Fintelekt

The State of Trade-Based Money Laundering Controls in the Indian Banking Industry

December 2018

OBJECTIVE OF THE REPORT

Trade-based money laundering (TBML) has been recognised by the Financial Action Task Force (FATF) as one of the most prevalent money laundering methods used by criminals through the abuse of trade transactions and trade financing.

In an increasingly globalised world, the magnitude of trade volumes coupled with intricacies such as different trading methods, complex documentation, cross-border financial transactions and multiple regulatory requirements make detection, monitoring and prevention of trade-based money laundering very challenging.

Globally, regulators such as the Office of Foreign Assets Control (OFAC), Monetary Authority of Singapore (MAS) and Hong Kong Monetary Authority (HKMA) have been spearheading the regulatory direction on TBML monitoring in recent years.

Within the Indian context, strong macro-economic fundamentals and global demand is resulting in increasing trade volumes, inherently leading to growing vulnerability of the Indian financial system being abused for TBML.

In December 2015, the Financial Intelligence Unit, India finalised an approach for implementation of a set of red flag indicators (RFIs) for TBML, which included behavioural / observational and transaction / event-based scenarios. These RFIs were circulated to all banks for implementation* as the primary control mechanism against TBML.

The objective of this Fintelekt Quick Insights Report on the State of TBML Controls in the Indian Banking Industry is to understand the progress in implementation of TBML controls among banks, highlight the challenges and discuss the way forward for the industry.

* *These red flag indicators and the guidelines around them issued by the FIU-IND are not in public domain and hence have not been published in this report.*

This Fintelekt Quick Insights report seeks to address questions such as:

- Have banks implemented all the Red Flag Indicators (RFIs) circulated by the FIU-IND?
- What are the challenges faced by the AML teams for TBML controls?
- What is the prevailing regulatory focus and oversight mechanism for TBML monitoring?
- How can challenges be addressed in a collaborative manner by the industry?
- What is the way forward for more robust TBML controls?

Growing Trade, Growing Vulnerability

Trade is integral to the Indian economy - Indian exports touched USD 221.8 billion in the April-August 2018 period, increasing by 20.7 per cent over the same period last year, as per data from the Ministry of Commerce and Industry. Imports in the same period were USD 269.5 billion, growing 21 per cent over the same period in the previous year. With rising trade, the demand for trade finance is growing too. A report by International Chamber of Commerce in 2017 shows that India was among the top five fastest growing exporters as well as importers using Letters of Credit (L/Cs) transmitted through SWIFT in the world.

However, trade is highly vulnerable to being used for illegal money transfers and terror financing. A report by Global Financial Integrity (GFI) pointed to as much as 80 per cent of illicit financial flows from developing countries being accomplished through trade-based money laundering. Estimates show that for India, illicit outflows of money due to trade mis-invoicing between 2008 and 2014 amounted to 1 to 2 per cent of trade volumes, while the inflows were 5 to 13 per cent of India's trade volumes.

> "Illicit outflows of money from India due to trade mis-invoicing between 2008 and 2014 amounted to 1 to 2 per cent of trade volumes, while the inflows were 5 to 13 per cent of India's trade volumes"
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> *- Global Financial Integrity Report April 2017 – Illicit Financial Flows to and from Developing Countries: 2005-2014*

As an integral part of the trading ecosystem and as the agency nodal to the flow of money, banks are obligated to put in place controls and monitoring systems to identify and report suspicious trade transactions and thereby expected to play an important role in the fight against TBML.

Regulatory Developments

Taking cognizance of the regional developments, in particular, guidance papers by the MAS, HKMA, as well as the FATF recommendations on TBML monitoring, the Financial Intelligence Unit India (FIU-IND) issued statutory guidelines for detection of TBML cases in December 2015. A working group chaired by FIU-IND along with participation from eight prominent banks finalised an approach for implementation of a set of red flag indicators (RFIs), which included behavioral / observational and transaction/ event-based scenarios involving trade transactions and trade finance. These RFIs were circulated to all banks, the implementation of which started in 2016 after an approach was put in place through mutual discussions among the involved parties.

