



**Re-thinking de-risking: a systems theoretical approach**

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## Re-thinking de-risking: a systems theoretical approach

### Abstract

**Purpose** – The paper seeks to explain the de-risking phenomenon through Luhmann’s risk/danger model and demonstrate that de-risking should be facilitated and encouraged.

**Design/methodology/approach** - The paper applies Luhmann’s system theory and more specifically his risk/danger model in order to describe the de-risking phenomenon and identify recommendations to address its consequences.

**Findings** – The paper finds that re-defining risk and the AML’s community’s understanding of it can support key stakeholders’ understanding of ML risk and the way to better address consequences of AML decisions.

**Practical implications** – The paper has implications for the banking and regulatory community in relation to the interpretation of de-risking. As systems aim to minimize their exposure to risk, they should not be prevented from de-risking.

**Originality/Value** - This paper aims to move away from a narrative description of AML phenomena and presents a theoretical foundation for the analysis of ML risk. The current response to de-risking which demonises it and aims to prevent it is deconstructed through this theoretical lens.

**Keywords** - money laundering, Niklas Luhmann, systems theory, decision, risk, danger

**Paper type** – Conceptual paper

## INTRODUCTION

The domain of Anti-Money Laundering (AML) has seen a number of key transitions in relation to how the *risks* associated with Money Laundering (ML) have been handled. In the rules-based approach, ML-risk was managed through fixed sets of constructed indicators (Ross and Hannan, 2007). In the transition to the risk-based approach (RBA) (FATF, 2007), a more malleable and flexible path was sought, with risk sensitivity and a cluster of additional risk-related concepts being introduced to allow institutions to express their personalised and customised risks. These have allowed risk prioritisations and customisations for financial institutions and other Designated Non-Financial Businesses and Professions (DNFBPs). However, this malleability has also led to the emergence of ambiguity, with *de-risking* as the pinnacle of such perceived unintended consequences. Since then, de-risking in AML has been vilified and seen as a misunderstanding of the RBA, the refusal to apply it and, increasingly, the realization that the RBA may essentially imply a de-risking approach. Admittedly, some well-founded objections to de-risking included the possible push of laundered funds into alternative underground remittance systems and less-monitored routes (Ramachandran, Colin and Juden, 2018). But overall, is this attitude towards de-risking an accurate reflection of the complexities of risk? With the entanglement of the risk-based approach and de-risking, the concept of risk has come to occupy a central stage in our field. But how well do we understand risk to begin with? How can we explore AML risk and its broader fabric of interferences?

This paper aims to deconstruct the nature of risk within the domain of AML and explore how different stakeholders observe and manage ML risk, thereby impacting the risk management initiatives of each other. A greater insight into the nature of AML risk will give us the tools to a) understand the key drivers of de-risking, b) enhance risk management approaches to handle de-risking, and c) consider the systemic character of risk in the domain of ML prevention efforts. It is in this context that this paper seeks to dissolve one of the most recent contemporary myths in the domain of AML: the myth that de-risking can be, and more importantly, should be prevented. Following the review of related work in the next section, the paper takes a systems theoretical treatment of risk that is based on the work of sociologist and systems theorist, Niklas Luhmann. Based on the insights drawn from applying Luhmann's work into Barclays bank's handling of High-Net-Worth Individuals and an illustrative case of its de-risking of Money Services Business (MSB) Dahabshiil, the paper posits that de-risking should

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3 not be demonised and should be viewed instead as an *essential element within the broader*  
4 *nexus of risk-based management* and governance of ML risk.  
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### 8 9 **RELATED WORK**

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11 Current literature on the domain of ML risk, de-risking and risk appetite, fails to develop  
12 theoretical foundations or frameworks through which AML risk can be reflected upon. Such  
13 frameworks should not only be integrative of the challenges faced by risk practitioners across  
14 various financial institutions but should also capture the perspectives of Financial Intelligence  
15 Units or regulatory bodies. Current scholarly or industry work relating to AML is either  
16 anecdotal or descriptive on risk, with key strands revolving around ML typologies (Menz,  
17 2019), regulation (Rose, 2019), or the wider financial and economic consequences of de-  
18 risking (Ramachandran *et al*, 2018). Such work is useful in informing both practitioners and  
19 academics of latest risk-related developments and in reflecting on regulators' and obliged  
20 entities' initiatives as well as internal processes (Naheem, 2020). However, more theoretical  
21 work is required so that we can approach the foundational conditions upon which AML risk is  
22 expressed. Without challenging the foundations of risk in AML, it is difficult to maintain an  
23 informed debate around what the future of the RBA should be.  
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35 Although there has been an increase in the ML-risk related narratives observed over the past  
36 30 years (Hutter, 2005; Le Bouter, 2014; Wildavsky, 1979), with AML regulation following  
37 suit and becoming risk-based, ML risk and risk appetite has not been “conceptualised and  
38 analysed in much more concrete terms than in the past” (Ross and Hannan, 2007, p.113).  
39 Discussion in current academic and industry literature on *the actual nature of ML risk* is  
40 disappointingly sparse (Artingstall *et al.*, 2016). Ultimately, ML risk and its key attributes need  
41 to be understood and the RBA simply does not provide the tools to achieve this.  
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49 For instance, the published FATF guidance on the RBA (FATF, 2014) mentions risk appetite  
50 just twice and does not provide guidance as to how an institution could or should articulate it.  
51 Furthermore, the FATF statement concerning ML risk appetite is not specific: “supervisors  
52 have to take steps to check that their staff are equipped to assess whether a bank’s policies,  
53 procedures and controls are appropriate in view of the risks identified through the risk  
54 assessment, and its risk appetite” (FATF, 2014, p. 15). Similarly, financial institutions’ remarks  
55 regarding ML risk appetite are vague. Financial institutions’ “risk appetite statements often  
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3 contain broad definitions of acceptable risk, such as minimal tolerance for residual Financial  
4 Crime risk” (Artingstall *et al.*, 2016, p. 8). In addition, research on de-risking sponsored by the  
5 Financial Conduct Authority states: “we find that ML/TF risk appetite is difficult to articulate  
6 and measure, perhaps unsurprisingly. Banks are still developing this art and in particular find  
7 it difficult to ‘price’ (in broad terms) ML/TF risk” (Artingstall *et al.*, 2016, p.23).  
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13 In summary, there exists no explicit ML risk appetite documentation nor official  
14 communication between financial institutions and regulators as to their respective risk  
15 appetites. This must be differentiated sharply from the risk-based applications of typologies  
16 where the categories of ML/TF entity-based suspicion are expressed. For example, by relying  
17 on the RBA, a financial institution would recognise the categories of ML risk that it considers  
18 as high-risk (PEPs, Cash-Based Institutions, etc) but this articulation suffers from two  
19 contingencies: a) it results in the paradox of the risk-based approach as each category requires  
20 further differentiation (Demetis, 2009) wherein we can have a Politically Exposed Person  
21 (PEP) automatically classified as high risk as per FATF recommendations but subsequently  
22 assigned a *high* PEP risk or a *low* PEP risk, ultimately undermining the ‘umbrella’  
23 classifications of the RBA to begin with, and b) it remains unlinked to the risk appetite of the  
24 institution.  
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36 The phenomenon of de-risking is particularly illustrative of the way the RBA fails to  
37 accommodate institutions’ risk appetite as well as risk’s systemic nature. Although de-risking  
38 is the empirical manifestation of financial institutions’ appetite to risk, de-risking is currently  
39 narrowly defined as “the phenomenon of financial institutions terminating or restricting  
40 business relationships with clients or categories of clients to avoid, rather than manage, risk in  
41 line with the FATF’s risk-based approach” (FATF, 2014, para. 1). It has had unfortunate  
42 repercussions such as, for example, “reducing the flow of remittance to developing countries”  
43 (Ramachandran, *et al.*, 2018, p. 250) and making such flows less transparent by being pushed  
44 into Hawala networks which are not easily regulated. How did we come to this position? How  
45 did the application of the risk-based approach lead to de-risking?  
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54 Although there are a number of drivers of de-risking (declining client profitability, increased  
55 compliance costs, increased regulatory and reputational risks), one of de-risking’s key drivers  
56 is the application of the RBA itself. This can be traced back to the FATF and how it has  
57 encouraged institutions to develop risk assessment tools, identify high-risk clients and  
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3 implement initiatives to mitigate high risks. Annex III of the fourth AML directive goes as far  
4 as to list correspondent banks and money transfer businesses as high-risk clients as if the  
5 category within which they belong, automatically makes them a high-risk entity. This paradox  
6 of the risk-based approach and the denial that - within each category - there is a myriad of other  
7 characteristics, attributes, proxies, that can reduce/increase the individual risk for each entity  
8 has only attenuated the problems. Behind the denial of this paradox lays the belief that risk is  
9 an objective construct which can be dissected, measured and deployed in AML. However, all  
10 the problems that institutions are experiencing when applying the RBA is proof, if needed, that  
11 risk is a subjective and an observer-relative construct. Consequently, categorisations like  
12 “money transfer businesses are high-risk clients” are both ontologically and epistemologically  
13 absurd. Alas, they are convenient for institutions that handle millions of transactions from such  
14 customers and they try to reduce their complexity en masse when needed.

