

## Conference Paper

# Analysis of Methods for Regulating the Activity of Pawnshops in the Field of AML/CFT

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### Abstract

The increasing number of pawnshops working in the shadow economy has been an important problem in Russia for several years. The paper investigates the dynamics of the number of registered pawnshops, the reasons for the toughening of their AML/CFT regulation and analyzes the further development of the industry. Based on the analyzed data, the forecast of the number of registered pawnshops up to 2020 is compiled using the consolidation of the moving average methods and the analytical trend alignment, as well as the expert evaluation method. The main methods of pawnshop activity regulation have been analyzed and an expert evaluation of the effectiveness of their implementation has been carried out. The results obtained during the study allowed the authors to formulate a hypotheses on increasing the effectiveness of the methods under consideration, as well as to offer their methods for regulating the activity of pawnshops in the field of AML/CFT.

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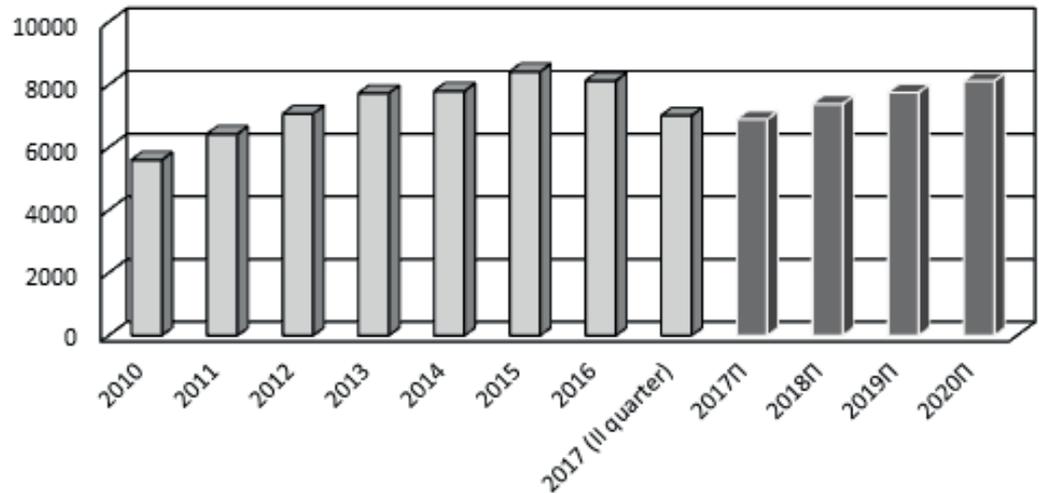
**Keywords:** AML/CFT, "gray" pawnshops, non-credit financial organizations, high-risk activities, the Central Bank of the Russian Federation, internal control rules.

## 1. Introduction

The popularity of pawnshops among the population in Russia has significantly increased since the currency crisis in 2014. This growth is due primarily to the lack of funds from citizens and the ease of obtaining microloans in pawnshops. The purpose of this article is to analyze the methods of regulating the activity of pawnshops in the field of AML/CFT by the Central Bank of the Russian Federation (further – CBR), as it has begun to regulate, control and supervise the activities of non-credit financial organizations (further - NFO) since September 1, 2013 in accordance with the Federal Law № 196-FL «On pawnshops» of 19.07.2007 (as amended on 13.07.2015) [1, p. 82].

Consider the dynamics of the number of registered pawnshops for 7.5 years and forecast the development of this industry until 2020.

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**Figure 1:** Dynamics of the number of registered pawnshops in the Russian Federation in 2010-2020. Source: compiled by the author based on data of the review of the state of financial accessibility in the Russian Federation for 2015-2016. URL: [http://www.cbr.ru/finmarket/development/development\\_affor](http://www.cbr.ru/finmarket/development/development_affor).

Figure 1 illustrates the constant growth in the number of registered pawnshops inclusively up to 2015: in 2015, this amount increased by 50.3% as compared to 2010. But in 2014, the CBR began to pursue an active policy to reduce high-risk and «gray» pawnshops, so the number of organizations in this industry has declined sharply: in the second quarter of 2017, the number of pawnshops fell by 16.7% as compared to 2015. Moreover, the CBR has seriously tightened the requirements for regulating pawnshops: regular reporting, providing the necessary documents in the field of AML/CFT, filling in detailed questionnaires, preparing reports on cash flows, etc.

In 2015, the CBR filed about 580 claims against pawnshops, out of which 432 were related to the liquidation of organizations. Despite such rapid cleaning already in 2016, this ratio was reduced almost twofold: more than 220 lawsuits were filed, out of which 93 were aimed at the liquidation of organizations [2].

