

# Organization of Internal Control in Banks Towards Money Laundering Prevention: A Practical Approach

ORIGINAL RESEARCH PAPER

UDC 347.734:657.633

336.7:343.37

DOI: 10.46793/Rev24108141M

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**Summary:** *Preventing money laundering is one of the most important challenges facing the banking sector to preserve the integrity of the financial system. This paper investigates the practical aspects of the organization of internal controls in banks aimed at combating money laundering. Emphasis is placed on key elements, including developing policies and procedures, strengthening governance structures, risk assessment, transaction monitoring and employee training. Key challenges were identified. The paper concludes that effective internal control, based on a proactive approach and continuous adaptation, not only strengthens banks' resistance to money laundering threats but also contributes to global financial stability.*

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**Received:** 12.10.2024.

**Accepted:** 17.11.2024.

**Published:** 27.12.2024.

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**Keywords:** *money laundering, banks, internal control framework, efficiency*

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## INTRODUCTION

Money laundering is a criminal activity with considerable economic consequences. As a global phenomenon, it has multifaceted adverse effects: it compromises the stability, transparency, and efficiency of financial systems; generates economic disruptions; threatens the success of reform initiatives; leads to reduced foreign investment; and adversely affects a country's international reputation. Money laundering is a pervasive global issue that impacts financial institutions worldwide. Essentially, money laundering involves illegal activities wherein criminal networks seek to conceal their illicit operations to generate profit (16).

Money laundering, defined as the process of disguising the illicit origins of criminal proceeds to render them legitimate for future use, has emerged as a significant global issue (7; 14). The extent of money laundering remains challenging to quantify, yet it is widely regarded as substantial. According to estimates from the United Nations Office on Drugs and Crime (UNODC), between 2% and 5% of global GDP is subject to laundering annually. This translates to an estimated range of EUR 715 billion to EUR 1.87 trillion each year (6).

In recent years, by Basel III guidelines and requirements (3), there has been an increased focus on anti-money laundering (AML) procedures, internal controls activities and the roles of compliance officers, specifically Money Laundering Reporting Officers (MLROs). This paper focuses on a literature review addressing the strengthening of AML Compliance systems and provides insights into a practical approach for the AML second-level internal control framework.

The structure of the remainder of this paper is organized as follows. Section 2 presents a comprehensive literature review on the effectiveness of current measures against money laundering in banks. Section 3 outlines the methodology used and is followed by detailed findings and a discussion of the research design in Section 4. Finally, Section 5 provides concluding remarks and identifies potential areas for future research.

## THEORETICAL BACKGROUND

### **The Impact of Money Laundering on Banks**

Money launderers frequently target banking institutions for laundering illicit funds, owing to the extensive range of financial services provided by banks. Many countries are dedicating substantial efforts to combat money laundering, particularly within the banking sector, to mitigate the detrimental effects associated with this practice (8; 21). Concerning the implementation of controls concerning money laundering prevention, several risks can be detected. Firstly, regulatory risks present the risks of measures by the regulator and/or supervisor (e.g. payment of fine) to which the bank is exposed in the case it fails to implement

or implements deficiently the legislative requirements, especially in the implementation of due diligence of a customer and assessment of risks. Banks could be exposed to the risk of loss of reputation if the supervisory bodies, business partners, customers or owners of the bank identify inappropriate implementation of legislative requirements or extreme risk appetite in case of money laundering and conducting business with high-risk customers. The supervisory bodies may publish the violators and the content of the violation, following the legislation, which negatively affects the bank's reputation in international banking operations and at the same time reduces the economic competitiveness of the bank in the international environment. Such reputational risks represent a significant operational threat with the potential to undermine the stability of financial institutions. For example, an incident involving an unauthorized employee—referred to as a “rogue trader”—resulted in a loss of approximately \$100 million, causing substantial financial harm to the third-largest bank in Croatia (2). And, finally, banks could be exposed to the risk of money laundering if the employees implement the AML policy inappropriately and thus allow for the possibility of money laundering through the services the bank offers its customers.

