

## Conference Paper

# Transforming the Regulation of Russian Financial Institutions: a Response to Modern Challenges of Money Laundering and Terrorist Financing

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## Abstract

The paper reveals the approach to the regulation of Russian financial institutions, which is aimed at identifying their vulnerabilities to risks and building risk profiles for a set of interrelated risks. In the framework of this approach, the authors outline the concept of the relationship between the vulnerabilities of financial institutions and households to the risks of money laundering and terrorist financing, as well as a methodology for identifying the vulnerabilities of systemically important banks to these risks. As a result of the application of this methodology, three types of risk profiles of Russian banks were identified, their visualization was presented, and the corresponding vulnerability zones were specified. The authors formulated proposals for the mega-regulator of the Russian financial market and for systemically important Russian banks based on the regulation of financial institutions aimed at reducing their vulnerability to risks.

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**Keywords:** vulnerabilities of financial institutions, money laundering and terrorist financing risks, risk profiles.

## 1. Introduction

Transformation of the system of regulating Russian financial institutions is taking place in response to modern challenges and threats, caused by both the unsustainable development of the global financial market and the active dissemination of new financial technologies. It is possible to single out the following directions in regulatory transformation:

- 1) supplementing the risk-oriented approach to the financial market, based on Basel requirements, by the provisions of the risk-based approach developed by the FATF and implemented in the system of anti-money laundering and combating the financing

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of terrorism (AML/CFT), namely: by emphasizing the identification of financial vulnerabilities institutions as an element of risk assessment within the triad “threat – vulnerability – consequences”. This will allow passing on to a preventive response to threats;

2) taking into account the interrelationships of financial institutions and households, as changes in the population’s savings activity and its operations in the financial market significantly affect the stable functioning of financial institutions, including their AML/CFT risks;

3) developing risk profiles of financial institutions for both money laundering and terrorist financing risks, and for other types of financial risks, and introducing monitoring of such risk profiles as a tool for regulating the activities of Russian financial institutions.

The risk-oriented approach has become the mainstream of financial regulation. However, the practice of its implementation is different depending on the subject of regulation and the scope of application. The risk-oriented approach is treated by the megaregulator of the Russian financial market as identical to proportional regulation, i.e. dividing financial institutions into systemically significant and insignificant ones and establishing separate regulatory regimes for each of the groups. At the same time, it is obvious that in this case the assessment of the risks of financial institutions is replaced by the assessment of systemic significance, which is not the same. After all, within their group, systemically significant financial institutions can differ in the level of risks, which means insufficient effectiveness of the regulatory regime established for the whole group.

On the other hand, within the AML/CFT system, which includes financial institutions as subjects of primary monitoring, the risk-oriented approach relies on the notion of risk as the triad “threat – vulnerability – consequences”, from which it follows that risk assessment should be implemented in a comprehensive manner, but the identification of vulnerabilities as a key element of risk creates opportunities for the regulator to reduce risks and take protective measures.

These differences in approaches and risk assessment taken together create the basis for the formation of a regulatory approach that is focused on the vulnerability of financial institutions. The approach involves identifying vulnerabilities, creating measures for additional protection or reducing vulnerabilities. Vulnerabilities are understood as those areas and activities in which the threat of the risk can be realized, as

well as those factors that contribute to the realization of the risk. In contrast to the risk-based approach based on Basel requirements, the proposed approach allows reacting to the risks of financial institutions.

A preventive response to threats of systemic risk growth is understood as early identification of threats, detection of existing vulnerabilities to these threats, and taking measures to neutralize threats, as well as to reduce or further protect vulnerabilities.

The proposed approach solves macroeconomic problems, and at the same time logically complements the approach and the pilot project of Rosfinmonitoring on the typology of risk profiles of financial organizations, which was launched in 2016 on the basis of 12 largest banks. The combination of these approaches can create a positive synergetic effect in the regulation of the financial market.

In the framework of the presented approach, we have developed a concept of the relationship between the vulnerabilities of financial institutions and households to the risks of money laundering and terrorist financing, as well as a methodology for identifying the vulnerabilities of systemically important banks to these risks.