Also, the authors predicted a scenario for the further development of the industry by 2020, using the moving-average method and the analytical trend alignment. The analysis revealed that the number of registered pawnshops would grow despite the tightening of control by the Central Bank. If the mathematical methods of forecasting are consolidated with an expert method, then we can get a more accurate forecast, oriented to the current situation in the industry.

That is why, the forecast was focused on the expert assessment, which also speaks about the further development of pawnshops, but at a more steady pace. Relating to this, it was decided to reduce the obtained data using mathematical forecast methods by 15%. This conclusion is based on the analysis of the completion of the CBR policy

aimed at reducing the «gray» pawnshops, as well as mitigating the supervision of small pawnshops (now they include companies with a turnover of up to 7.5 million rubles per quarter). As a document stipulating the conditions for regulating the operation of pawnshop, the Central Bank and the largest pawnshop associations prepared a roadmap for the development of the pawnshop market until 2020, which is being implemented since 2017 [3].

The sharp tightening introduced in the regulation of pawnshop operations led to the fact that since the beginning of 2017, 700 pawnshops have left the Russian market, and specifically into the shadows. Nowadays, about 30% of all pawnshops are working in the shade, or are transiting to commission stores, as it becomes unprofitable for owners to work on new terms [4]. Firstly, consumers suffer from «gray» pawnshops, as commission shops almost do not have any obligations, and organizations working in the shadows do not give any documentary evidence of transactions performed, so in most cases the client cannot return the pledged property.

The main goal of the existence of the «gray» pawnshops is to get the most profit from performing illegal operations or buying up stolen goods. One of the types of such illegal transactions is the legalization (laundering) of cash, or cashing for a commission of 12-15%. But today there are schemes for cashing out money from which pawnshops suffer themselves, without being aware of their own involvement in criminal activities.

Consider one of the ways of modern cashing money, which was discovered in 2016. A person can hand over any valuable thing to a pawnshop, and then return within a short time (less than 1 day) and buy the pledged property back with a credit card. With the help of this scheme, any person can cash out the necessary amount of money for a small commission of 0.3-0.4%. This is because the pawnshop charges for a one-day loan use less than the bank does for withdrawing money from a credit card at an ATM. Sberbank charges 3-4% for cash withdrawals, Alfa Bank - 3.9-5.9%, VTB 24 - 1-5.5%, besides per-diem limits are set on operations at ATMs [5].

This scheme of cashing monetary resources is unprofitable for pawnshops, for when paying through a POS terminal the pawnbroker spends up to 3% on cash withdrawal and acquiring, which means that pawnshop owners suffer losses. Moreover, when large amounts are being cashed, the owners also should pay an additional 2% for the collection.

The Bank of Russia has not taken any action to combat this type of cash withdrawal yet, since in early 2016 a statement was made that in 2015 about 400 billion rubles were cashed with the help of bank cards, and the above the scheme cost only 1.2 billion

rubles – that was 0.3% of the total cash withdrawn. Therefore, today pawnshops have started to form black lists of unscrupulous borrowers [5].

## 2. Materials and methods

We will consider the methods for regulating the activity of pawnshops of the Central Bank and will identify their effectiveness for the state and for the owners of the organizations. So, as the main method of regulating the activity of pawnshops, it was decided to create internal control rules for AML/CFT purposes. This document is the main internal document of the pawnshop, which regulates the internal control procedures. Its content is determined by Federal Law № 115-FL «On Countering the Legalization (Laundering) of Proceeds from Crime and Financing of Terrorism» of 07.08.2001, as well as by the regulations of the Bank of Russia [6]:

- Regulations on requirements for internal control rules of non-credit financial organizations with a view to counteract the legalization (laundering) of proceeds from crime and financing of terrorism (approved by the Bank of Russia on December 15, 2014 № 445-P) (as amended on July 28, 2016);
- Regulations on the identification of clients, client representatives, beneficiaries, beneficiary owners with the aim of counteracting money laundering and financing of terrorism by non-credit financial organizations (approved by the Bank of Russia on 12.12.2014 № 444-P) (as amended on 18.08. 2016).

The rules for internal control (hereinafter - IRC) for AML/CFT purposes are first requested from pawnshops when conducting inspections by the supervisory authorities - the Central Bank of Russia and the Prosecutor's Office. All the ICR documentation must be up-to-date and executed in accordance with the requirements of the legislation of the Russian Federation.