## Literature Review

In the context of academic research, there are various literatures on anti-money laundering that analyze how ML affects economic stability and other individual rights. AML encompasses a range of processes, methods, laws, and regulations designed to curtail the generation of funds through illicit or criminal activities. Jaeger (9) explains why money laundering continues to be a challenge for banks, highlighting their roles as gatekeepers and the limitations of current anti-money laundering (AML) measures. The pressures that banks face is explored, such as competitive demands and misaligned incentives, which can hinder effective AML compliance. In that regard, several recommendations for improving banks' roles as gatekeepers against money laundering are suggested in a way to establish a more integrated approach to AML compliance, ensuring that oversight is not fragmented across different management functions. Another study highlights that banks should enhance their AML compliance frameworks by investing in better transaction monitoring systems and ensuring that personnel responsible for compliance are adequately trained and staffed. This includes implementing Know Your Customer (KYC) initiatives and improving customer-activity monitoring capabilities (22).

Several insights into the effectiveness of current measures against money laundering in Zambia are given by Simwayi & Wang (19). Despite the commercial banks in Zambia have generally complied with the Bank of Zambia's Anti-Money Laundering (AML) directives, the study points out that some Money Laundering Reporting Officers (MLROs) are not adequately trained or qualified to meet the demands of their roles. This lack of training can hinder the effectiveness of AML measures. In addition, the performance of MLROs is negatively impacted by external factors, such as a lack of feedback from the Anti-Money Laundering Investigations Unit (FIU) and slow investigation processes.

Several studies stress the importance of anti-money laundering internal control activities. In the case of Malaysia, Said, Ghani, Omar & Yusuf (17) observed that commercial banks in Malaysia implement various internal controls to prevent money laundering. These controls include Customer Due Diligence (CDD) procedures, acquiring information from customers who are reluctant to provide it, updating compliance programs by relevant laws and regulations, monitoring customer accounts for suspicious activities, submitting Suspicious Transaction Reports (STRs) to regulatory authorities, and providing anti-money laundering training to employees. Okab (15) further revealed that anti-money laundering control activities, such as implementing Know Your Customer (KYC) policies, maintaining automated record-keeping systems, delivering employee training, and monitoring customer transactions, are effective in mitigating money laundering within Jordanian banking institutions. The study suggests that banks should enhance their internal control systems by regularly updating their policies, conducting employee training, and utilizing technology for monitoring transactions. A study by ElYacoubi (5) has substantiated the critical relationship between customer due diligence (CDD) practices, such as effective customer identification, transaction monitoring, and risk assessments concerning bank customers, products and services, delivery channels, and jurisdictions, and the capacity of financial institutions to adequately meet the requirements of anti-money laundering (AML) regulations and laws. Similarly, Chatain et al. (4) have highlighted customer due diligence as a key factor in ensuring robust compliance with AML/CTF policies within financial institutions. Schott (18) further corroborates these findings, elucidating the pivotal role of CDD practices in enhancing compliance attitudes among financial institutions towards AML/CTF regulations. Moreover, major international organizations and frameworks, including reports and recommendations from the Financial Action Task Force (FATF), the Basel Committee, the European Banking Authority (EBA) and the International Finance Corporation (IFC), have acknowledged the significant contributions of CDD practices in advancing global adherence to AML/CTF regulations and policies. These international bodies uniformly identify effective CDD practices as a fundamental prerequisite for any compliance efforts undertaken by financial institutions and banks (18).

Based on this literature review, it can be concluded that the prevention of money laundering in the banking sector depends on the implementation of various anti-money laundering control activities adopted by banks. However, none of these studies provides a detailed examination of the implementation of measures related to the application of regulatory policies in combating money laundering. Consequently, this paper aims to present a practical approach to implementing internal controls within banks, to manage the risk of money laundering effectively. Given that both regulators and banks have significantly intensified their scrutiny and due diligence practices, all banks must ensure the adequacy of their AML control measures.

## METHODOLOGY

Based on the literature review and identified practical solutions addressing the subjects of strengthening AML Compliance systems, a practical approach for AML second-level internal control framework is designed.

