the Financing of Terrorism in 2009, significant successes

have been achieved with the joint work of banks and other monitoring agencies, including the Central Bank, the Financial Monitoring Service (FMS). As an example, may consider the following:

- The regulatory framework has complied with international standards
- Azerbaijan removed from the monitoring of the Financial Action Task Force (FATF) in October 2010
- Regularly training organized by FMS has served to educate banks, other monitoring entities, and the public.
- On July 11–15, 2011, at the 19th Plenary Meeting of the Egmont Group of Financial Monitoring Authorities, FMS was elected a full member of the Egmont Group.
- FMS cooperates closely with international organizations such as FATF, MONEYVAL, Egmont Group and so on.

The aforementioned achievements are important for the international image and further development of Azerbaijan. The transition to sustainable economic growth and economic development in Azerbaijan requires adequate policies anti-money laundering and financing of terrorism.

One of the key indicators of the importance of improving the PL / EMS system in our country is that MONEYVAL, the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, periodically assesses whether member of the Council of Europe has effective AML/CFT (Anti-Money Laundering/Combating the Financing of Terrorism) systems and adheres to international standards in this area. The most recent assessment of the AML/CFT system in Azerbaijan was in 2014 and the results were not satisfactory. The next assessment is scheduled for 2019. Therefore, the Financial Market Supervisory Authority of the Azerbaijan Republic and Financial Monitoring Service of the Republic of Azerbaijan has started intensive inspections, preparation of various tasks and recommendations, implementation of new projects on this area in local financial institutions. This greatly increases the relevance of this research.

The dissertation aims to analyze the role of financial institutions in ensuring the security of the country, the implementation of the standards

set by international organizations in the fight anti-money laundering and financing of terrorism in our country and the issues emphasizing strengthening the internal control of the banking system.

The actuality of the problem and its limited processing conditioned the choice of this theme of the dissertation, the purpose, objectives, subject, and object of the research.

Degree of scientific study of the problem. In the dissertation, especially should be noted books and scientific articles by Salmanov A.F., Hajili Z.N., experts in the area of anti-money laundering and combating financing of terrorism in our country, scientific articles and normative acts by the international experts in the area from western countries, such as Sally Quillian Yates, John J. Byrne, Robert S. Pasley, Alldridge P., Bartlett B., Boorman J., Charles F., Daniel T., Demits D., Danziger Y. and others, also from the CIS countries, such as Antropcheva IO, Zubkov VA, Osipov SK, Krolli LO, Sokolova OA, Krestovskiy I. A., Proshunin MM, Tatçuk M.A. and others, in particular, the scientific works of Z.F. Mammadov, Z. Zeynalov and many other scientists on the stability of the banking sector, the role of banks in the economy of the country, the preservation of financial stability. The dissertation also includes Basel Committee standards, which are the international standards on anti-money laundering and financing of terrorism, 40 recommendations of the Financial Action Task Force (FATF), the principles of the Council of Europe and other international documents, the experience of leading banks (Citibank (USA), Raiffeisen Bank International (Austria), etc.).

The purpose and objectives of the research. The purpose of the dissertation is to introduce new practical combating mechanisms for preventing banks from being used as AML/FT by improving the theoretical and methodological approaches to anti-money laundering and combating terrorism financing in the banking sector of Azerbaijan.

To achieve this goal, the following tasks are interrelated:

1. Investigation of the requirements and approaches identified by the leading world banks and international standards in this area;
2. Investigation of schemes, tools, and methods used for anti-money laundering and financing of terrorism in the banking sector around the world;

3. Investigation of the impact of anti-money laundering on the activities of banks, their sustainability, as well as on international correspondent banking, including reputation and rating;

4. Increasing transparency of cash flows, financial operations in local banks and identifying approaches and methods for achieving this;

5. Identification of key areas for strengthening and improving the system of combating money legalization and financing of terrorism for the local banking sector.

The object of the research is banks, which are the main financial institutions that combating legalization of money in Azerbaijan.

The subject of the research includes theoretical, methodological and practical problems related to the improvement of the system of combating legalization of money in the banking sector.

Theoretical-methodological and information base of research.

Theoretical-methodological bases. In the dissertation, the international standards in this field, the experience of advanced countries, publications of leading international specialists and experts in this field were collected and summarized. The characteristics and applications of the approaches of banks in this area have been particularly taken into consideration.