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25 The ever-increasing focus on AML and CFT within a risk-based regulatory environment has  
26 essentially developed a culture that can only aspire to de-risking (Rose, 2019). And yet, the  
27 FATF and supervisory authorities assume that de-risking is risk avoidance instead of risk  
28 governance and management. They fail to see that the majority of financial institutions that  
29 terminate certain relationships aim to reduce the complexity they face after having assessed,  
30 through the RBA, that ML risk is a composite of many elements and parameters that are  
31 interdependent. On such occasions, de-risking is a decision made by a financial institution to  
32 communicate its new risk appetite and regulate its exposure to ML risks.

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40 The concept that de-risking is a form of risk governance and management is re-inforced by the  
41 FCA report on de-risking (Artingstall *et al.*, 2016). This report highlights that both FATF and  
42 FCA statements on “wholesale cutting loose of entire classes of customers” (FATF, 2015) and  
43 “banks dealing generically with whole categories of customers or potential customers” (FCA,  
44 2015) are frustrating to banks. “A bank’s decision on risk assessment may be the same whether  
45 it is undertaken on a case by case basis or wholesale basis, because the factors applied will not  
46 vary too much” (Artingstall *et al.*, 2016, p. 19). “Risk assessments will score similar customers  
47 in similar ways. A set of similar customers will fall outside the FIs’ risk appetite and thus be  
48 exited” (Artingstall *et al.*, 2016, p. 24). Regulators should be cognisant of this fact. Far from  
49 being a phenomenon that should be demonised and prevented at all costs, de-risking should be  
50 accepted and, as subsequently argued, facilitated and incentivised. Consequences associated  
51 with de-risking can be avoided by acknowledging the systemic nature of risk and implementing  
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3 recommendations that aim to counter-balance the impact of de-risking initiatives. Under certain  
4 circumstances, consequences like having financial access difficulties, can be detrimental to  
5 other institutions or entities as documented in current literature (Buckley and Ooi, 2014;  
6 Oxfam, 2013; Ramachandran *et al.*, 2018). This is further explored in the following section.  
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11 Another weakness of the RBA is how it fails to capture the differences in risks faced by  
12 financial institutions and regulators and the dynamic feedback loop between those risks, again  
13 highlighting the wider issue raised by Ross and Hannan (2007) and Demetis and Angell (2007)  
14 on the “complexity of representing risk” (p. 426). Certainly, both financial institutions and  
15 regulators are required to manage and minimise ML risks through the RBA. However, while  
16 financial institutions must focus on managing regulatory risk (defined as risk of changes to  
17 regulation or misalignment of regulatory interpretation), regulators face another kind of risk,  
18 namely the risk of losing their credibility. For instance, Black and Baldwin highlight the  
19 challenges faced by regulators when applying the RBA:  
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28 “Risk-based regulators have to address a number of issues including: the risks they will  
29 identify as requiring attention; the indicators and methods they will use to assess those  
30 risks; where they will prioritise their attention and where they will not. They will also  
31 have to decide how the implementation of the risk-based framework will be managed;  
32 how it will be justified and communicated both internally and externally; how they will  
33 respond to changes and, ultimately, what level of risk or failure they are prepared to  
34 accept” (2012, p. 2).  
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37 Hence, should ML scandals arise, regulatory bodies need to be able to justify their previous  
38 and current decisions as well as actions in order to preserve their credibility. Press releases and  
39 reports issued by the Estonian and Danish regulators in the aftermath of the Danske Bank  
40 scandal, for example, certainly offer an excellent illustration of this point.  
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46 The incongruence between how the RBA implementation is expressed and how the risk  
47 appetite of a financial institution could be articulated is further illustrated by the lack of  
48 methods to quantify ML risk. Efforts to perform these tend to go through the application of the  
49 Risk Based Approach which is, right now, the only widely available method to evaluate ML  
50 risk. The RBA methodology aims to split ML risk into a set of pre-identified risk categories  
51 such as “country or geographic risk, customer risk, and product/services risk and the  
52 application of these risk categories is intended to provide a strategy for managing the potential  
53 risks” (FATF, 2007, p. 22). However, we find that this reductionist approach, while useful in  
54 *observing* individual risk categories, fails to identify and account for the interconnectedness  
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3 and the systemic character of risk (Ackerman, Eden, Williams and Howick, 2007). Unlike other  
4 phenomena, risk feeds off itself, generating further risk that ripples across institutions in a  
5 dynamic way. For example, as of March 2021, the impact and consequences of the decisions  
6 made by Danske Bank Estonia to onboard high-risk non-resident customers in 2007 are still  
7 being felt, despite the fact that the non-resident portfolio was closed in 2015. In late January  
8 2020, the Danish Business Authority, Denmark's business watchdog, announced that two Ernst  
9 and Young auditors were being brought before the Danish Disciplinary Board of Auditors for  
10 failing to meet auditing standards when providing services for Danske Bank in 2014. Similarly,  
11 a group of institutional investors are launching a EUR 358 million lawsuit against Thomas  
12 Borgen (ex-Danske CEO) for misleading investors (Monroe, 2020). In addition, the September  
13 2020 FinCEN files leak indicates that Danske Bank Lithuania may also have weaknesses in its  
14 AML controls as well as the fact that Danske Bank had links to drug trafficking gang 'The  
15 Brothers' circle', money-launderer Altaf Khanani, and was involved in mirror trading (ICIJ,  
16 2020). Thus, six years on, the scandal continues to reverberate beyond what classical AML  
17 methods would have assessed and predicted since risk feeds off itself and cannot be ringfenced  
18 within one institution, nor jurisdiction, nor a specific point in time.  
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34 This complex set of risk related elements that propagate from one institution to another, point  
35 to feedback and systemic irritations that cannot be accounted for by the current AML  
36 framework; the current deconstruction of ML risk into sub-risks using the risk-based approach,  
37 ignores the systemic nature of ML risk (Demetis and Angell, 2007). In their attempts to  
38 deconstruct risk, some obliged entities have created additional prisms through which to observe  
39 ML risk—namely, regulatory risk, reputational risk, market risk, correspondent banking risk,  
40 risk of poorly integrated IT systems, failed internal AML procedures, staff complacency and  
41 internal collusion—which have been superimposed onto the traditional categories documented  
42 in the FATF's risk-based approach guidance. This condition is telling of risk and underscores  
43 a deep epistemological delusion whereby the conversion of risk as a subjective, sociotechnical  
44 construct is attempted into a quantifiable reality that can be acted upon. German Sociologist  
45 Niklas Luhmann describes this process as 'scientization'. "The process of 'scientization'  
46 reflects a method through which humans mistakenly identify social constructions as naturally  
47 occurring phenomena" (Russell and Brabow, 2011, p. 244). Attempts to understand risk solely  
48 through a predictable, automated methodology can actually be counterproductive. For  
49 example, if a low risk customer performs a transaction to a high risk jurisdiction, the  
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3 scientization of risk scores confuses the process. The transaction may be high risk but the  
4 customer is not. In sum, in spite of its burdensome complexity, such a tool may flag cases too  
5 broadly to be useful. One instance where this can be observed is in the application of transaction  
6 monitoring software, where the scientisation of risk generates false positives (Demetis, 2019).  
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8 This hinders AML efforts, creating further dangers that require internalisation.  
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12 Attempts to capture ML risk through an ever-expanding list of risk categories, evolve when  
13 knowledge about new (sub)categories of ML-risks emerges through the latest ML scandal or  
14 accumulated via AML reporting routes (e.g. FATF typology reports). Such attempts indicate  
15 that ML risk has no boundaries, travels across a multitude of environments and systems and is  
16 thus observable to fraud risk specialists, operational risk practitioners, journalists, investors,  
17 shareholders, the media, laypeople, etc. Thus, ML risk evolves through the eyes of multiple  
18 observers and environments, creating further risk and enhancing ML risk's interconnectedness.  
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27 Given the systemic characteristics of risk and the gap in the industry's current approach in  
28 dealing with ML, we adopt a systemic view of risk in the tradition of second order cybernetics  
29 (Von Foerster, 1981; Luhmann, 1993). By doing so, we attempt to approach the foundations  
30 of risk as a social construction and relate systemic risk to the challenges faced within the  
31 domain of AML. This theoretical approach can allow us to reflect on the structure of its  
32 propagation from one system to another and the wider consequences of risk. In order to provide  
33 a systemic framework within which to understand and analyse ML risk, a brief introduction to  
34 Luhmann's Systems Theory is offered below with an emphasis on risk (Luhmann, 1993). The  
35 concepts described will be subsequently applied onto AML phenomena and we shall use an  
36 illustrative case from Barclays bank's de-risking of Money Services Businesses (MSBs) in  
37 order to explain why de-risking should be accepted, facilitated and incentivised.  
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## 47 **THEORETICAL APPROACH THROUGH LUHMANN'S RISK FRAMEWORK**