From April 2015, the FIU-IND also mandated banks and other financial institutions to file Cross-Border Wire Transfer Reports (CBTRs) for all fund transfers over Rs. 5,00,000, with an intention to analyse the flow of illegal funds out of the country, a major chunk of which are suspected to be routed through trade mis-invoicing.

Another initiative by the Reserve Bank of India (RBI) was the introduction of automated transaction systems for export and import data – namely the Export Data Processing and Monitoring System (EDPMS) which was introduced in 2014, and the Import Data Processing and Monitoring System (IDPMS) introduced in 2016 – aimed at digitalisation and simplification of the trade documentation system, better compliance, easier tracking and thereby likely reduction in fraud.

Disparity in TBML Controls by Banks

Trade due diligence comprises monitoring and screening of all third parties involved in a trade transaction (buyer, seller, shipper, etc), screening of integrated goods, vessel, port and country risks, pricing validation using real-time pricing data and real-time shipment tracking (vessels, routes, ports).

However, in reality bankers face several challenges in the process. Issues around verification of pricing, tracking vessels used for transportation, country-level sanctions, etc. arise mainly owing to the fact that bankers have limited visibility into the complete trade transaction.

Moreover, estimates suggest that not more than 20 per cent of the trade volumes flow through the banking system in the form of trade finance, while the remainder is through open trading accounts. Banks have even lower visibility into the transaction when they are involved only as a third-party payment provider.

Globally, most of the focus of TBML monitoring is around trade finance monitoring, while open account transactions are treated as cash transactions. In India, compliance officers find significant risk in open account transactions in the areas such as advance remittances and cash payments. These have to be considered in addition to risks in the areas of trade finance.

The complexity involved in trade and the volume of trade transactions makes TBML monitoring a highly resource intensive and expensive proposition. Fintelekt research across a number of banks in India shows that currently there is significant disparity on the state of TBML controls across the industry.

This is especially the case in terms of implementation of the red flag indicators (RFIs) circulated by the FIU-IND in 2015. There is consensus among AML compliance professionals that these RFIs can be divided into two groups:

- The first group comprises RFIs which relate to customer and trade profiling and have an overlap with existing AML scenarios. Banks are finding these indicators relatively easier to automate into the existing AML monitoring system.
- The second group of indicators are subjective in nature and are more challenging to implement due to lack of specific data or insights. Alerts for these RFIs / scenarios are being generated manually by the trade finance operations teams, branch banking staff or the customer relationship managers.

Depending upon the level of awareness of the TBML threat, priority given to implementation of RFIs and the budgets/resources allocated to TBML monitoring, performance across various groups of banks varies significantly.

The foreign banks are leading the industry in the fight against TBML due to their exposure to global best practices, relatively higher budgets and more sophisticated technology support. On the other hand, some of the smaller banks, especially public-sector banks demonstrated very low awareness of the TBML threat itself and are mostly relying on manual alerts for TBML monitoring.

Based on discussions with AML compliance managers across a variety of banks, the state of TBML controls categorised by three different types of banks can be summarised as follows:

Global Foreign Banks	✓ Awareness of the TBML threat is high ✓ Relatively ahead on implementation of TBML controls as they are expected to comply with regulations in multiple jurisdictions ✓ Level of automation for AML transactions monitoring is high ✓ Relatively larger compliance budgets and more senior managerial buy-in for investing into technology, training and resources for TBML monitoring ✓ Usually have specialised teams within the central processing unit (often for global operations) handling TBML alerts, and therefore level of specialisation and knowledge is relatively high.
Private Sector Indian Banks and Large Public Sector Banks	✓ Relatively high awareness of the threat posed by TBML ✓ Level of automation for transactions monitoring is fairly high ✓ Most are already compliant or are in the process of automating the basic group of RFIs ✓ Implementation of subjective RFIs is at various stages of development, with some banks having made more progress than others ✓ Senior managerial buy-in for TBML is fairly high ✓ In most of these banks, roughly 10 to 15% of the AML team is focused on dealing with TBML alerts ✓ In some cases, staff is recruited from trade finance or trade operations teams which brings in specialised knowledge aiding AML analysts.
Smaller Public Sector Banks	✓ Many of the smaller public-sector banks seem to have relatively low awareness about the TBML threat ✓ Many of these banks are still in the process of implementing the basic RFIs, as there is low level of automation within the AML system as a whole ✓ Despite high transaction volumes, banks are relying largely on manual alerts generated by the trade finance team or branch level staff for TBML monitoring for all types of RFIs ✓ AML analyst teams in these banks are proportionately much smaller than those at private or foreign banks. Staff is transferred within the bank to various other departments leading to a serious lack of specialised knowledge on TBML, which may be a challenge for effective disposal of TBML alerts even where they are generated.

Disclaimer: The above observations are broad generalisations based on discussions with a limited sample of compliance officers; the performance of individual banks may vary significantly against this categorisation.

Implementation Challenges

Bankers face several challenges in the process of TBML monitoring. Some of the issues that merit highlighting are:

Training and Knowledge Building

Trade finance is a highly specialised area of knowledge and AML analysts dealing with TBML alerts often find it difficult to understand complex documentation, products and pricing related issues. The knowledge gap is being addressed by some banks by hiring or deputing staff from the trade finance operations team into the AML team, or over time training members within the AML analyst teams to specialise on TBML. However, AML teams grapple with high staff turnover and hiring challenges.

In public sector banks especially, the prevalent system of transferring resources from one department into another without a fixed tenure has created a serious lack of specialisation within the AML team. This has resulted in lower awareness of the TBML threat and therefore piecemeal application of TBML controls. Another problem is the relatively smaller size of AML teams which again impacts the ability to specialise in disposal of TBML alerts.

Apart from training and knowledge building within the AML compliance team, continuous training and unambiguous communication to operational staff for identifying and flagging off suspicious behaviours is equally important. Without the right amount of knowledge, AML compliance teams will not be able to create guidelines and put processes in place to effectively monitor TBML within the organisation.

"Compliance managers at public sector banks are transferred every two to three years, which leaves them little time for building the knowledge and understanding to draft clear policies and put in place a robust compliance programme"

Use of Technology

Over the years, automation in a variety of processes within banks have allowed AML teams to scan millions of transactions by applying RFIs and model scenarios based on money laundering typologies. However, when it comes to trade operations, the lack of standardisation in data and in many cases, manual data collection and storage does not allow the same level of automation for TBML controls.

The main challenge for most banks is to integrate their trade operations and AML systems with the core banking system so as to allow access to customer data and profiles on a single platform. In most banks, the trade operations system has not kept pace with the developments on the core banking system and it is only when these elements undergo upgradation that greater automation on TBML monitoring becomes a possibility.

Given the growing volume of trade and the number of transactions, the use of technology is becoming increasingly critical in areas such as real time screening, monitoring of shipments, detecting the presence of dual use goods, as also making data comprehensively available for the AML analyst to make robust decisions while disposing of alerts.

Effectiveness of Controls

Despite putting in place a number of controls, AML analysts point to the existence of a significantly large proportion of false positives in TBML alerts. The proportion of Suspicious Transaction Reports (STRs) filed is very low, and in some cases, reportedly negligible, which leads to the question of whether monitoring systems are adequate and effective.

An independent TBML-focused assessment will help understand the areas of high risk within the specific bank. It will help objectively evaluate the effectiveness of prevalent controls and emphasize improvement areas for the organisation, beyond the implementation of the general set of RFIs.