In the dissertation, systematic analysis, theoretical generalization and systematic approach methods were used. Methods of analysis and synthesis, generalization and systematization have provided assessing the appropriateness of country policy to national interests for combating legalization of money and financing of terrorism.

Information base. The information base of research is based on international directives, international practices and the legislative framework of our country, foreign and local press releases, lectures and reports. Normative-legal and legislative acts of Azerbaijan, experience of foreign countries, methodical materials of the Central Bank of the Republic of Azerbaijan, analytical studies of international financial organizations and expert opinions were used for the analysis.

Scientific novelty of the research. The scientific novelty of the dissertation is that the methods and mechanisms of establishing an internal control system for anti-money laundering and financing of terrorism for local banks have been identified and theoretical and

practical proposals and recommendations for strengthening existing systems have been made.

The main scientific results of the dissertation research area are as follows:

- New methods of "customer recognition" policy, which will be implemented in local banks have been identified;
- Forms of methods for identifying unusual and suspicious transactions and methods for monitoring adapted to local practice have been identified;
- Issues that should be taken into account in terms of AML/CFT and measures that should be done, were introduced in case local banks have the same relationship with banks operating abroad.
- "Risk-based approach" was introduced by banks operating in the country to segment their clients and divide them into risk groups;
- Internal control systems and methods for establishing these systems have been identified for local banks for anti-money laundering and financing of terrorism.

Theoretical significance of the research. The research clarifies possible limits on the money laundering and terrorism financing priorities in the banking system. The international standards used in research, the experience of advanced banks can be used as a methodological source for improving the legislative framework and regulatory acts in this area in our country. The proposed measures to strengthen AML/CFT measures in the banking sector and prevent attempts to do so may be a conceptual basis for a deeper understanding of the strategic development of our economy as well as the security of banks.

Practical significance of the research. Banks can set up a more sustainable and transparent anti-money laundering system using the results of their dissertation. This will ensure that banks are not used as a tool for money laundering and financing of terrorism. Additionally, the "risk-based approach" method proposed in the dissertation will enable banks to save time for paperwork and customer acceptance during new customer acquisition and participation. This will reduce the costs of banks and customers will serve faster.

Approval of the research. The main provisions of the dissertation are reflected in the author's reports and speeches at international scientific conferences, as well as international scientific conferences and seminars in Russia - Moscow, Ganja, Sumgait, Lankaran.

The number of publications of the author at international conferences abroad is 1-in Russia, at international conferences organized by ANAS and the Ministry of Education of the Republic of Azerbaijan is 3 and in periodical scientific publications recommended for publication of main dissertation results in the Republic of Azerbaijan is 5.

The volume and structure of the dissertation. The dissertation consists of an introduction, 3 chapters, 9 paragraphs, conclusions and suggestions, additions and abbreviations, as well as a used literature policy covering 81 titles. The text of the dissertation is 158 pages (250.805 symbol), including 7 tables, 3 charts and 4 figures.

Structure of the dissertation:

Introduction

Chapter I. Theoretical bases and international regulation of the prevention of the legalization of criminally obtained funds and financing of terrorism

1.1. Investigation of theoretical bases for the prevention of the legalization of criminally obtained funds and financing of terrorism

1.2. International relations in the area of money legalization and the research of the main goals and objectives of international organizations

1.3. Investigation of new trends and changes in the money legalization in different sectors of the economy

Chapter II. The role of Azerbaijani banks in the prevention of the legalization of criminally obtained funds and financing of terrorism

2.1. Basic principles of "Customer Acceptance Policy (CAP)" implementation in local banks

2.2. Assessment of existing practice in Azerbaijan on identifying unusual and suspicious transactions on money laundering

2.3. The basis of audit measures necessary to establish correspondent relations of local banks

Chapter III. Priority directions of improvement of the internal control system in Azerbaijani banks on the prevention of the legalization of criminally obtained funds and financing of terrorism

3.1. Determination of money legalization system for local banks

3.2. The methods to apply a risk-based approach in accordance with international standards

3.3. The ways of improvement of the internal control system in Azerbaijani banks

Conclusion

References

Additions

BASIC CONTENT OF THE RESEARCH

1. Investigation of theoretical bases for the prevention of the legalization of criminally obtained funds and financing of terrorism

During my research, I determined that there is no unified approach to international standards regarding the use of the term money legalization. In addition to money legalization, the use of terms such as money laundering is widespread in international standards and practices. The word "laundering" mentioned in the money laundering phrase means the creation of an image of the origin and legalization of illegally obtained funds. Although the phrase "money laundering" has been included in our country's dictionary since 2009, it has long been recognized as a serious threat to the security and economy of many developed countries, especially in Europe.