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50 Luhmann's theoretical framework is based on a multiplicity of disciplines, including biology  
51 (Maturana and Varela, 1980), mathematics (Spencer-Brown, 1969), sociology, (Parsons, 1951)  
52 and cybernetics (Ashby, 1957; Bertalanffy, 1968; von Foerster, 1974, 1981). Indeed,  
53 "Luhmann sees the nucleus of cybernetic thought in the notion that a system whose operations  
54 are oriented on the fulfilment of certain purposes will orient its behaviour on a constant  
55 feedback from the environment and can therefore cope with a high, unknown level of  
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3 complexity” (Paetau, 2013, p. 79). Financial institutions, insofar as they are dealing with a web  
4 of ML typologies, compliance-oriented challenges, and the unavoidable ambiguities of RBA’s  
5 interpretation, face similar levels of complexity, both within their own systems, and in their  
6 respective environments. As argued by Borsch (2011), it is precisely this multidisciplinary  
7 approach within systems theory that enables Luhmann to develop a grand theory successfully.  
8 As the field of AML itself draws from different disciplines in its attempts to tackle ML, a more  
9 general theoretical approach can allow us to identify the wider transitions that occur within our  
10 field. Luhmann’s insights on risk can thus be applied to the RBA.  
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18 Following a long tradition of systems theorists, Luhmann observes the world as systems and  
19 environments. A system is distinct from its environment, and since the environment is not a  
20 system, it does not have the same capabilities as the system (Luhmann, 1995a). Furthermore,  
21 a system cannot exist without being separated from its environment. If the distinction between  
22 a system and its environment is not made, “if everything blends into everything else and no  
23 clear boundaries can be established, then no system exists” (Borsch, 2011, p. 21). Thus, for  
24 any given system, the system is “nothing but the difference to its environment” (Luhmann,  
25 2002, p. 66).  
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33 For Luhmann, systems have their own functions and system formation is the key feature of  
34 modern society. As such, the *system* is Luhmann’s essential starting point and the starting point  
35 of any system’s theoretical analysis. However, the function of the system is, simply, that of  
36 differentiation (or distinction) between system and environment for the purpose of minimising  
37 the complexity of the environment. Indeed, “the social world comprises enormous complexity  
38 which social systems each, in their own way, reduce” (Borsch, 2011, p. 7).  
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45 The following diagram conceptualises the system and its environment:

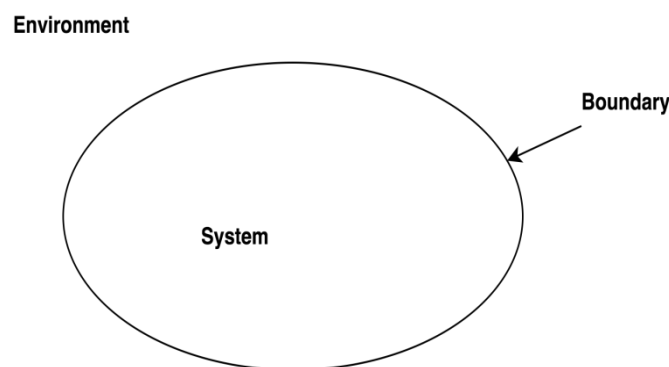


Figure 1: System, Environment and Boundary

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3 The difference between system and environment can only be delineated by the *observing entity*  
4 marking the boundaries between system and environment.  
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8 Therefore, “the definition of a system, indeed any definition for that matter, is above all an act  
9 of choice and an observer-relative act. The observer is crucial in the construction of any  
10 system” (Demetis, 2010. p. 42). Depending on what the observer is focusing on (e.g. an AML  
11 transaction monitoring system, or the system of the Egmont group), a system can be anything  
12 ranging from a human organism, society, a financial institution, or a financial intelligence unit,  
13 among countless other entities. It can be anything the observer conceives of as a system.  
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19 While the environment is more complex than the system because it has more options, variety,  
20 and degrees of freedom, the system compensates for its ‘inferiority’ by eliminating or  
21 introducing degrees of freedom. For instance, referring back to Figure 1, if the system is a  
22 financial institution and the ruling government (i.e. another system within the environment)  
23 were to announce further economic and financial sanctions against Russia, the system might  
24 decide to no longer bank with Russian nationals in order to avoid sanction breaches and  
25 regulatory fines. Now that system and environment have been introduced, risk according to  
26 Luhmann can be discussed.  
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34 To Luhmann, risk is not ontologically real but instead, it is a social construction. As he  
35 mentions:  
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39 “The already familiar discussions on risk calculations, risk perceptions, risk  
40 assessment and risk acceptance are now joined by the issue of selecting the risks to be  
41 selected or ignored. And once again, discipline specific research can reveal that this  
42 is not a matter of chance but that demonstrable social factors control the selection  
43 process” (Luhmann, 1993, p.4).  
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46 Luhmann’s work on risk operationalises a key distinction: that between *risk* and *danger*. The  
47 key difference between risk and danger is that of attribution: the difference is determined by  
48 the observer. In short, a decision maker will observe the consequence of his decision as a *risk*  
49 that he has decided to internalise while the non-decision maker (i.e. the affected party) will  
50 observe the consequence of someone’s decision as a *danger* emanating from its environment.  
51 Nevertheless, both the affected party and the decision maker observe the same phenomenon,  
52 albeit with an observer-relative sensitivity towards its interpretation in the duality between  
53 risk/danger. Thus, both *risk* and *danger* are manifestations of the same phenomenon observed  
54 by different observers. The fundamental point to consider, however, is that the distinction  
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3 between risk and danger does not hinge on certainty or safety but on attribution: risk is  
4 attributed to the system's decisions while danger is attributed to the environment. Risk is "the  
5 possibility of future damage, exceeding all reasonable costs, that is attributed to a decision"  
6 (Luhmann, 1990, p. 225) while "danger is a possible loss considered to have been caused  
7 externally" (Luhmann, 1993, p. 22). However, from the perspective of an individual who did  
8 not make the decision or accept the associated risks, the possibility of a loss is perceived as a  
9 danger that is caused by an external force. Thus, even though a decision may be made as part  
10 of a democratic process, the possibility of loss or damage is not voluntarily accepted by all  
11 potentially affected parties through the decision making process. As Luhmann discusses:

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20 "Decisions are always the decisions of somebody, not the decisions of everybody.  
21 Therefore the real dangers in modern society are the decisions of others. Almost all  
22 other dangers, including natural disasters, can be avoided, for instance by moving out  
23 of a region threatened by storms or earthquakes and settling elsewhere. But the danger  
24 that results from the decisions of others cannot be avoided because others are  
25 everywhere" (Luhmann, 1990, p. 226).

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29 The 2008 financial crisis illustrates this point. Senior management and shareholders of the big  
30 financial institutions that were deemed "too big to fail" (Sorkin, 2009), perceived the  
31 possibility of a financial crisis as a risk while taxpayers perceived it, and ultimately experienced  
32 it, as a danger. However, the 2008 crisis also showed that decision-makers - such as Lehmann  
33 Brothers, Merrill Lynch or Freddie Mac and Fannie Mae - became affected parties too. The  
34 danger such financial institutions generated through their very own decision-making was so  
35 great, that their environment (i.e. governments and regulators) had to internalise it as risk. This  
36 generated further danger to the initial decision makers who therefore became victims.

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43 Overall, on the basis of the few concepts described above (e.g. system/environment,  
44 risk/danger), we illustrate Luhmann's risk model in figure 2. There are two separate systems  
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46 describe the basic principles of the model right after with an example.  
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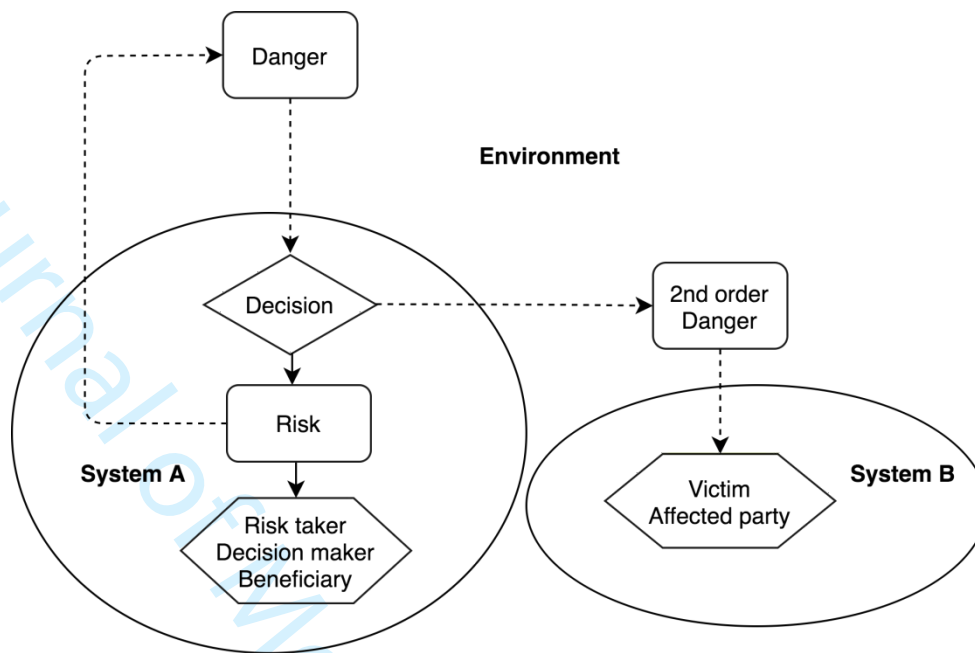


Figure 2: Luhmann's Risk Model (based on Luhmann, 1993)

We take System A here to be a financial institution. Danger (e.g. a customer that may be actively looking to launder money or simply a high risk Politically Exposed Person (PEP) or a High Net Worth customer) originates from the environment and irritates system A. If the financial institution (i.e. System A) makes the decision to internalise the danger (e.g. accept a high-risk client which may expose the institution to ML risk and/or regulatory scrutiny) then System A will *internalise danger into risk* and reap any associated rewards (e.g. high commission rates on future transactions). Thus, once internalised, the danger becomes a risk for System A.

