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Consequences of Money Laundering in Banking Sector

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Abstract

Banks are traditionally measured as pillars of economic prosperity. The best banking system will be able to ensure good production in all sectors of the economy. Money laundering is the process of providing legitimate appearance to the illegally gained revenue. Money Laundering has the tradition of eroding the financial institutions and weakening the financial sectors' role in economic growth. It has the habit of facilitating corruption, crime and other illegal activities at the expense of countries development and can increase the risk of macroeconomic instability. Banks and other financial institutions are at the forefront of the battle against the money launderers. The negative economic effects of money laundering on economic development are difficult to quantify. International society expects every bank to perform customer identification and due diligence as it is the important control measure in preventing criminals from entering into the legitimate economy. The cost involved in combating money laundering and terrorist financing transactions are increasing largely on yearly basis however unable to eradicate them.

Keywords: Money laundering; anti-money laundering; black money; financial institutions

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■1.0 INTRODUCTION

"Financial institution" is defined as any person or entity who conducts operations for or on behalf of a customer, acceptance of deposits, lending, financial leasing, financial guarantees, currency exchange, portfolio management and insurance. A country's economic fortune depends on the evolution of trade, commerce industry, agriculture, transport and communication etc. The Banking industry provides the basic power to withstand any kind of situation to all these industries with their fiscal services. Banking system promotes the economic status of the people by providing them all kinds of fund management services.

Banks are traditionally measured as pillars of economic prosperity. The best banking system will be able to ensure good production in all sectors of the economy, which will help in creation of more employment. The banking sector has undergone some reputation hits in the last two decades due to money laundering issues and subsequent penalties. The common form of money laundering is through financial services and products offered by the banks, insurers, stock brokers etc.

■2.0 MONEY LAUNDERING

Money Laundering is the proceeds of an "unlawful activity", unlawful activity can be any activity which is related, directly or indirectly to any crime or illegal activity. Launders utilize arms transportation, smuggling, human trafficking, embezzlement, tax fraud, bribery, drug trafficking and prostitution for generating huge amount of funds. After the generation of illegal money, con artists requires concealing the sources, converting the form and transfer of money to different jurisdiction and regions where it is less likely to attract attention of the authorities. Money laundering has three different stages

Placement: introduction of illegal proceeds into fiscal system in the form of cash or cash equivalent. This can be accomplished through deposit, currency exchanges, purchase of monetary instruments etc.

Layering: separation of illicit money from their source by layers of financial transactions. The objective is to conceal the audit trail so that it is difficult for law enforcers to trace the illicit proceeds.

Integration: providing legitimacy to illicit wealth by the re-entry into the economy. In the last stage it will be difficult to differentiate between legitimate and illegitimate funds.

Financial Action Task Force (FATF) an Inter-governmental body promoting policies to combat money laundering and terrorist financing defines of Money Laundering as:

The conversion or transfer of property with knowledge that it is derived from criminal activity or from participation in that

activity, for the purpose of concealing or disguising the illicit origin of the property, or assisting anyone who involved in the commission of the acts to evade the legal consequences of his action.

- Concealing or disguising the nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that the property is derived from criminal activity or from an act of participation in that activity.
- The acquisition, possession or use of property, knowing when it is received, that it was derived from criminal activity or from an act of participation in the activity.
- Participation in, association to commit, the attempt to commit, and the aiding, abetting, facilitating and counseling the commission of any of the mentioned actions.

■3.0 INTERNATIONAL ORGANIZATIONS INVOLVED IN COMBAT MONEY LAUNDERING

FATF is an inter-governmental body established in 1989. The objectives are to set standards and promote the engagement of regulatory, legal and operational measures for combating money laundering and terrorist financing threats to the integrity of the international financial system. The FATF has issued "40 Recommendations" which was first issued in 1990 and revised in 1996, 2003, 2004 and latest version came in 2012. The Basel Committee is established by the central bank governors of the G-10 countries in 1974, it promotes sound supervisory standards worldwide. It has published papers on Customer Due Diligence for Banks (2001); sharing of financial records between jurisdictions in connection with the fight against terrorist financing (2002); guide to Account Opening and Customer Identification (2003); consolidated KYC Risk Management Paper (2004).