The origin of the term "money laundering" coincides with the early 20th century. At that time, the mafia were trying to legitimize their money from fraud, prostitution, gambling, the sale of illegal alcohol, and so on. The main problem faced by the criminals at that time was to ensure that large amounts of cash inflows attempted into the economy. It was not possible to put so much money into the bank, because there was a fear of demanding its source. To this end, criminals began to associate illegal money with legitimate businesses operating in cash. As a result, criminals discovered new techniques such as jet-assisted machine guns

and laundry facilities. The phrase "washing" is also associated with these laundries. So that, according to the L'express newspaper on April 14, 1994, a man named Al Capone, a cashier of the local mob in Chicago in the 1920s has purchased a network of automatic laundry facilities that were popular in the country at the time and only supported cash payments and has begun to legalize the “dirty” money from mafia activities by joining the legal revenues of laundry. The English word "laundering" also originates here, and was first used in the Guardian newspaper during the scandal called 1973 "Watergate Scandal". The reason for the scandal was that US President Richard Nixon transferred illegally collected funds to his Mexican account and then back to his company in Miami.

During my research, I determine, in general, that there are three stages of money laundering that are traditional in international practice:

- Accommodation
- Operations
- Integration



Figure 1. Stages of money legalization¹

• **Accommodation stage.** This stage is characterized by the inclusion of illegal funds in the financial system through any financial institution. At this stage, cash is deposited mainly. Additionally, it is

¹ Hajili Z.N. The book of "Anti-money laundering", Baku 2010

implemented that the conversion of cash into larger denominations of banknotes or other currencies.

• **Operation stage.** In this stage, the source of illegal revenue generation is hidden through numerous contracts and related financial transactions. As a result, at this stage, the main aim is to eliminate or cover up the illegal cash and their source of origin. Concealment of the source of illegally obtained funds is ensured by transboundary financial transactions and to this end, the services of offshore banks and organizations are widely used.

• **Integration stage.** This is the last stage of money legalization. Here, legalized cash flows into the legal economy by investing.

2. International relations in the area of money legalization and the research of the main goals and objectives of international organizations

During the research, it was determined that international cooperation on anti-money laundering and combating financing of terrorism is one of the main goals of each international organization and international documents. International relations and documents aim to protect states' own security and interests. For example, if a terrorist attack occurs in any country, other countries immediately respond to it and call for the fight against terrorism, otherwise, the consequences of the war on terror are inevitable.

As a result of global development and the rapid renewal of technology, the process of money laundering becomes more globalized over time and begins to embrace many countries. Eventually, it reaches such a level that a strong and effective anti-money laundering in a country is not possible without the support of other countries. The need to solve such problems has also led to the emergence of many international standards in this area. If it was not possible to develop and predict international cooperation in the area of AML/CFT, then all anti-money laundering standards could not be developed internationally.

In general, the urgency of the money laundering problem in the globalized world began to increase in the eighties (80s) of the last century, and in 1988, the initial text of a draft The United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (Vienna Convention) was prepared and submitted to the

countries for ratification. At that time, the AML problem became a global problem. In solving these problems, the role of international organizations in the anti-money laundering and combating financing of terrorism is indispensable. The main bodies that play a regulatory role in this area, setting standards, shaping international relations and their responsibilities are:

- **The Financial Action Task Force (FATF)** is an inter-governmental body established in 1989 by the Ministers of its Member jurisdictions at the Paris G-7 Summit. The objectives of the FATF are to set standards and promote the implementation of legal, regulatory and operational measures for anti-money laundering, financial supporting to the proliferation of weapons and ensuring the reliability and security of the global financial system. Thus, the FATF is a “policy-making body” which works to generate the necessary political will to improve local legislation and regulatory reforms in these areas.