However, decisions made by the financial institution to internalise dangers and convert them into risks will also produce *second order dangers* which are external to the financial institution (System A) and impact other systems such as System B. For instance, an institution's decisions to consistently onboard high risk customers may expose the jurisdiction it is based in, the wider regulatory environment and the regulator to the danger of higher exposure to ML. In figure 2, System B is the regulator who faces the danger that results from System A's decision.

To a second order observer, the risk/danger distinction changes depending on who the first observer is (i.e. System A or B). Consequently, risk is also an observer-relative construct. In summary, decision makers generate risks and victims, who are not involved in the decision making process, face the associated dangers.

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3 To provide an empirical illustration of Figure 2, we refer to the 2015 Barclays bank case  
4 resulting in a GBP 72 million fine. In 2011 and 2012, Barclays executed a series of transactions  
5 amounting to GBP 1.88 billion on behalf of ultrahigh-net-worth (HNW) clients that were  
6 Politically Exposed Persons (PEPs) (Financial Conduct Authority [FCA], 2015). In order to  
7 take on the clients as quickly as possible and to generate GBP 52.3 million in revenue, Barclays  
8 decided *not* to apply its own standard procedures, consisting in performing enhanced Customer  
9 Due Diligence (CDD) as required by the RBA. The identity of the clients was so sensitive that  
10 the bank agreed to pay them GBP 37.7 million should their names ever be revealed. In  
11 November 2015, the FCA (the UK regulator), fined Barclays GBP 72 million. At the time, the  
12 FCA made the following statement: “While we make no finding that the transaction involved  
13 financial crime, the circumstances of the transaction gave rise to a number of features which  
14 indicated a higher level of risk. This required Barclays to adhere to a higher level of due skill,  
15 care and diligence but Barclays did not follow its standard procedures” (FCA, 2015). In  
16 addition, the FCA made the following statement:  
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28 “Barclays failed to follow its own standard procedures, failed to implement any  
29 adequate alternative procedures, and failed to have sufficient regard to the JMLSG  
30 Guidance and other relevant guidance in issue during the relevant period. Barclays  
31 focused on its objective of entering into the business relationship and executing the  
32 transaction quickly and on the exceptional confidentiality restrictions in place, rather  
33 than on the importance of completing the EDD required and making a careful and  
34 considered assessment of the potential financial crime risks” (FCA, 2015, p. 22).  
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37 Ultimately, Barclays is a financial institution driven by revenue, profits and shareholder  
38 approval. The following extract from the FCA report documenting the circumstances leading  
39 to the fine, points to that direction as:  
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43 “On the basis of the EDD information available to it at that time (which, as outlined in  
44 paragraphs 4.32 to 4.47 below, was inadequate) Legal and Compliance did confirm that  
45 the appropriate level of EDD had been conducted, including that the PEPs had been  
46 properly identified, and that the Clients’ sources of wealth were legitimate. This was  
47 not compliant with Barclays’ usual procedures that required the front office to give this  
48 confirmation. In addition, Legal and Compliance did not have the benefit of the  
49 knowledge held by front office senior management about the Business Relationship and  
50 a number of relevant issues that had emerged during negotiations between the Clients  
51 and senior management” (FCA, 2015, p. 16).  
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54 The compliance subsystem could be interpreted as having had to ‘surrender’ to the greater will  
55 of the sales subsystem while the goal seeking behaviour of the entire system was oriented  
56 towards securing the deal.  
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In the figure below, Figure 3, we illustrate Barclays' 2015 AML fine by applying the basic risk/danger skeleton of Figure 2. Barclays bank is represented as system A, system B can be society or the regulator for instance. System A's decision not to apply enhanced due diligence in order to quickly onboard the HNW PEP clients, perform the GBP 1.88 billion transaction and secure GBP 52 million in revenue may result in a potential fine which is the risk that the front office has decided to internalise. The regulator is the victim who, not having been part of the decision making process, sees the onboarding of ultrahigh-net-worth clients that are PEPs and the execution of GBP 1.88 billion transaction as ML danger to its jurisdiction.

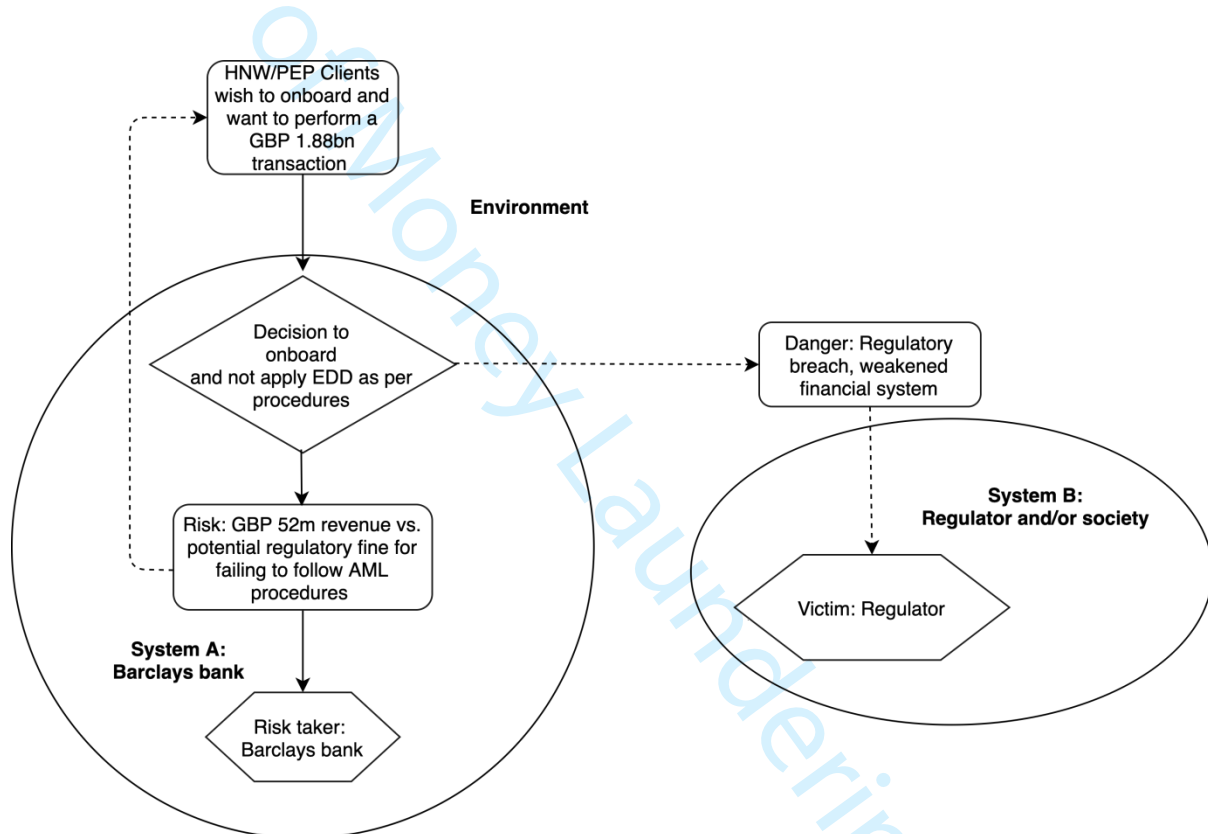


Figure 3: Analysis of Barclays Bank 2015 fine through Luhmann's risk/danger model

At this point, the key building blocks of Luhmann's systems theory should be clear: When stimuli from the environment (e.g. ultra HNW PEPs that want to be onboarded) is considered by system A (i.e. Barclays bank in our case), the decision to execute a transaction is brokered through internalising the danger that HNW PEPs' transactions may violate AML regulation and weaken the financial system. To the decision-maker (Barclays bank), the consequence of risk-taking is the reward (GBP 52 million in revenue), and the risk is receiving a financial fine (a GBP 72 million fine on this occasion). To the victim (the regulator), the danger is a breach



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3 of regulation, a threat to the confidence in the financial system and/or a failure to adequately  
4 manage and prevent financial crime in the UK.  
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8 The relevance of Luhmann's work on risk and the risk/danger distinction has been illustrated  
9 through Barclays Bank's 2015 regulatory fine. To demonstrate the versatility of Luhmann's  
10 theoretical framework for exploring and understanding the AML domain, we will now apply  
11 Luhmann's risk/danger model to the de-risking phenomenon.  
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### 15 16 17 **DE-RISKING, RE-RISKING AND BARCLAYS' ILLUSTRATIVE CASE** 18 19 20