## FINDINGS AND DISCUSSION

### **Internal Control System in the Bank**

Following international standards, the AML/CFT programme consists of five essential pillars (1):

- policies and other documents (rules, instructions, procedures), procedures and internal controls (first line of defence – prevention);
- established AML function and appropriate placement of the AML Officer in the member's organisational scheme (second line of defence);
- customer due diligence, regular monitoring of customers' business activities and checking and updating customers' data and documentation (first and second lines of defence);
- regular training and awareness raising of the employees;
- independent internal audit function, implementing comprehensive control of the efficiency of the AML/CFT programme (third line of defence), and independent testing.

In that regard, there is a need to establish a three-level system of defence/controls within the governance structure of AML compliance program in banks: (i) the business line, (ii) compliance (within the AML team) and (iii) internal audit.

- (i) The first line owns and manages the collection of customer due diligence information, which means that it is responsible for ensuring that adequate information is obtained so that an effective screening of customers and transactions can be performed as well as all other 1st level controls. The function of the business lines and other organizational units that perform the 1st level control activities is to implement operational controls when a business event happens. They own risks and manage risks at the operational and implementational levels and are responsible for the appropriate performance of tasks.
- (ii) The second line of defence ensures the customer's due diligence procedures and processes applied by the first line are designed properly, established firmly, and applied as intended. It reviews the effectiveness of controls used to mitigate AML risks, provides information on the first line, and investigates possible noncompliance with AML restrictions.

(iii) the internal audit function as the third line of defence supervises the appropriateness of the control environment in the organisational units in the first line of defence. Part of its tasks and responsibilities include testing the functioning and efficiency of internal controls. The internal audit assesses the overall compliance and efficiency of the AML/CFT programme, including the policies, procedures and processes. In addition, the internal audit, as part of the third line of defence against risks in the internal management system, shall, in compliance with international standards, audit the AML/CFT function regarding the implementation of statutory tasks and responsibilities of the AML Officer.

Compliance with the requirements in AML, adequacy and the effectiveness of the control environment can be established through the performance of controls specified below, which is suggested in this paper to ensure that the AML compliance control environment is working adequately and efficiently.

### **AML Compliance Second Level Internal Control Framework – – A Practical Approach**

AML compliance second-level internal controls are a key responsibility of the AML organizational unit and are designed to identify and measure the regulatory risk at the bank level. The objective of AML compliance second-level internal control is to ensure compliance with the applicable laws and regulations regarding the prevention of money laundering and financing of terrorism. Thus, AML compliance second-level internal controls serve the purpose of preventing, detecting, and addressing identified deficiencies, primarily within the first level of controls, regarding the application of the law. Additionally, these controls aim to enhance internal systems for detecting transactions and individuals suspected of involvement in money laundering or financing of terrorism activities. This ensures adequate control activities, risk management, evaluation of the adequacy, reliability, and effectiveness of the system for preventing money laundering and financing of terrorism, compliance with regulations and internal acts, reporting and informing the management bodies and organizational units/departments of the Bank about identified deficiencies in the system for preventing money laundering and financing of terrorism, along with proposed measures to address these deficiencies and enhance the risk management system for money laundering and financing of terrorism. In that manner, the bank should establish comprehensive guidelines for the design, planning, execution, and reporting of ex-post controls related to anti-money laundering (AML). These guidelines must be integrated with all relevant AML processes and procedures to ensure effective implementation and compliance. To develop critical and effective controls, each AML organizational unit must maintain a comprehensive understanding of the business and the activities and processes subject to evaluation. This ongoing awareness of potential issues and risks that may impact current or future AML compliance controls is essential for informed planning and for addressing broader

concerns effectively. AML organizational unit should be responsible to develop controls and establish an appropriate methodology for their implementation, beginning with an assessment of relevant regulatory areas and the associated risks of non-compliance with applicable laws and regulations.