- **Egmont Group.** In 1995, a group that acknowledges the need to expand the Financial Intelligence Units (FIUs) network met at the Egmont Arenberg Palace in Brussels to form an informal group to promote international cooperation. The organization, known as the Egmont Group of Financial Intelligence Units (Egmont Group), meets regularly to share information, provide training and share experiences. The goal of the Egmont Group is to increase cooperation among FIUs around the world in anti-money laundering and combating financing of terrorism and to create conditions for the implementation of local programs in this area.

- **The Wolfsberg Group.** The Wolfsberg Group is an association of 11 global banks which sets standards for financial services for the management of financial crime risks, respect to know your customer, anti-money laundering and combating financing of terrorism policies. The Group has been created in 2000, at the Château Wolfsberg in north-eastern Switzerland, in the company of representatives from Transparency International, including Stanley Morris, and Professor Mark Pieth of the University of Basel, to work on drafting anti-money laundering guidelines for Private Banking. The Wolfsberg Group has published a significant number of documents (“Anti-Money Laundering Principles for Individual Banking”, “Anti-Money Laundering Principles

for Correspondent Banking” and so on). These documents help sector stakeholders and regulators to identify policies and procedures as well as anti-money laundering.

The Basel Committee on Banking Supervision (BCBS). The Basel Committee on Banking Supervision is a forum for regular cooperation on banking supervisory matters. The purpose of the Committee is to improve the quality of knowledge and banking supervision and to promote common understanding on key world-wide issues through the exchange of information on local control issues, approaches and methods. The Committee encourages contact and cooperation between its members and other bank supervisors. It distributes both published and unpublished documents in the form of banking supervision guidelines among regulatory authorities around the world. The Secretariat of the Committee is located at the Bank of International Settlements in Basel, Switzerland and consists of professional supervisors, who are temporarily sent from their member organizations. Based on anti-money laundering reflected the Basel AML Index (The Basel Anti-Money Laundering Index) 2017 Report, data from countries strengthened by development efforts are as follows:

Table 1
Countries developed efforts in the area of AML/CFT in 2017²

* 1 - minimum score, 10 - maximum score

Country	Total score (2017)	Total score (2016)	Difference between scores
Sudan	7.02	7.85	-0.83
Taiwan (China)	4.34	5.12	-0.79
Israel	4.25	4.89	-0.64
Bangladesh	5.79	6.40	-0.61
Germany	4.78	5.33	-0.55
France	4.52	5.03	-0.51
Australia	4.49	4.99	-0.50
Luxembourg	5.40	5.89	-0.49
Latvia	4.44	4.91	-0.46
Greece	5.11	5.53	-0.42

² *The Basel AML Index 2017 Report*

Table 2
Countries weakened in the area of AML/CFT in 2017³

* 1 - minimum score, 10 - maximum score

Country	Total score (2017)	Total score (2016)	Difference between scores
Jamaica	6.60	4.16	+2.44
Tunisia	6.37	4.62	+1.74
Hungary	5.41	4.15	+1.26
Uzbekistan	6.09	5.10	+0.99
Peru	5.25	4.31	+0.95
Senegal	6.31	5.37	+0.94
Egypt	5.66	4.74	+0.92
Ecuador	6.37	5.48	+0.89
Trinidad and Tobago	6.80	5.92	+0.89
Laos	8.28	7.40	+0.88

3. Investigation of new trends and changes in the money legalization in different sectors of the economy

In the globalized world, groups seeking to commit crimes such as money laundering and financing of terrorism are creating new ways, changing mechanisms, developing new trends and thus creating new trends, in spite of the intensification of measures to combat all these at the country level and the development of joint struggle and relations between the countries. Each year, international organizations, such as MONEYVAL, prepare a report on new typologies of money laundering and financing of terrorism in order to enlighten and inform about new trends. Typologies encourage countries to be more sensitive and careful about such procedures, as well as to strengthen internal monitoring.

As it is known, technology is rapidly developing in modern times and it becomes more difficult to track, identify, audit trail the operations performed by technology. This creates a favorable environment for criminals for money laundering and financing of terrorism. Minimum regulations and procedures should be established to prevent AML/FT risks and mechanisms should be created to identify and monitor

³ *The Basel AML Index 2017 Report*

suspicious transactions by banks when business relationships are formed or operations are realized through using technology without contacting customers. These regulations and procedures should also include measures to identify and validate customers whose banks are not in direct contact.