21 The FCA defines de-risking as banks removing "bank accounts/services from customers or  
22 other relationships which they associate with higher money laundering risk. It has been  
23 attributed to the increasing overall cost of complying with regulatory requirements"  
24 (Artingstall *et al.*, 2016, p. 5). The belief is that de-risking is performed in a wholesale manner  
25 with banks unwilling to truly assess the risk associated with such customers.  
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31 When considered through Luhmann's risk/danger model, de-risking describes a phenomenon  
32 whereby financial institutions no longer wish to maintain risks in exchange for potential  
33 rewards. They therefore seek to externalise those risks they maintain internally, remove them  
34 from their own systems and feed them back into the their respective environments; in the  
35 process, they will therefore convert risk back into danger. De-risking arises for a multitude of  
36 reasons: declining client profitability, increased compliance costs, increased regulatory and  
37 reputational risks (Ramachandran, *et al.*, 2018), but is essentially driven by the decision-  
38 making system aiming to minimise the complexity it faces. When too many decision-making  
39 systems externalise their risks, while at the same time, other systems in their respective  
40 environments are not willing to internalise the corresponding dangers then an accumulation of  
41 danger emerges in a particular category (e.g. money service businesses). In this regard, we can  
42 articulate the systemic definition of de-risking as *a state of 'suspended dangers' that are not*  
43 *internalised by systems.*  
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54 One side-effect of de-risking is that it may reduce visibility of such 'suspended dangers' and  
55 either push ML into smaller institutions that lack the resources and expertise needed to manage  
56 high-risk clients. Furthermore, it could also push ML and terrorist financing into financial  
57 mechanisms, such as alternative remittance systems, that exist outside of regulatory scrutiny.  
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3 In addition, de-risking can exclude legitimate businesses and consumers from the financial  
4 system, which can have negative effects on a country's economic and social development.  
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6 Finally, such dangers can threaten the credibility of regulators should the latter fail to address  
7 them (Grima et.al., 2020; Ramachandran *et al.*, 2018; Rose, 2019). To regulators, de-risking  
8 clearly represents a *danger*, as it "may drive financial transactions underground which creates  
9 financial exclusion and reduces transparency, thereby increasing money laundering and  
10 terrorist financing risks" (FATF, 2015). This concern is also expressed by the FCA which  
11 states: "we require banks to put in place and maintain policies and procedures to identify, assess  
12 and manage money-laundering risk. This requires banks to use an effective risk-based  
13 approach" (FCA, 2015). Thus, when a financial institution transforms a danger "that was  
14 formerly seen as external into processable and manageable activities" (Renn, 2004, p. 103), its  
15 decision generates (second-order) danger for entities that neither took part in the decision  
16 making process nor benefited from the decision. In this case then, such entities can be the  
17 regulators and the de-risked customers that are the *victims* of the de-risking process. The  
18 regulator has to handle such danger one way or another. The issue, however is that the  
19 regulator, as a system, communicates and responds through regulation. For instance, if there  
20 is a critical mass of financial institutions and banks that no longer wish to internalise dangers  
21 in exchange of potential rewards, there will be a high volume of danger that will require  
22 internalisation. The regulator will want to incentivise systems to internalise such danger and  
23 will need to do so through regulation.  
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39 In sum, by de-risking their own systems, financial institutions create irritations for regulators.  
40 However, while financial institutions can produce irritations for regulators, they cannot steer  
41 regulators' responses to these irritations; responses are determined by the regulator itself. In  
42 the UK, for example, regulators threatened to fine financial institutions that could not provide  
43 robust rationale for de-risking activities. Systemically, such an approach essentially  
44 discourages financial institutions from externalising danger and aims to incentivise institutions  
45 to maintain risk within their systems. This approach, however, imposes a level of complexity  
46 that financial institutions will not or cannot handle. Placing obstacles to de-risking will have  
47 its own unintended consequences. The irony in this context is that essentially de-risking is the  
48 result of the application of the risk-based approach. However, if regulators attempt to prevent  
49 the application of the FATF's recommendations, institutions may start "seeking much more  
50 specific guidance on managing high-risk relationships of the types that have led to account  
51 exit" (Artingstall *et al.*, 2016, p. 70) possibly demanding the introduction of prescriptive  
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regulation in order to obtain legal safe harbour for instance. It is the management of this dynamic that is now at stake. Figure 4 below presents how the risk/danger distinction is operationalised in the context of de-risking.

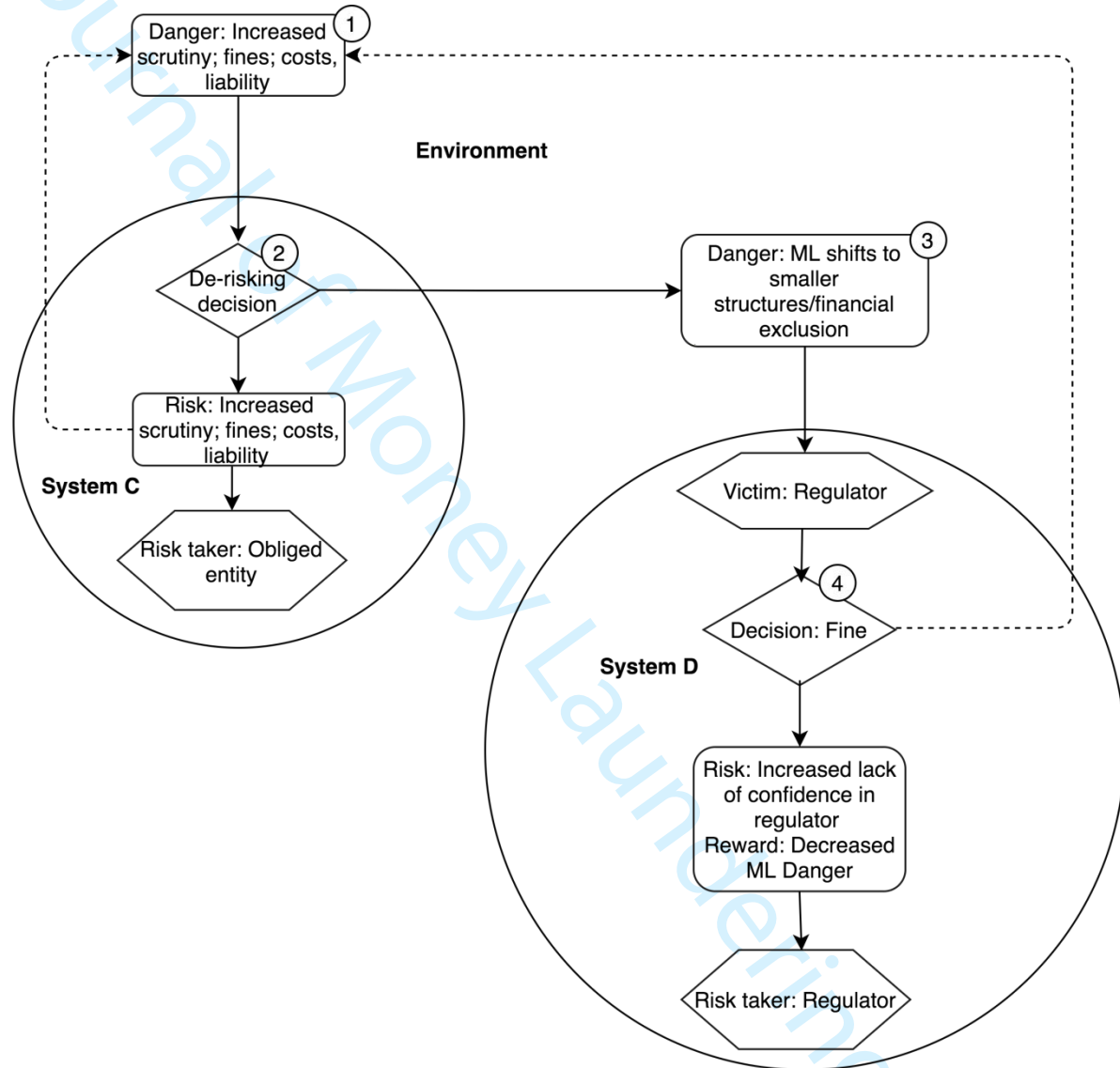


Figure 4: De-risking through Luhmann's risk/danger model

In Figure 4, the top box represents danger (1). As discussed, it is believed that de-risking is a response to an increased cost of compliance, increased regulatory scrutiny, regulatory fines and liability. Because of dangers associated with certain customers judged as representing higher ML risks, the financial institution (System C) makes the decision to de-risk (2) and thus terminates its relationship with higher ML risk customers. This allows the financial institution to externalise the *risk* associated with managing such clients into *danger* at its environment (3), which in turn generates danger for entities that were not involved in the decision-making