Wolfsburg is an association of 11 global banks which has the aim of developing standards for money laundering controls for banking sector. European Union Directive requires the EU members to prevent money laundering and also issued papers on money laundering. In 1995, The Egmont Group of Financial Intelligence Units was formed; it is an informal international gathering of financial intelligence units (FIUs). They have issued papers on Principles for Information Exchange Between Financial Intelligence Units for Money Laundering Cases (2001), Best Practices for the Exchange of Information Between Financial Intelligence Units (2004) etc. The International Monetary Fund has laid policies and also published research papers to combat money laundering and terrorist financing.

■4.0 EXPECTATIONS FROM GLOBAL SOCIETY

International society expects every bank to perform customer identification and due diligence as it is the important control in preventing criminals from entering into the legitimate economy and financial system. By using the watch list published by governments, international organizations at least the known criminals can be kept out of banking transactions, the significant lists include Office of Foreign Asset Control (OFAC) list, United Nations (UN) list, European Union (EU) list etc. Suspicious activity report (SAR) filing is an initiation of investigation against the suspected money launders and other criminals hence sharing of timely information will help the prosecutors to identify the con artists. Benami transactions can be minimized by identification of ultimate beneficial owners.

Anti Money Laundering (AML) department operating under the banks are likely to act as the 'first line defense' against money laundering, utilizing their due diligence activities to identify and report relevant account holders. Transaction pertaining to cash intensive business has to undergo high level scrutiny. The list of businesses that are
vulnerable to money laundering are casinos including Internet casinos, real estate, bars and restaurants, trade in high-value items, such as expensive cars, antiques, precious metals, precious stones. Trainings are to be provided to every employee of the bank on Anti Money Laundering requirements, which will avoid tipping off as it is considered to be serious criminal offense. As per record keeping requirement every record pertaining to identification evidence and financial dealings are to be maintained for minimum five years even after the closure of account. Monitoring of customers is typically performed based on both an automated procedures and manual analysis.

FATF suggests the following as elements of AML program:

- Development of internal policies, procedures
- Designation of a compliance officer
- An on-going training program
- An audit function to test programs

■5.0 PENALTIES PAID BY THE BANKS:

Globally, penalties paid by banks for not adhering to Anti Money Laundering requirements are very high. In 2012 HSBC paid a record penalty of 1.9 Billion USD, in 2010 ABN AMRO Bank paid 500 million USD for stripping information from funds transfer instructions.

In 2012, Coutts & Company paid 8,750,000 GBP for failing to take reasonable care to establish and maintain effective anti-money laundering systems and controls. In January 2004, UK's Financial Services Authority (FSA) has fined Bank of Scotland PLC 1,250,000 GBP for failing to maintain proper records for customer identification as required by the FSAs Money Laundering Rules.

In India, on 9th October Reserve Bank of India (RBI) fined ICICI Bank 30,00,000 INR and ING Vysya Bank 55,00,000 INR for violating Know Your Customer
and Anti-Money Laundering requirements. In the first six months of 2011, 48 banks have been fined by RBI for the violation of KYC and AML norms.

Table 1 Banks penalized in united states for not complying with aml norms

Year	Name of the Bank	Fine Amount
2012	HSBC Bank	1,900,000,000 USD
2012	First Bank of Delaware	15,000,000 USD
2012	Moneygram International, Inc	100,000,000 USD
2011	Ocean Bank	10,900,000 USD
2011	Lower Sioux Indian Community	250,000 USD
2011	Pacific National Bank	7,000,000 USD
2011	Victor Kaganov	25,000 USD
2011	Zions First National Bank	8,000,000 USD
2011	Mizrahi Tefahot bank	350,000 USD
2010	Pinnacle Capital Markets	50,000 USD
2010	Intercredit Bank	200,000 USD
2010	Eurobank	25,000 USD