Some of the more common trends and methods in today's money laundering and financing of terrorism are:

Hawala mechanism. Hawala is alternative or parallel payment system. This system was formed in India before Western banking practices and the introduction of the current basic payment system used around the world. The main difference that distinguishes Hawala from other payment systems is the main focus on the use of wider relationships such as trust and family relations and regional ties. Money transfer are based on current relationships between members of the network of Hawala dealers. Although this system prefers to make payments in cash, contacts and confirmation of the payment, and etc., are implemented electronically (via fax, e-mail). The phrase, "money transfer without money movement" is a successful expression to characterize Hawala.

Commercial websites and internet payment systems are one of the new ways of money laundering and financing of terrorism. The main factors that facilitate the use of these methods are:

- Registration without face-to-face contact;
- User anonymity;
- The speed of transactions;
- Limited human intervention (Limited human intervention);
- Multiple operations;
- International experience;
- Limited coverage;
- Difficulties in monitoring and identifying suspicious transactions for traditional financial institutions.

One of the major money laundering mechanisms of recent years is **prepaid cards**. Prepaid card is a card that is registered elsewhere and used to access the card's amount, provides access to the amount stored on the card through electronic method or a chip used to access the amount associated with the card, allows you to pay and withdraw money

in various ways (e.g. cards, also known as e-wallets). Prepaid cards are the most widely used new payment method in modern times. New payment methods have emerged due to the need for alternatives to replace traditional financial services. In some cases, this is due to the need for one or more secure or more convenient payment methods for online trading. In other cases, this development is formed by a demand to provide financial services to people who do not have access to traditional financial services and by the stems from the assumption that new payment methods will have a positive impact on national budgets, including local and global economic development.

Research shows that prepaid card programs offer pre-defined and limited-service cards. Such cards rarely attract criminals because of their immediate use and the impossibility of their subsequent cash withdrawal through storage. The methods listed are just a few of the recent cases of money laundering and financing of terrorism. These methods and schemes mentioned in modern times are growing, developing, and expanding their geography. The country's international organizations and financial intelligence authorities have a high responsibility in determining these trends.

4. Basic principles of “Customer Acceptance Policy (CAP)” implementation in local banks

The research revealed that each bank may be at risk of money laundering or financing of terrorism. Banks can minimize the risks when they have internal control mechanisms that allow them to monitor transactions in terms of risks of money laundering and financing of terrorism. Among these control mechanisms, “Customer Acceptance Policy” is the most important means.

The bank should have sufficient information of its customers, prevent its customers from misusing the bank's services and products for various purposes and should ensure to minimize the risk of the customer or the counterparty. The main purpose of this standard approach, which the bank has developed to identify its customers, is to protect the bank against counterparty and therefore reputation, operational, legal and concentration risks. All of these risks are inherently interrelated, and each of these risks, individually or together, can result in significant financial losses in the bank. The customer acceptance program of the

banks ensures the compliance with the legislation of the Republic of Azerbaijan, including the current legislation in the area of AML/CFT, and the consistency of the bank's activities with professional ethics principles.

The customer acceptance program is of great importance for the security and sustainability of the bank for the following reasons:

- Prevents the bank from using as a " instrument" for financial crimes,

protects the Bank from any possible financial losses, and in the event, defends its image. These measures have contributed to the sustainability of the entire banking system.

- Includes the basic elements of a comprehensive risk management system (such as establishing a base for identification, determining limits on risk for assets and liabilities, and so on).

“Customer Acceptance Policy” means a complex measures system including the collection of the necessary information about current and potential customers, the correct verification of their identity and the source of their money or other property. All these measures have been realized by financial (commercial banks) and non-financial institutions identified as participants in the monitoring process in the area of money laundering and financing of terrorism in accordance with the internal legislation of the Republic of Azerbaijan. Customers are the persons, who have personal bank accounts or bank account was opened for them. The persons, who do not have an account in the bank but legally use the services and products of its, are also customers.

In the Customer Acceptance Policy, eligibility criteria for customers which can be accepted by the bank (types of clients, area and segment diversification, volume and types of transactions, related accounts, etc.) should be determined. The bank should consider customer status, country of origin, territory or their roots, public status and position, business activities, organizations, and other risk factors – as common background about their while defining a customer acceptance policy. Customer acceptance policy should not restrict the population's access to low-income, socially disadvantaged or national minorities access to banking services and products. In addition, the bank should have a stringent set of measures and even completely restrictive capabilities to

limit access to the bank's products and services for illegal commercial activities, suspected criminals and terrorists. More stringent inspection measures should be applied for high-risk clients. The elements of a customer acceptance policy in a bank can be uttered as an integral part of regulatory documents for each product or service, rather than a document.