The concept of the relationship between the vulnerabilities of financial institutions and households to the risks of money laundering and terrorist financing (ML/FT) is as follows. Financial institutions, by their nature, are vulnerable to ML/FT risks [1]. Moreover, studies (for example, [2]) show that households with different risk tolerance and financial literacy may be vulnerable to ML/TF risks. Being interconnected in their activities, financial institutions can both transfer their vulnerabilities to the ML/FT risk to households, and vice versa, become vulnerable to household risks.

The transfer of vulnerability to the ML/FT risk from financial institutions to households can occur through:

- 1) direct involvement of money resources legally raised from households in money laundering, that is, households become indirect involuntary participants in the money laundering process (for example, according to the schemes outlined in [3]);

- 2) indirect involvement of money resources legally raised from households in money laundering. An example is the loss of household funds as a result of revocation of banking licenses due to repeated violations of the requirements contemplated in Articles 6 and 7 of Federal Law No. 115-FZ within one year.

The channels for transmitting vulnerabilities to the ML/FT risk from households to financial institutions are fraudulent schemes. In the securities market these are such schemes "as: the laundering of money by an individual (household) by purchasing an open joint-stock shell company, money laundering by an individual (household)

obtained as a result of tax evasion by electronic transfer of securities or acquisition shares in another country, money laundering by an individual (household) obtained as a result of insider trading" [2], through Internet-based trading accounts and others.

There are "the following fraudulent schemes organized by individuals in the sector of non-banking financial institutions: the organization of a fictitious pawnshop by an individual (household) for cashing cash, collusion of an unscrupulous client-individual with a pawnshop about distorting the appraised value of a thing for cashing in of money resources," and others [2].

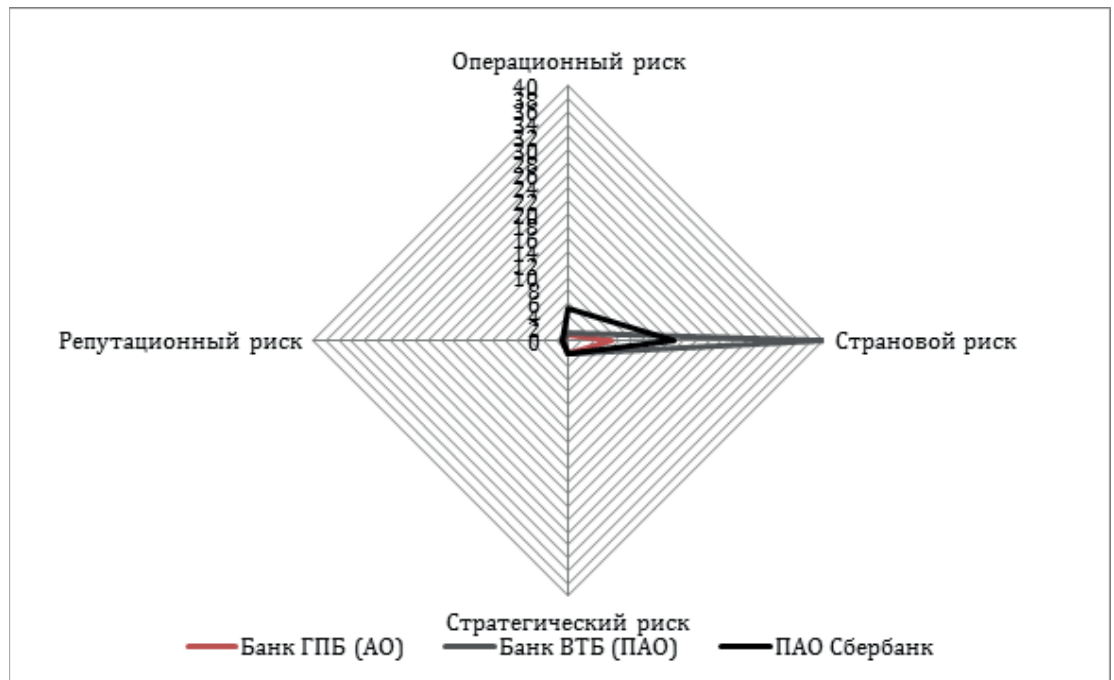
In the banking sector, the following fraudulent schemes are known: "the organization of pseudo-entrepreneurial structures for the purpose of money laundering by means of withdrawing and crediting funds to bank accounts, organizing the cashing of criminally acquired funds abroad" [2], illegal banking activities [4].