All AML compliance controls can be consolidated into a unified Repository of controls, which should be periodically implemented as a minimum requirement. Such a Repository of controls comprises a set of activities that are continuously implemented within the Bank, integrated into business activities, processes, and procedures, to ensure control over business processes and oversight by management bodies, thereby facilitating the achievement of the Bank's established business objectives. The Repository of controls should define the methodology, key AML second level controls, as well as the regulatory basis from which they derive, the approach to sampling, the frequency of controls, and the criticality of control results. In practice, not all defined controls within a specific area may have corresponding second-level controls, owing to various relevant factors. These may include the presence of adequate automated controls or alternative controls executed by other functions (e.g., front office, IT, payments, etc.), the irrelevance of certain risks, or risks that are addressed through preliminary assessment of AML activities or through actions taken directly by the AML organizational unit itself.

Key AML second-level controls are those deemed essential, and their ineffective implementation could expose a Bank to significant regulatory and reputational risk. Accordingly, such Repository of controls shall contain the list of key AML second-level controls for relevant regulations within the AML perimeter and should include the following types of controls: Customer on-boarding KYC process, Regular batch screening and periodical KYC, Identification of sanctioned persons/entities and risk management, Transaction screening, Alert management and Transaction due diligence, Transaction screening and alert management, Data adequacy, and Education and Trainings. All these controls can be categorized as preventive, which focuses on evaluating the appropriateness and effectiveness of procedures, regulations, and business products in mitigating non-compliance risks, and as retrospective, which are conducted routinely at the end of an operation or process. The latter aims to assess the effectiveness of those processes and procedures while ensuring adherence to established rules of conduct. Each retrospective control is distinctly linked to a risk indicator, which offers a representation of actual risk exposure or potential exposure that requires further investigation through additional analysis. The risk indicator is assigned a specific value based on predefined risk categories (e.g., high-risk, medium, low risk) determined by established thresholds.

When actual risk exposure is recognized and deficiencies/shortcomings are identified, the remediation action plan must be defined and implemented. This includes a detailed plan of activities which need to be undertaken to remediate the shortcomings, including deadlines that reflect the severity of the identified shortcoming. To eliminate any ambiguity, shortcomings classified as "high-risk" shall be addressed with the utmost priority and urgency to mitigate the risks to an acceptable level. Mitigating and remedial actions

must be identified to address structural shortcomings and issues, leveraging IT-related solutions and controls (where applicable) to support systematic approaches while minimizing reliance on manual and ad hoc controls. The action plan should outline these mitigating actions, with the AML organizational unit responsible for:

- Identifying and/or approving corrective measures;
- Coordinating and aligning corrective measures with other stakeholders, risk owners, and action owners;
- Setting timelines and deadlines for the implementation of corrective measures;
- Monitoring the implementation of corrective measures and escalating concerns as necessary.

Finally, it is essential to establish an adequate and transparent management reporting process regarding all results of conducted controls and the corrective actions taken in the context of minimizing identified risks. Knežević et al. (11) and Mitrović et al. (12) state that an effective internal audit with strong support of internal control can largely prevent the occurrence of illegal practices. Janković et. al. (10) stress that the cooperation of the police and accounting forensics can provide strong support in suppressing various activities related to fraud. Stanišić (20) highlights the importance of internal audit in risk management and control processes.

## CONCLUSION

This paper attempts to explore in detail the performance of implemented anti-money laundering (AML) measures within the banking sector through the analysis of relevant literature and good practices in the field of risk management related to money laundering. It is concluded that none of the existing research offered a comprehensive analysis of the implementation of measures about the application of regulatory policies in the fight against money laundering. Therefore, this paper attempts to design a practical framework for implementing internal controls within banks, to manage the risk of money laundering effectively. Compliance with the requirements in the AML area, adequacy and the effectiveness of the control environment could be established through the performance of controls specified in this paper to ensure that the AML compliance control environment is working adequately and efficiently.

The findings could have practical implications for banks looking to improve their internal control systems and enhance their anti-money laundering (AML) practices. It contributes to the academic discourse on AML practices and internal controls, potentially influencing future research and policymaking in the field. Further research in this matter should involve interviews and discussions with AML compliance officers from banks as well as representatives from the banking supervision department to assess the density of money laundering risk when performing AML second-level control.

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