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3 process (e.g. de-risked customers or the regulator). In Figure 4, we show one impacted party  
4 as the regulator (System D) that needs to internalise such phenomena that affect the wider  
5 financial system's stability (3). De-risking is perceived by regulators as a danger that may  
6 affect consumers or create wider competition problems. Thus, if regulators object to an  
7 institution's attempt at reducing its own complexity, they may create the danger of fines against  
8 that very financial institution, which, if levied (4), would represent a new danger (1) that the  
9 financial institution would be forced to internalise because it made the initial decision to de-  
10 risk (2). At a minimum, regulators could create new guidelines to suppress phenomena like de-  
11 risking. However, these in turn would lead to their own unintended consequences and subjected  
12 to the variable danger/risk distinctions imposed by various institutions. Ultimately, the  
13 recursive cycles between danger/risk are inescapable. The very existence of a risk-based  
14 approach presupposes a de-risking-based approach (DRBA) at the same time. Without the  
15 development and formalisation of both an RBA and a DRBA, regulators cannot steer their  
16 institutions (in the cybernetic sense) and they cannot maintain a balance between the two  
17 distinct phenomena that represent them.  
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31 Even a prescriptive rules-based approach implies that some rules are imposed instead of others.  
32 In turn, the non-inclusion of other possibilities for rules, generates dangers that can affect AML  
33 systems in different ways. Put differently, the prescription of a rules-based approach amounts  
34 to a forced prescription of the non-inclusion of other rules, with each 'rule' enabling a mix of  
35 danger and risk. Ironically, a rules-based approach in itself is also a form of forced de-risking.  
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41 What we also need to highlight is that the financial institution (system C) and the regulator  
42 (system D) are located in one another's environment. Decisions in system C generate dangers  
43 that may be internalised as risks in system D. System D then responds to the risk by creating  
44 new dangers for system C, which may, in turn, decide to internalise these dangers as risks and  
45 may then respond by making new decisions perceived as dangers by system D, so on and so  
46 forth. Thus, the risk/danger distinction is self-referential and reproduces itself at every step of  
47 the decision-making chain. As Demetis (2010) explains, "risk cannot therefore be specified or  
48 pointed out simply because it is categorised, even when the perception of risk is communicated;  
49 its re-genesis will transcend any system that attempts to manipulate it" (p. 113).  
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58 Now that de-risking has been described through Luhmann's risk/danger model, we explore this  
59 phenomenon further by looking at how the victim or affected party does not necessarily have  
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3 to accept its role of victim and how under such circumstances, *re-risking* arises. This is  
4 explored through the Barclays bank vs. Dahabshiil case, which we will now discuss.  
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### 8 **BARCLAYS VS DAHABSHIIL ILLUSTRATIVE CASE**

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11 In May 2013, Barclays bank announced it would close approximately 250 accounts belonging  
12 to Money Service Businesses (ACAMS, 2013). The rationale was that “some of them,  
13 including some remittance companies, did not have the necessary systems in place to spot  
14 criminal activity with the degree of confidence required by Barclays’ regulatory environment”  
15 (Tran, 2013a). The response to such a decision was met with controversy with charities  
16 explaining that remittance companies “provide a lifeline for 40% of the Somali population”  
17 (Tran, 2013b) representing USD 1.2bn annually, more than the country’s annual international  
18 aid (UN Food and Agriculture Organization). As Dahabshiil stated:  
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26 “It is important to remember that we are not just a business. We provide a lifeline  
27 service to Somalia and other African countries. We enable Somalis to help themselves,  
28 by sending money to every corner of the Somali territories to enable relatives and  
29 friends to buy food, medicine and to pay for education. Remittances are also used for  
30 investment in business start-ups and property – remittances are helping Somalis get the  
31 country back onto its feet after two decades of war” (Dahabshiil, press release, 23  
32 February 2017).  
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37 Barclays Bank, however, explained in a statement that it had “made a legitimate decision to  
38 exit these businesses based upon the well-known risks of money laundering and terrorist  
39 financing in the money service business sector” (Moore, 2013). Essentially, Barclays bank’s  
40 decision was driven by exposure to financial crime risk. Yet, Dahabshiil’s solicitors issued a  
41 high court application seeking to prevent Barclays from closing its accounts. They claimed  
42 that:  
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49 “by giving them notice of its intention to withdraw banking services from their  
50 businesses Barclays has acted (or is threatening to act) unlawfully, because (put shortly)  
51 Barclays is alleged to be in a dominant position in the market for the provision of  
52 banking services to money service businesses, either generally or in relation to the  
53 particular sector in which the relevant claimant operates, and by ceasing to provide such  
54 services without objective justification Barclays would be abusing its dominant  
55 position contrary to Article 102 of the Treaty on the Functioning of the European Union  
56 (“TFEU”) and the Chapter II prohibition in the Competition Act 1998” (Dahabshiil &  
57 others v Barclays Bank Plc, 2013).  
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4 In October 2013, the court granted an injunction preserving business relationships between  
5 Dahabshiil and Barclays until the full trial took place and awarded Dahabshiil the costs of  
6 seeking the injunction.  
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10 To understand this case through Luhmann's risk/danger model, we now consider Figure 5.  
11 System E represents Barclays, which has previously on-boarded MSBs (identified as being  
12 high-risk by the FATF) and internalised the risk presented by this customer base. More  
13 specifically, on-boarding MSBs as clients is a risk that was accepted by the banking institution  
14 and, as decision maker, the institution implemented adequate mitigating tools for managing  
15 this risk. Now system E has decided to de-risk, which entails the financial institution to unbank  
16 MSBs because of a new climate of close regulatory scrutiny, for instance, thus lowering  
17 financial crime risk tolerance for this sector.  
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25 Barclays (system E) terminates this relationship to comply with its obligation to apply the risk-  
26 based approach. Dahabshiil (system F), affected by Barclays' decision, takes Barclays to court  
27 and obtains an injunction against Barclays, preventing it from terminating their relationship.  
28 Through this process, Dahabshiil internalised the danger posed by Barclays' de-risking  
29 decision by means of taking Barclays to court. This internalisation turned that danger into risk,  
30 more specifically, the risk of having the court judging in favour of Barclays bank. However,  
31 the court's decision allowed Dahabshiil (system F) to refuse system E's de-risking. By taking  
32 Barclays to court, system F rejected Barclays' de-risking decision and prevented it from being  
33 able to externalize its financial crime risk. This is described in Figure 5 with the process  
34 "Refuse de-risking" → "Second-order de-risking within F". Furthermore, the decision to reject  
35 Barclays' de-risking attempt impacted Barclays itself. Barclays was taken to court and was  
36 impacted by such events, financially of course and reputationally. This is shown in Figure 5 by  
37 the arrow between the "second-order de-risking within F" box and the "Second-order danger"  
38 box, which then leads to the "Danger" box affecting System E. This case illustrates the  
39 repurposing of system F danger into system E danger.  
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52 The key takeaway, however, is the fact that Dahabshiil was unwilling to internalise the danger  
53 of being de-risked and by taking Barclays to court, it rejected the level of complexity that would  
54 have come with being unbanked.  
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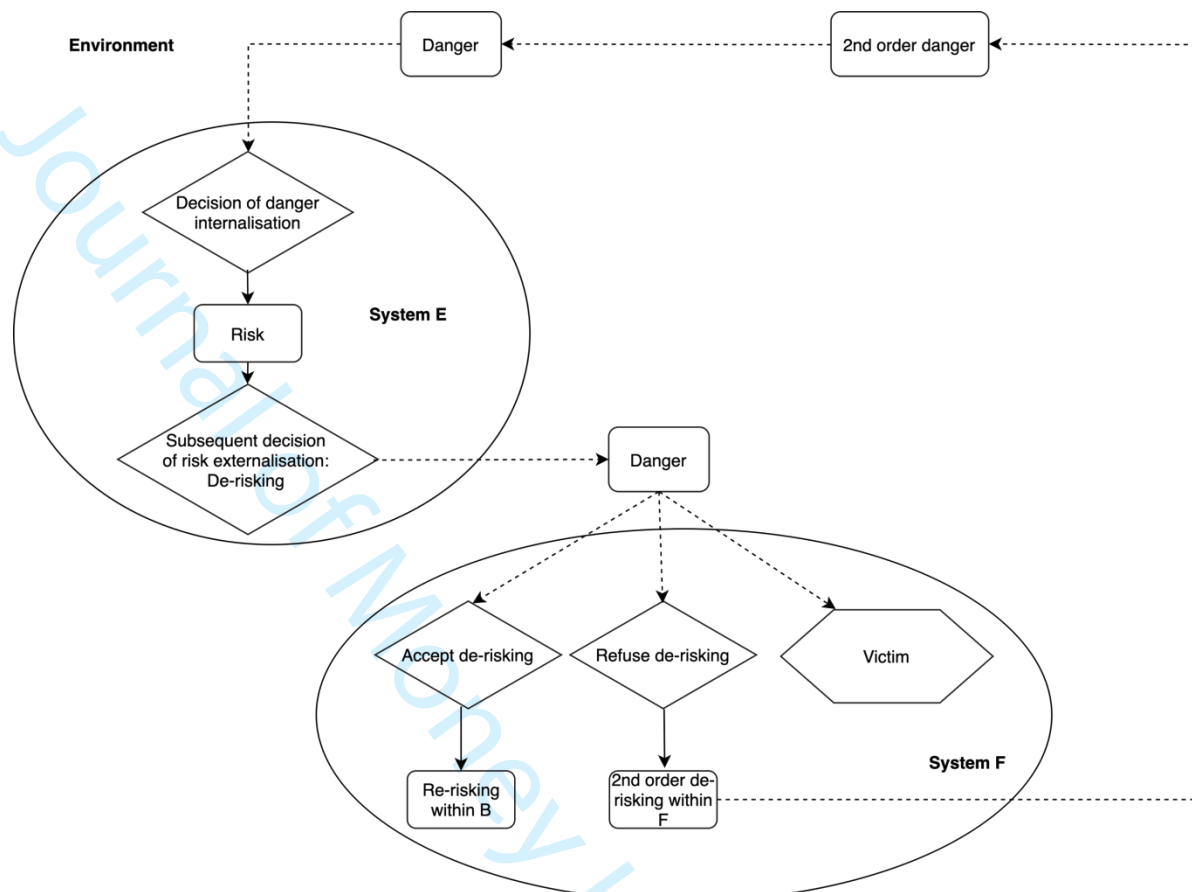