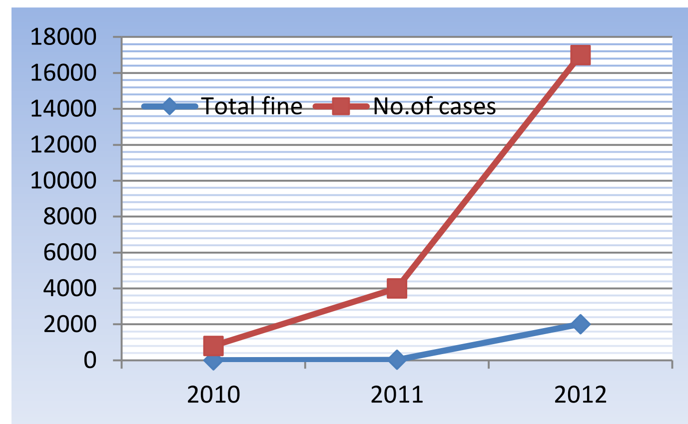

Figure 1 A graph shows the number of cases in Banks of USA for not complying with AML Norms

Table 2 Descriptive statistics and correlation matrix

Year	Total Fine in US $	Mean	Standard Deviation	Variables	V1	V2
2012	2015000000	671666667	1064616519	Total fine (V1)		
2011	26525000	4420833	4790261	No.of banks (V2)	-0.5	
2010	**275000**	68750	89850	No.of defaulting cases (V3)	0.98	-0.33

Table 3 KPMG survey on cost of AML compliance surveillance

	KPMG 2004 survey	KPMG 2007 survey	KPMG 2011 survey
Cost of Compliance	The Cost of AML Compliance increased sharply. Average increase over the previous three years was 61%, with no respondents reporting a decrease in investment	AML costs grew beyond expectation. Average costs grew 58% in the previous three years, compared to a prediction of 43% growth in 2004	Costs continue to rise, at an average rate of 45%, against a prediction of over 40% in 2007. The extent of cost rises is underestimated by many

■6.0 CONSEQUENCES OF MONEY LAUNDERING IN BANKING SECTOR

Banks and other financial institutions are at the forefront of the battle against the money launderers. The usage of banking products to transfer criminal proceeds for money laundering and terrorist financing undermines the integrity of financial system. Financial market has become direct or indirect victim of money laundering. The cost spent by banks to combat money laundering has grown enormously due to the investment in modern software to identify money laundering transactions.

The difficulty of estimating AML costs is that costs are spread across several functions like operations, compliance, risk management etc involving direct and indirect costs. These features obscure the estimation of the cost level and assessment of past and future changes, which also impacts the quality of the information. AML activities require large investment for enhanced transaction monitoring and revision of KYC documentation for existing customers. Institutions failure to report could expose them to fines and sanctions by the competent authorities and worst case can result in revoking of banking license.

■7.0 BANK'S ROLE IN COMBATING MONEY LAUNDERING

Over the past years money launders has shown new patterns, to handle the emerging threats from criminals banks has to develop Anti-Money Laundering department. Anti-money laundering (AML) department has become an essential department in every bank as their progress is closely monitored by central banks, government, judicial system and international organizations. AML department is a cluster of several teams starting with Training, Know Your Customer (KYC), Watch list Filtering (Sanctions), Transaction Monitoring, Quality Assurance along with a team to fulfill the requirements of FATF and reporting requirements. Banks has their own risk appetite and risk based approach to increase or decrease the number of teams and workload within AML department.

Training: Every bank is expected to form a formal written AML training program depending on the role and relevance of every permanent staff and contract staff.KYC program is the best way to prevent money laundering. Periodical risk scoring and risk reassessment will ensure clients to get mapped under the accurate risk score. Watch list Filtering (Sanctions) is very crucial as it is the process of online verification of transactions against the watch list entities during every domestic and international transactions. Transaction Monitoring is an analytic process as the AML analyst has to identify suspicious and unusual transactions among millions of genuine transactions. Quality Assurance acts as internal audit which will have the opportunity to scrutinize all activities performed within AML teams like monitoring and filtering.

■8.0 CONCLUSION

Banks have a vital role in establishing trust among individuals, countries and also measured as a bridge between the government and common people. Awareness on money laundering and its consequences was realized by the international society in the last decade. Money launderers take advantage of the financial system using the differences between countries supervision, regulation, disclosure, and AML requirements. Banks operating in multiple jurisdictions are making significant changes to their business models in response to the far-reaching global initiatives against money laundering. World-wide there is an increase in the number of reports filed in every country FIU due to improved monitoring systems and increased staff awareness. At this current situation it is impossible to rule out the consequences of money laundering in the banks however by increasing the automated systems ability and vigilance among the banking staff there is an opportunity to control it.

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