Customer identification is the basis of the customer recognition program. The bank should have a systematic procedure to identify all new customers. Identification measures can be of 3 types - reinforced, normal and simplified, depending on the customer's risk profile. No business relationship and banking transactions should be established with customers (unidentified) until the identification data meet bank requirements. During the customer identification process, foreign citizens should be supervised especially. For identification purposes, a strict identification procedure should be applied to customers who cannot physically contact the bank. The customer identification process must begin before the customer contacts the bank. All identification data should be documented reviewed at the time of the next transaction. Customers should be identified in the local structural units (hereinafter referred to as the LSUs) when receiving a request for account opening by responsible persons. LSU executives, chief accountants, and supervisors are responsible for the quality of these operations.

Continuous monitoring of accounts (especially high-risk) and transactions: The bank should be able to quickly detect unusual and suspicious transactions customers want to realize through their accounts by understanding the essence of normal and justified transactions. It should therefore be able to effectively manage the counterparty's risks. This information is particularly important because the bank has an obligation to send suspicious transactions to the Financial Monitoring Service of the Financial Market Supervisory Authority of the Republic of Azerbaijan. The scope of the monitoring process for each account should be determined by the risk sensitivity criteria. The Bank should have a comprehensive system (software, monitoring, reporting system) to detect unusual and suspicious transactions in all customers' current accounts. The monitoring process should be arranged in such a way that unforeseen negative changes in customer activities can be observed.

These changes should be used as a sign for checking customers' accounts. Based on the facts revealed during the monitoring, the customer's risk rating should be redefined.

In my opinion, the development and implementation of the “customer recognition policy” have become an objective requirement for banks in order to control and prevent operations with the risk of money laundering and the financing of terrorism, drug trafficking and other illegal activities at the expense of these funds. The “customer recognition policy” that developed and implemented effectively in accordance with the requirements allows obtaining necessary data about the source of funds used by the bank's customers and the essence of the client's activities. Thus, banks provide the basis for effective risk management and reduce the risk of banks being used for money laundering and financing of terrorism.

5. The methods to apply a risk-based approach in accordance with international standards

A risk-based approach is an effective method of anti-money laundering. This should not exempt banks from the need to take enhanced identification measures in case of detection of risky transactions. Banks should be able to make decisions to ensure that the AML/FT prevention measures are relevant to the identified risks and the efficient use of their resources.

Banks should have regulations and procedures for identifying risks legalizing money and financing of terrorism, assessing, managing, monitoring in various aspects and troubleshooting. The basic principle of a risk-based approach is that banks, in high-risk cases, should use advanced identification measures to manage and minimize those risks and in low-risk cases, should use simplified identification measures. In cases of doubtful money laundering, simplified identification measures should not be applied.

It is important to use modern technological innovations in risk assessment and customer classifications. Because to determine the client's risk category, each category should be assigned a score in the following areas, the risk assessment should be realized, and the customer's risk category should be determined through an econometric calculation using a risk calculator:

- Area of customer's activity, organizational and legal form of legal entities

- Risk assessment of banking products
- Bank service channels
- Geographical areas where the client operates, and so on.

Scores on these categories can be defined as follows:

Table 3
Distribution of risk categories

Categories	Level of risk	Scores
The risk of customer’s organizational and legal form	Low	1
	Medium	12
	High	25
Risk of customer's activity directives	Min	1
	Max	25
Risk of service channels	Min	1
	Max	25
Risk of the country where the customer is a resident	Low	1
	Medium	12
	High	25

[source: made by author]

These categories should also have subcategories and each of them should be assigned a 25-point risk score. Now we can look at examples from each category:

- The risk of customer’s organizational and legal form - financial institute / state organization / municipality / peasant-family farm / public union, etc.
- Risk of customer's activity directives - correspondent banking / precious stones-metal trade / sale of tobacco products / military industry, etc.
- Risk of service channels - online services / internet-mobile banking / physical services, etc.
- Risk of the country where the customer is a resident - Afghanistan / Iran / Russia / Germany, etc.