Figure 5: De-risking and re-risking

Now that we have discussed the Dahabshiil vs Barclays case, we delineate three distinct possibilities in how the decision making process of System F could react to system E's de-risking decision:

#### *Scenario 1: Accepting De-risking*

System F represents an MSB that now faces a decision in relation to handling the danger generated by system's E decision. The MSB could decide to accept the signalling from system E and implement processes to establish and maintain the existing relationship with system E, or it could secure a relationship with another financial institution. System F may thus decide to improve its own risk management system to address the banking sector's risk aversion to regulatory scrutiny. More specifically, system F may decide to implement better procedures for account monitoring, develop KYC policies, audit Customer Due Diligence processes, and/or strengthen risk management systems. In this scenario, system F assumes the role of decision maker and internalises the danger generated by system E (through risk externalisation). Under such circumstances, re-risking occurs. This is represented in figure 5 with the process "Subsequent decision of risk externalisation: De-risking" → "Danger" →



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3 “Accept de-risking” → “Re-risking within F”.  
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6 *Implication for de-risking:* Under scenario 1, system E successfully de-risks and system F,  
7 through its own decision-making, is not a victim who faces danger. Instead, *system F re-risks*  
8 its own system.  
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12 *Scenario 2: Rejecting de-risking*  
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15 Another scenario illustrated by Figure 5 is the possibility that system F rejects system E’s de-  
16 risking, refusing to internalise the risk that system E has externalised through de-risking. In  
17 such a case, system F does not re-risk its own system, and similar to what we observed in the  
18 Dahabshiil vs Barclays case, through its own decision-making, *system F transfers the danger*  
19 generated by system E into the environment.  
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24 *Implication for de-risking:* Under scenario 2, danger re-enters the environment because system  
25 F makes the decision not to internalise it as risk (as observed in Figure 4, step 4). System E  
26 may be able to de-risk successfully if system F transfers the danger into the environment,  
27 without it impacting system E. However, if system E becomes the victim of system F’s  
28 decision, system E will be unable to de-risk successfully thus impacting its ability to manage  
29 risk and sustain its systems and controls as per its risk appetite.  
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36 *Scenario 3: Enduring de-risking*  
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39 The final scenario illustrated in Figure 5 is that in which system F does not make any decisions  
40 and remains victim of the consequences of system E’s de-risking initiatives.  
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43 *Implication for de-risking:* System F is the victim that now needs to find other systems (i.e.  
44 other financial institutions) that will accept to onboard it as customer. When viewed  
45 collectively, the frameworks and scenarios we present above can serve as a blueprint for  
46 introducing a de-risking based approach (DRBA).  
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## 53 **OVERVIEW AND RECOMMENDATIONS**

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56 De-risking is essentially the contagion effect of risk assessments. This point is re-enforced by  
57 the FCA’s sponsored report on de-risking that highlights FATF and FCA statements on  
58 “wholesale cutting loose of entire classes of customers” (FATF, 2015) and on “banks dealing  
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3 generically with whole categories of customers or potential customers” (FCA, 2015). The  
4 FATF has essentially designated whole categories of customers and sectors as high-risk. It  
5 ultimately flags the probability of ML risks unto entire classes of customers. Why is then de-  
6 risking stigmatised when it is the mirror-image of the FATF’s process? In fact, de-risking is a  
7 naturally occurring phenomenon which follows the risk assessment and hence the decision  
8 making process dictated by the FATF. Regulators are essentially denouncing the fact that too  
9 many institutions are abiding by the FATF’s guidance.

10  
11 This is frustrating to banks because “a bank’s decision on risk assessment may be the same  
12 whether it is undertaken on a case by case basis or wholesale basis, because the factors applied  
13 will not vary too much” (Artingstall *et al.*, 2016, p. 19). “Risk assessments will score similar  
14 customers in similar ways. Thus a set of similar customers will fall outside the Financial  
15 Institutions’ risk appetite and thus be exited” (Artingstall *et al.*, 2016, p. 24).

16  
17 Furthermore, the cost of compliance is high, there is a lack of confidence in the regulator and  
18 fear of misinterpretations of regulatory expectations. Financial institutions simply do not feel  
19 that they have the support from the regulator. The FCA sponsored report on de-risking states:

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21 “Many of the banks we have spoken to have indicated that, although they take a RBA  
22 to each client relationship, they are not just building in the actual risk of a client (or its  
23 customers) acting in a damaging way—they are also building in their assessment of  
24 how the appropriate regulators, or financial institutions higher up the ‘food chain’ (who  
25 are almost seen to be acting in a quasi-regulatory capacity), will assess their approach.  
26 Essentially there is a certain amount of second-guessing going on. In today’s  
27 environment, the vast majority of these assessments will fall on the side of caution”  
28 (Artingstall *et al.*, 2016, p. 40).

29  
30 Hence de-risking also reflects financial institutions’ lack of confidence in the regulator and  
31 uncertainties in relation to regulatory expectations. In addition, de-risking concerns private  
32 sector responses to irritations from its environment (such as the regulator), communicating a  
33 willingness to forfeit a region or a sector to signal good faith based on ML scandals. This is  
34 what Deutsche Bank did when it “broke off its relationship as a correspondent bank for US  
35 dollars with Danske in Estonia in September 2015 because of concerns over non-resident  
36 customers” (Milne, 2018). Similarly, Danske Bank announced in 2018 that “it would scale  
37 down its business in the Baltic countries to focus on the Nordic markets” (Reuters, 2018).

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39 Such an exit is, of course, not the result of a simple fear of misinterpreting regulatory  
40 expectations; rather it is a move that demonstrates Danske Bank’s understanding of regulatory

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3 expectations. On such occasions, de-risking is a decision made by a financial institution to  
4 communicate its new risk appetite and regulate the system's exposure to regulatory scrutiny of  
5 course, as well as to ML risks.  
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10 “Many of the banks we have spoken to have indicated that, although they take a RBA  
11 to each client relationship, they are not just building in the actual risk of a client (or its  
12 customers) acting in a damaging way—they are also building in their assessment of  
13 how the appropriate regulators, or financial institutions higher up the ‘food chain’ (who  
14 are almost seen to be acting in a quasi-regulatory capacity), will assess their approach.  
15 Essentially there is a certain amount of second-guessing going on. In today's  
16 environment, the vast majority of these assessments will fall on the side of caution”  
17 (Artingstall *et al.*, 2016, p. 40).  
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20 Although de-risking is perceived by the regulator as danger from its environment, it is the result  
21 of irritations triggered by the regulator itself, which in turn affect its own environment. As  
22 such, the regulator needs to be mindful that ML risk and regulatory risk feed off one another  
23 and affect financial institutions' perception and understanding of risk. Another element that  
24 needs to be raised is the fact that de-risking is to be expected since organisations seek to  
25 minimise their exposure to risks that sit outside their appetite. Yet, if too many organisations  
26 de-risk at the same time, externalising their risk into danger, there may be a critical mass of  
27 victims (as per Luhmann's risk/danger model) facing such danger. This is a phenomenon  
28 observed in the USA where a World Bank survey (2014) identified that 80% of MSBs were  
29 struggling with account opening. Under such circumstances, we prescribe encouraging and  
30 incentivising re-risking.  
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40 De-risking initiatives observed amongst financial institutions are strategies for the latter to  
41 minimise their systems' exposure to risk and externalise ML and regulatory risk. The regulator  
42 may respond to a new ML danger by introducing a new regulation for MSBs for example. The  
43 risk for such a new regulation may be the deployment of additional supervisory resources to  
44 ensure compliance. As we have seen, the danger to financial institutions may be uncertainty  
45 with regards to the regulator's expectations resulting into the institution's de-risking of MSBs.  
46 In addition, since de-risking aims to minimise exposure, it should not be prevented as it  
47 involves imposing a complexity that the system is not willing to handle. However, on the other  
48 hand, de-risked customers such as MSBs are in turn encouraged to reject their role of victim  
49 (as per Luhmann's risk/danger model) and the danger they face once de-risked. Inevitably, the  
50 financial institution's de-risking may result into second order danger such as MSBs seeking  
51 services from institutions that do not have the bandwidth or level of sophistication to deal with  
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3 high ML risk clients such as MSBs, thus exposing the jurisdiction to additional ML danger.  
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5 Similarly, we note that regulators object to de-risking when too many decision-making systems  
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7 reduce their complexity and convert their risk back to danger while other systems do not or  
8  
9 cannot internalise such danger.

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11 To prevent too many decision makers from de-risking at the same time and ensure that victims  
12  
13 have the ability to become decision-makers, the regulator needs to consider its actions through  
14  
15 Luhmann's risk/danger theory. Essentially, the regulator has the following approaches to  
16  
17 address de-risking:

- 18  
19 - Provide means for victims to internalise or reject danger;
- 20  
21 - Provide means for decision-makers to maintain danger internalisation;
- 22  
23 - Increase decision makers' ability to internalise danger;
- 24  
25 - Decrease the danger within the environment;

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27 In light of the above points, we are proposing that the regulator should act as a router steering  
28  
29 the transition from de-risking to re-risking and vice versa. Formalising the options we  
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31 deconstruct above into a De-Risking Based Approach (DRBA) and introducing a coherent set  
32  
33 of recommendations for managing de-risking when it occurs can allow a better distribution  
34  
35 between risks and their (institutional) handlers.