Availability of Customer Data

An effective TBML monitoring programme hinges on strong and comprehensive Know Your Customer (KYC) processes and on-going customer due diligence. Lack of focus on KYC and due diligence leads to information necessary for customer risk profiling, details about the customer's business or historical transaction details necessary to dispose alerts effectively not being available for AML analysts. In the absence of KYC data, the use of advanced technology such as artificial intelligence or machine learning is also not feasible for AML scenario building or for bringing down the proportion of false alerts.

Way Forward

Specific Regulatory Oversight for TBML Monitoring

Both the regulatory bodies overseeing the AML functions of banks in India, viz. the Reserve Bank of India (RBI) and the FIU-IND follow a risk-based approach in supervision, which could limit the ability and focus on supervision and regulatory action in specific areas such as TBML controls. This is also evident in the fact that not many penalties have been levied for lapses in TBML monitoring in the last few years.

There is thus a need for stricter and more targeted regulatory oversight in the area of TBML and levying of higher penalties so as to act as a suitable deterrent for banks to enhance their TBML monitoring programmes.

Collective efforts are needed across the industry to combat TBML and bring all banks on to a common baseline on TBML controls. Regulators can look at enforcing certain minimum checks that all banks must have in place to deter money launderers from mis-using trade finance systems.

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Harmonisation Across the Trade Ecosystem

Besides the measures needed at the level of each bank, there is an urgent need for harmonisation across the different elements of the trade ecosystem – ports & customs authorities, airlines, shipping companies, domestic shipping companies / truckers, agents, commodity dealers, etc. Digitalisation across these elements will allow a unified view of the trade transaction to players such as banks, on whom the onus of detecting TBML transactions currently lies.

The use of blockchain technology in bringing together all stakeholders such as involved trading parties, banks, shipping companies, customs and other regulatory authorities on to a single platform could be expected to have a disruptive effect on the availability and quality of data and documents in the trading process lead to greater efficiency and reduction of fraud.

Moving beyond the RFI approach

The RFI based approach to TBML monitoring may not take into account vulnerabilities on account of specific trade finance products within the bank. A risk-based approach that follows from continuous assessment of TBML risks classified by type of product can help individual banks to translate the RFIs into specific scenarios which will likely make TBML monitoring more effective. Further, building this risk into the AML monitoring system as well as the broader governance, risk and compliance strategy of the organisation will lead to more holistic coverage.

Industry Collaboration

Collaboration among various government agencies may also be necessary in enforcing higher standards in TBML monitoring. While FIU-IND is responsible for enforcing the PMLA in India, the trade finance teams of banks are regulated by the RBI. The Central Board of Excise and Customs, and the Directorate of Revenue Intelligence are the other two government bodies involved in the process of trade controls.

Discussions with industry players brought out the need to develop a negative list or registry of individuals or corporations who have been involved in TBML. While sharing of information in good faith is common among banks, a central repository could be spearheaded by the regulatory bodies to make the system more formalised.

Key Takeaways

Fintelekt's research points to disparities across banks in terms of TBML controls and challenges in combating TBML. The industry needs to come together and collaborate on several issues, especially in creating a system such that every stakeholder involved in TBML monitoring can get a unified view of every trade transaction end-to-end. This will ensure that money launderers and criminals do not take undue advantage by preying on the weaker links and loopholes in the system.

The importance of continuous training to staff to make them aware of trade risks and specialised knowledge building within the AML compliance team cannot be underscored more. Similarly, going forward for banks there may be no substitute to investment in technology for automation and real-time transaction monitoring to improve compliance in the right spirit.

Finally, an increase in regulatory focus, especially on smaller banks, will help the industry move forward towards more effective controls. This will not only enable individual banks to be better compliant with regulatory requirements but will also help mitigate money laundering and terrorist financing risks from trade at a national level.

Disclaimer

The information contained in this report is based on discussions with the banking industry and provides only a general guidance. Fintelekt does not take any responsibility for any loss arising to any person or organization acting or refraining from acting as a result of any material contained in this report or based on opinions expressed in this report. It is recommended that professional advice be sought based on the specific facts and circumstances.

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