Depending on the profile of the customer, the scores for those parameters should be summarized according to the corresponding parameters. Distribution of scores by risk category should be as follows:

Table 3
Score of total risk category

Low	0-20
Medium	21-40
High	41 - 100

[Source: made by author]

Example. Customer’s organizational and legal form is a Non-governmental organization - NGO (score 9), primarily receives grants and donations (12 points), usually uses online banking products (10 points) and mainly works with Iraq (12 points). Calculation procedure:

- Risk score = 9 + 12 + 10 + 12 = 43 (high-risk)

The example I mentioned is the method of risk calculation that we currently use at “Kapital Bank” OJSC. Each bank can self-dependent determine categories, scores and methods of calculation depending on their risk profile.

In terms of prime cost, the impact of the Bank's risk-oriented approach to business and customers should be balanced with the real value of the risks that a business could create in a bank with a money laundering and financing of terrorism. Therefore, the optimal route should be prioritized in a risk-oriented approach.

All risk preventive measures of the bank (assessment and identification of the risks, and other appropriate measures) should be properly documented. The bank should conduct a review process for newly recruited employees before hiring them. The bank should really know its employees and be aware of its past history. Continuous awareness-raising activities should be undertaken for all AML/CFT staff, as other employees of the bank. The high flow of senior managers should be considered and evaluated as a critical risk factor. Newly-appointed employees controlling accounts should be trained and educated. The bank's motivation system should be risk-based (such incentives should not be applied for employees, who poorly performing on opening accounts, transactions, and AML/FT control) and should evaluate employees working in main positions more seriously.

At the end of my research on this section, it can be concluded that the introduction of a risk-based approach has not been used by many local banks, although the legislation of the Republic of Azerbaijan

envisages it. The risk-based approach requires different documents from the client, depending on the client's risk category. Thus, the minimum documents are taken from the low-risk client and more documents from the high-risk client. This will enable the bank to better recognize its customers, as well as to serve its low-risk customers faster and reduce costs in parallel. As practice shows, more than 90% of customers belong to the "low" risk category. At present only "Kapital Bank" OJSC and "Pasha Bank" OJSC are working on a project to establish a risk-based approach that conforms international standards. Establishing a risk-based approach in banks enables to identify risky customer and transactions faster, react more efficiently, and reduce some bank costs. In this respect, for each bank, it is important to establish a risk-based approach along with the internal control system.

6. The ways of improvement of the internal control system in Azerbaijani banks

The main purpose of the internal control system is to minimize the risk of banks being used for AML/FT aim by implementing internal control measures.

It should be noted that the internal control system is used not only for addressing AML/FT risks, but also other types of risks - corporate governance, risk management that can occur in banks in general.

One of the most important issues is the effective implementation of the internal control system depends on the formation of culture in the AML/CFT, and most importantly, the bank board's approach. The combination area plays the role of a pillar in the bank. Thus, failure to keep in focus on these activities and the approach as unprofitable activity by other structural units of the bank may cause undesirable consequences of the bank.

The executive board of bank is responsible for the sustainable and effective implementation of the internal control system in the bank. The importance of applying the bank's AML/CFT approach to the daily activities of each employee should be clearly stated by the bank's executive board. Of course, the bank's board does not need to be an expert in this area, here the role of them should be only supervision. The implementation of an effective control system in financial institutions, including banks, requires certain costs. In most cases, spending on this

area may not be considered a priority for the bank. However, it should be borne in mind that the non-appearance of an internal AML/CFT control system may result in legal and reputation risks. It is important to note that the bank benefits from the economic implementation of the system, although the implementation of the AML/CFT system is costly for it. As a result of the establishment of this system, the bank receives detailed information about its customers and this information is subsequently used by other structural units of the bank.

In general, based on international standards for improving the internal control system and the experience of banks in developed countries, measures should be taken in the following areas:

- Improving the internal regulations and procedures;
- Strengthening the effectiveness of staff training;
- Improving the knowledge and skills of the person responsible for the AML/CFT
- Improving of internal audit mechanism;
- Strengthening customer profiles and transaction monitoring;
- Improving the system of documenting and securing data available on AML/CFT;
- Improving customer identification and verification systems;
- Improving the mechanism of data submission for financial monitoring service;
- Complying requirements and recommendations determined by the legislation on AML/CFT.