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37 Tension between regulating de-risking versus banning de-risking has been observed but  
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39 ultimately, the regulator needs to facilitate systems' ability to either internalise or reject danger  
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41 while also incentivising decision-makers to either internalise danger or maintain danger  
42  
43 internalisation. As such, the regulator should create mechanisms to facilitate danger rejection  
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45 as observed with Dahabshiil. Similarly, to encourage danger internalisation, the regulator  
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47 should provide support and/or training with the development of robust Know Your Customer  
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49 (KYC) and CDD for victims and decision-makers. In addition, more time can be provided to  
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51 other systems/institutions within the environment to decide whether they wish to internalise  
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53 danger and absorb systemic de-risking when it occurs. Regulators should increase the  
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55 minimum notice period between decision to de-risk and actual customer exit and provide a  
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57 mechanism, platform, or information system for swift onboarding to other institutions. An  
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59 information system for brokering KYC-interoperability and supporting the transferability of  
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onboarding documentation between institutions could support such efforts to regulate de-risking. Furthermore, to limit the regulatory uncertainty, the regulator should aim to provide

for customisations of its de-risking based approach for categories most affected by de-risking (Correspondent Banking Relationships, Non Profit Organisations, Fintechs, MSBs). Finally, to facilitate decision makers' ability to internalise danger, the regulator should provide further guidance and support for categories that represent a greater source of risk to financial institutions. It should develop and sign-off a risk appetite evaluation tool and methodology to validate financial institutions' risk appetite and ensure decision makers' risk appetite is aligned to that of the regulator.

The following table lists key actions the regulator could implement to address de-risking systemically:

Theory	Recommendations	Outcome(s)
Facilitate victims' ability to internalise or reject danger.	1) Create frameworks or mechanisms to facilitate danger rejection as performed by Dahabshiil (e.g. the use of courts and leveraging laws and regulation).	Financial institutions are incentivised to keep danger internalised and continue to manage the business relationship.  FIs identify which complexity they can face: dealing with potential victims' danger rejection or the potential ML risk they represent.  FIs may end up facing more complexity than their systems and controls can handle to avoid litigation.
	2) Provide support and/or training with the development of robust KYC/CDD for victims and decision-makers.	De-risked customers have stronger internal processes which may increase their costs but ensures ongoing access to banking services.  In turn, the banking industry develops greater confidence in its high risk customers' internal AML processes.
	3) Increase the notice period between decision to de-risk and actual customer exit and provide a mechanism, platform, or information system for swift onboarding to other institutions.	Provides time for victims to identify the next course of actions and enables other systems within the environment to decide whether they can internalise such newly generated danger.
Incentivise decision-makers	4) Customise de-risking proposals	The regulator regains a certain level of responsibility temporarily and hence liability

<p>to maintain danger internalisation.</p> <p>Decrease the danger within the environment</p>	<p>(Correspondent Banking Relationships, Non Profit Organisations, Fintech, MSBs).</p> <p>Provide further guidance and support for categories that represent a greater source of risk to financial institutions.</p>	<p>to ensure that the private sector has a clear understanding and visibility of the regulator's expectations.</p> <p>This may increase the regulator's reputational and credibility risk but in exchange such an initiative will reduce the FIs' regulatory risk.</p>
<p>Facilitate decision makers' ability to internalise danger.</p>	<p>5) Develop and sign-off a risk appetite evaluation tool and methodology to validate financial institutions' risk appetite and ensure decision makers' risk appetite is aligned to that of the regulator.</p> <p>Oversee and sign-off FIs' RBA.</p>	<p>By formalising their risk appetites, financial institutions may decide to unbank categories of customers in what the regulator may qualify as a wholesale manner. While this may create an initial de-risking wave, it will increase the transparency of the jurisdiction's overall risk appetite, facilitate information flow and as such increase decision-makers' confidence in the regulator, remove uncertainty, thus increasing decision makers' ability to internalise danger and facilitating re-risking across the financial system.</p>
<p>Facilitate decision makers' and victims' ability to transfer risk and danger to the environment and internalise danger.</p>	<p>6) Introduce guidance on a De-Risking Based Approach (DRBA) that formalises the management and handling of de-risking</p>	<p>Develop a set of flexible measures to assess countries and FIs' appetite and/or tolerance to ML risk more effectively and apply measures proportionate to the level of appetite and/or tolerance in order for FIs to focus their DRBA more effectively.</p> <p>Develop specific guidance and support for de-risking scenarios with case studies for both decision-makers and victims (as per Luhmann's risk/danger model) as per recommendations 1 to 5.</p>

Table 1: Recommendations to address de-risking



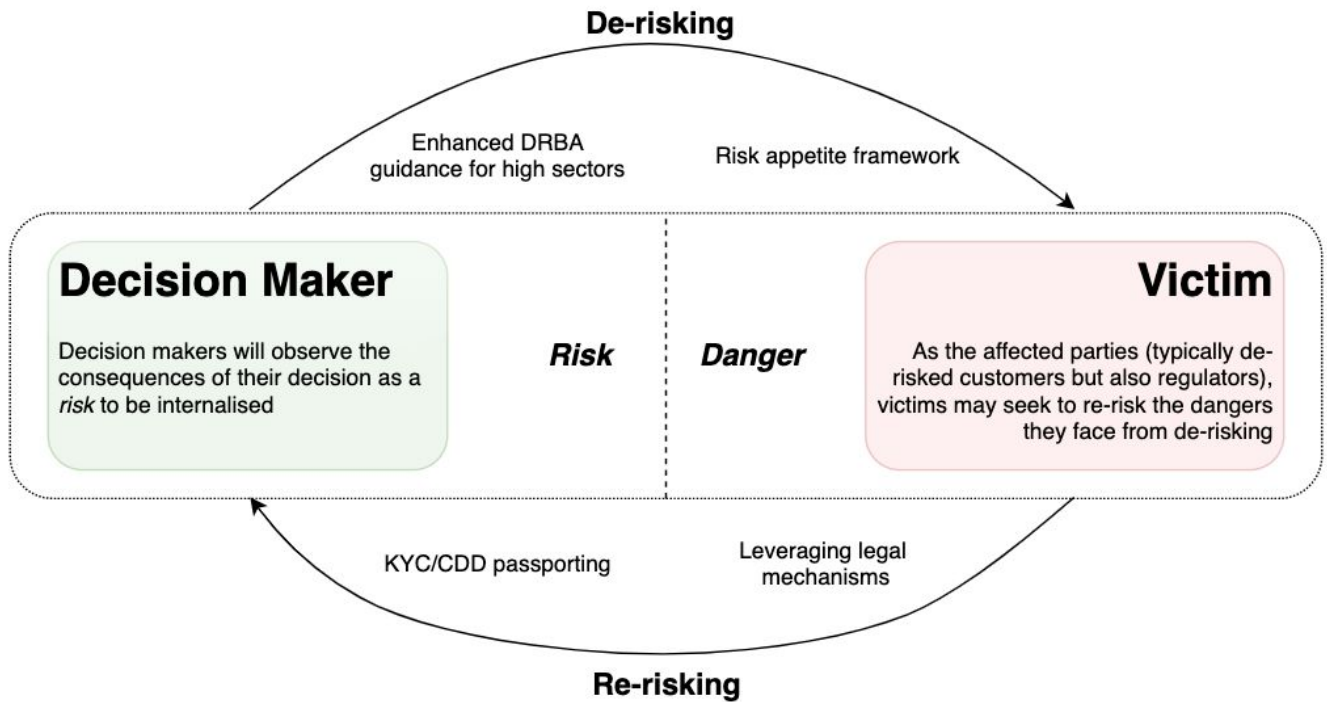


Figure 6: The De-Risking Based Approach

Figure 6 summarises the recommendations documented in Table 1 and articulates the De-Risking Based Approach.

## CONCLUSION

The relevance of Luhmann's work on risk and the risk/danger model has been illustrated through Barclays Bank's 2015 regulatory fine, the de-risking phenomenon, and Dahabshiil vs. Barclays Bank, thus demonstrating the versatility of Luhmann's theoretical framework for exploring and understanding the AML domain. In light of Luhmann's risk/danger model, we argue that de-risking should not be prevented nor discouraged. It needs to be managed carefully through the introduction of a de-risking based approach (DRBA). Organisations need to have the ability to de-risk in order to minimise their level of complexity and align it to the robustness of their internal systems and controls. Victims have the possibility to reject danger or to internalise it as a risk which, too, can subsequently be de-risked. Through the de-risking process, a system signals that a particular risk is being externalised and converted back into a danger that other systems can internalise as a risk or face as a danger. Accordingly, regulators should leverage the dynamic between risk and danger and implement measures to support victims of de-risking by enabling the latter to either reject or delay the danger of de-risking. In



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3 addition, regulators must manage the level of complexity faced by the risk-takers (i.e. the  
4 decision makers) once they feel that their systems can no longer handle a certain risk threshold;  
5 in this context, regulators should minimise the regulatory ambiguity and uncertainty which  
6 financial institutions perceive as regulatory risk. This can be achieved through accepting  
7 greater liability and developing greater transparency with regards to financial institutions' and  
8 regulators' ML risk appetite.  
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