After the exchange of vulnerabilities with households, financial institutions may become poorly protected before external threats, the impact of which is the realization of the risk of money laundering and terrorist financing.

## 2. Materials and methods

To avoid the growth of ML/FT risks, it is necessary to identify vulnerability zones, take measures to protect them or reduce them. In order to identify the vulnerabilities of banks to ML/FT risks, we developed an appropriate methodology, first introduced in [5].

The idea of the interconnectedness of risks in banking is the basis of the methodology for identifying bank vulnerabilities to ML/FT risks. Accordingly, in the first stage, bank risks related to the ML/FT risk were selected and the possible relationships were substantiated based on an analysis of the nature of violations by Russian banks of AML/CFT legislation. The next step is to assess the selected risks on the basis of the Bank of Russia regulatory recommendations and authoring developments. Based on the received values of bank risks, its original risk profile is formed for each bank. Further, the resulting risk profiles are grouped and split into types. "Grouping is implemented in the following way: the first group of banks has the values of at least one of four risks above the average level for the group; the second group has at least one of the four risks below the average for the group. Typologization is based on the nature of the risk profiles. The definition of vulnerable areas correlates with the rationale for the relationship of the risks under consideration" [6, p. 36].



**Figure 1:** The type of risk profile of Russian systemically important banks with the dominance of two risks. JSC Bank GPB, PJSC Bank VTB, PJSC Sberbank. Source: authoring

Approbation of the methodology was carried out for a group of 10 Russian systemically important banks for 2014. Moreover, in order to reveal the monitoring potential of this methodology, it was tested on the Public Joint-Stock Company “Bank Otkritie Financial Corporation” for 2014 – 2016. We used data presented in the monthly and quarterly financial statements of banks published on the Bank of Russia’s official website [www.cbr.ru](http://www.cbr.ru).

### 3. Results

Three types of risk profiles were identified: those with the dominance of two risks; those with the dominance of one risk; those without a pronounced emphasis on a particular risk based on the results of applying the methodology for identifying vulnerability zones of banks to the risks of money laundering and terrorist financing (Fig. 1-3).

“The type” with the dominance of two risks “includes banks in the profile of which two risks assume a value that is above the average for a group of systemically important banks” [6, p.36] (Fig. 1).



**Figure 2:** The type of risk profile of Russian systemically important banks with the dominance of a single risk. JSC UniCredit Bank, PJSC Promsvyazbank, JSC Raiffeisen Bank, JSC Russian Agricultural Bank. Source: authoring