Internal regulations, procedures and control mechanisms form the basis of AML/CFT policy. In this regard, the scope of relevant legislation and regulations should be defined and guided by banks, in order to develop the necessary internal rules, procedures and control mechanisms. Thus, the banks will determine the minimum requirements. Thereafter, risk assessment methods used within the banks should be considered and risk inclination should be measured. For example, banks with financial institutions may prohibit the establishment of a business relationship with a particular group of countries, services or products that they consider to be at high risk based on risk assessment methods. The established prohibitions should be reflected in internal regulations

and procedures, and control mechanisms, such as how to ensure the application of such rules and procedures, should exist. Additionally, periodic updates of the AML/CFT program are required for regularly monitoring the bank's AML/CFT and related legislation.

Banks should organize regular trainings for AML/CFT staff and ensure their participation in these trainings. Because, the main purpose of the training is the acquisition of relevant knowledge in this area for compliance of bank staff with national AML/CFT legislation, as well as requirements of bank control system in this area, in-house programs and internationally accepted regulations and procedures.

Trainings at the bank may be planned and unplanned. The training program must be prepared annually for the next year and approved by the bank's executive board. In international practice, training should be conducted by the person responsible for the AML/CFT in accordance with the program. Training programs should be developed considering the requirements of the AML/CFT legislation and the specifics of the bank and customers. Furthermore, the training program implemented should be periodically reviewed and maintained by the relevant staff. It should be updated if there is a change in legislation, as well as internal regulations and procedures.

Banks should designate a person responsible for monitoring AML/CFT compliance. This person responsible for the establishment and implementation of the AML/CFT program, appropriate additions and modifications, as well as informing staff about program deficiencies, the organization of AML/CFT training programs for employees, and the recent changes of legislation and international standards on AML/CFT.

Banks should have an internal audit structure and mechanism that regularly monitors the effectiveness and efficiency of applying AML/CFT legislation, including regulations and inter-bank regulations and procedures. Internal audits aim to identify deficiencies and shortcomings for applying the rules and procedures established by the legislation. Bank's board should also be responsible for periodic internal audits to check the efficiency of applying this area in the bank.

The internal control system is one of the key elements in anti-money laundering and combating financing of terrorism. MONEYVAL also

especially consider to the level of internal control system of banks when assessing the system of anti-money laundering by the member states of Council of Europe.

In my opinion, one of the main methods to improve the internal control system is the development of information, mechanisms and methods provided to financial monitoring body. In the modern era, there are many sophisticated means and programs that it is possible to transmit large amounts of data in short and small files by using their capabilities. As an example, the “GoAML” software of the United Nations Office on Drugs and Crime (UNODC) is currently used as a means of data exchange between banks and financial monitoring services in Azerbaijan. In addition, we can note modules of “TonBeller” software of Germany which has wide functionality such as analysis, data presentation, transactions filtering, and so on. Using these software will also reduce the cost of banks, automate business processes, save time and improve work quality.

The following articles and theses related to the subject of the dissertation have been published:

1) K.F.Lətifov. “Bank sektorunda çirkli pulların yuyulması risklərinin qiymətləndirilməsi və risk-qiymətləndirmə modelinin qurulması” / Azərbaycan Dövlət İqtisad Universitetinin Elmi Xəbərləri, Bakı, Oktyabr-Dekabr 2014, İSSN 2306-8426, səh. 125-132.

2) K.F.Lətifov. “Bank sektorunda çirkli pulların yuyulmasına qarşı mübarizə proqramının əsas elementləri” / Azərbaycan Dövlət İqtisad Universitetinin Elmi Xəbərləri, Bakı, İyul-Sentyabr 2015, İSSN 2306-8426, səh.134-141.

3) К.Ф.Лятифов. “Основные методы отмывания денег, полученных преступным путем в банковском секторе” / Проблемы теории и практики современной науки, Москва, 18.05.2016, ISBN 978-5-906883-09-4, səh.138-144.

4) K.F.Lətifov. “Çirkli pulların yuyulmasına qarşı mübarizə sahəsində siyasi xadim konsepsiyası və siyasi xadimlərə maliyyə institutlarında tətbiq olunan tədbirlər” / AMEA-nın Xəbərləri, İqtisadiyyat seriyası, elmi-praktiki jurnal. Bakı, iyul-avqust 2017, İSSN 2519-8130, səh.99-103.

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