When analyzing the effectiveness of this method, it should be noted that a full PVK system can be implemented only by large pawnshops whose revenues exceed 120 million rubles per month. As for small and medium-sized businesses, they account for the majority of fines for violations of the IRC, as well as suits in arbitration courts. That is why, it is necessary to create a methodological basis for the PVK for each type of business.

Another method is to tighten the rules for reporting, according to which pawnshops are required to provide their reporting to the CBR quarterly, every six months, every 9 months, and annually. On the one hand, it allows to monitor the activity of pawnshops

of any type and size on an ongoing basis. But, on the other hand, small and medium-sized businesses are again suffering from newly implemented methods, which cannot financially afford to carry out reporting with such frequency. Having analyzed the problem of fines for failure to provide reports, the Central Bank of Russia decided that it is necessary to transform this system.

That is why the developed agile map contains proposals to weaken the reporting requirements for small and medium-sized businesses in this area. Such pawnshops will be able to report only once every six months, as well as to pay fewer penalties for minor violations of AML / CFT requirements. If these requirements come into effect, our state will be able to minimize the percentage of pawnshops operating in the shadow to the previous 10-15%.

### 3. Results

As an elaboration, optimization of methods for regulating the activity of small and medium-sized pawnshops will be proposed, since it is wrong to make the same requirements for networks with 100 pawnshops and small entrepreneurs. Moreover, this is necessary to ensure that small-size pawnshops do not change their activities to those of commission stores, pay taxes to the state fully, and consumers would be protected when using services of a different nature [7].

### 4. Conclusion

Today, the methods for regulating pawnshop operations are imperfect, which leads to an increase in the number of organizations working in the informal sector every year. That is why the Central Bank of the Russian Federation has taken thought about the modernization of these methods and the easing of conditions for regulating pawnshop operations.

After the expert evaluation of the effectiveness of the existing methods for regulating the operation of pawnshops, some of them were modernized, which would allow not only pawnshops to increase the profitability of their activities, but also the state to exercise more effective control over pawnshops, as well as to minimize the number of organizations working in the shade [8, p. 13].

TABLE 1: Optimization of methods for regulating the activity of small and medium-sized pawnshops. Source: developed by the authors.

Criterion	Modern regulation	Optimization	Necessity of change
Working hours	8 a.m.-8 p.m.	24 hours a day	<ol style="list-style-type: none"> <li>1. Helps detain criminals on "hot" tracks</li> <li>2. Allows not to violate the competition between KOs and NCOs</li> <li>3. Increases turnover of pawnshops, which accompanies an increase in tax payments</li> <li>4. Allows citizens to get a quick loan if necessary</li> </ol>
Reporting	Mandatory provision of quarterly, semi-annual, 9-month and annual reporting of the Central Bank	Mandatory reporting of quarterly statements only	<ol style="list-style-type: none"> <li>1. Small and medium-sized pawnshops do not have enough financial resources to fulfill the set conditions</li> <li>2. The number of pawnshops that do not report is significantly reduced</li> </ol>
Encashment	Required	Optional, but extended cash flow statements are required	<ol style="list-style-type: none"> <li>1. For small and medium-sized companies this is an unreasonable waste, since they do not have large amounts of cash</li> <li>2. Expanded reporting will allow the Central Bank to track and control cash flow</li> <li>3. Pawnshops will be more responsible for meeting these conditions, since reporting requires less expenditure than daily collection</li> </ol>
PVC in the field of AML/CFT	The same system for pawnshops of any size	It is necessary to create an individual simplified methodology for conducting internal control	<ol style="list-style-type: none"> <li>1. Small and medium-sized pawnshops cannot fully implement IVF due to insufficient funds, so it is easier for them to pay fines</li> <li>2. Pawnshops will carry out all ICR in AML / CFT sphere, which means that the state will be able to minimize the risks of involving organizations in illegal activities</li> </ol>
List of activities	Limited (provision of short-term loans secured by valuables, provision of storage services, consulting and information services)	It is necessary to add: <ol style="list-style-type: none"> <li>1. renting of premises or safe boxes for rent</li> <li>2. provision of agency services (sale of insurance and money transfers)</li> <li>3. the operation of deposits up to 500,000 rubles.</li> </ol>	<ol style="list-style-type: none"> <li>1. Expanding pawnshop operations will allow the CBR to strengthen control over their activities through the introduction of additional reporting</li> <li>2. Additional services are needed to attract new players to the industry</li> <li>3. Expansion of activities will reduce the number of pawnshops operating in the shade, as it will be difficult for them to hide their activities</li> </ol>

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