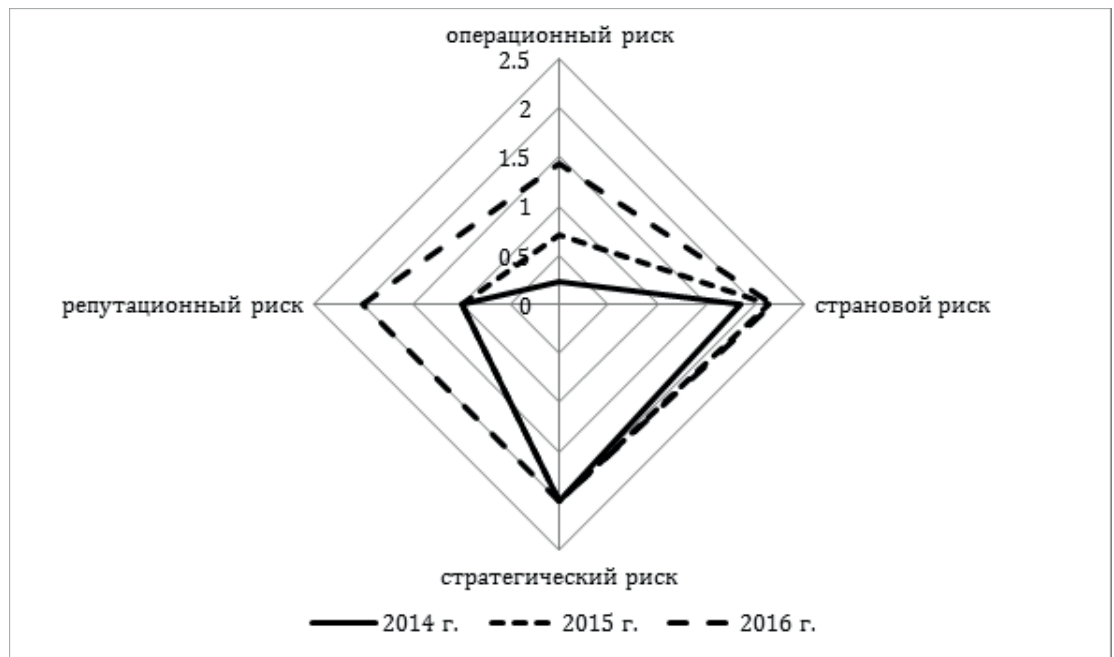


**Figure 3:** The type of risk profile of Russian systemically important banks with no expressed emphasis on a particular risk. JSC Alfa-Bank, PJSC Bank Otkritie Financial Corporation, PJSC Rosbank – Societe Generale Group. Source: authoring

The type “with the dominance of one risk” includes “banks in the profile of which one risk takes a value that is above the average for a group of systemically important banks” [6, p.37] (Fig. 2).

“The third type includes banks, in the risk profile of which there is no pronounced emphasis on any risk” [6, p.37] (Fig. 3).

The results of typologization show that “banks that have risk profiles with dominance of one or two risks are vulnerable to the risks of money laundering and terrorist financing” [6, p.38].



**Figure 4:** Change in the risk profile of Public Joint-Stock Company “Bank Otkritie Financial Corporation” in 2014-2016. Source: authoring

As for the risk profile of the Public Joint-Stock Company “Bank Otkritie Financial Corporation”, Figure 4 shows an increase in the levels of operational, reputational and country risks in the period from 2014 to 2016.

Thus, additional testing of the author’s methodology for 2014-2016 for the Public Joint-Stock Company “Bank Otkritie Financial Corporation” shows the accumulation of vulnerabilities of this bank, resulting in the application of financial recovery measures to it in 2017. We believe that this demonstrates the possibility and effectiveness of using the author’s methodology for determining zones of banks’ vulnerability to ML/FT risks for preventive responses to risks.

#### 4. Discussion

Analysis of risk profiles of Russian banks allows us to conclude on the following vulnerability zones for Russian systemically important banks: “1) correspondent relations with foreign banks and foreign trade contracts; 2) the actions of bank customers, counterparties and employees, forming a business reputation of banks” [6, p.38].

In order to reduce the vulnerability of correspondent relations with foreign banks and transactions in foreign trade contracts to ML/FT risks, we believe it is possible to recommend to Russian banks the analysis of counterparty countries in foreign economic transactions, which will supplement the country’s risk assessment with the

results of the position evaluation in the international AML/CFT system. By the country's position in the international AML/CFT system, we mean the country's membership in the FATF and/or FATF-style regional groups, as well as the results of the procedure for assessing the implementation by the countries of the FATF Recommendations.

In order to protect clients, counterparties and employees of the bank from unfair and improper actions that may lead to the disclosure of information about the insufficient effectiveness of the internal control system or the involvement of the credit institution in illegal financial transactions, we believe it is possible to recommend to the Bank of Russia to include evaluation of reputational risk on a regular and possibly uniform methodological basis into the range of instruments for banking regulation and supervision.

## 5. Conclusion

The approach which is focused on the vulnerability of financial institutions to risks, and its in-depth characterization by the example of the risks of money laundering and terrorist financing, implies a meaningful transformation of the regulation of Russian financial institutions, because it:

- provides a preventive response to threats to the stability of financial institutions and the financial market as a whole;
- relies on the construction of risk profiles as an illustrative, clear and easy-to-use tool for analysis;
- can be used to monitor the risk profiles of systemically important financial institutions;
- is also applicable at the level of the financial market regulator in order to take measures to protect typical vulnerabilities or vulnerable areas for a group of financial institutions, and at the level of individual financial institutions in order to reduce the vulnerabilities existing on an individual basis.

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