PART 4.
RISKS MET BY BANKS IN THE SYSTEM OF FACTORS INFLUENCING THE MONEY LAUNDERING PROCESSES

4.1. Use of monitoring to reduce bank risk in the area of money laundering and terrorist financing

In the process of the development of the modern market environment, the competition in the internal and external markets is intensifying, which results in the emergence of factors affecting efficiency of banking activity. Under these conditions, the issues of increasing efficiency of risk management in the banking sector remain urgent.

The globalization of financial markets and the change in the system of financial and economic relations with all the corresponding positive and negative consequences for the subjects of this system is a characteristic feature of modern economic processes. Under such conditions, the increase in banking operations occurs at a qualitatively new level, through the implementation of international standards of banking and resource support for the implementation of active transactions. As a negative consequence, the system of banking risks has also changed, especially under the influence of the growth of economic forms exceeding the officially recognized social norm in the context of money laundering. Banking activity is considered as one of the key instruments for the legalization of proceeds from crime, which gives rise to the probability of financial losses under the influence of a money laundering risk. Thus, at the macro and micro level, solving this problem is an extremely topical issue.

Such outstanding scientists as V. Bobyl [45], L. Bondarenko [47], O. Burbelo, L. Chunikhina [49], O. Krykliy [98], L. Kryvonos [103], L. Prymostka [145], and many others have paid considerable attention to studying the problems of management of banking risk of money laundering and terrorist financing. However, despite the significant scientific results obtained by the above mentioned and other scientists, measures to reduce banking risks in the field of money laundering remain insufficiently studied.

The aim of the work is to study the essence and specifics of risks in the banking system, in particular those related to money laundering, and the formation of recommendations for mitigating such types of risks by monitoring tools.

Risk is inherent in all types of business activity and it cannot be avoided when making decisions about placing money in a bank, buying shares and other securities, investing in new production, etc. In most cases it is impossible to make an absolutely accurate forecast for a whole range of characteristics of economic objects, projects, processes that are being analyzed (inflation rates, market conditions, etc.). The use of innovative ideas and new technologies is always accompanied by risk, but attempts to avoid innovation can stop the progress of society [195].

When studying the concept "banking risk", in most cases scientists are trying to adapt the definition of the category "risk" to specific conditions of its emergence in banking activity. In view of this, there can be no significant differences in the approaches used in both cases. Thus, for example, S. Dmytrov singles out six approaches to the definition of the concept "banking risk" [61]: as probability of deviation from the expected result; threat of loss; probability of both incurring losses and receiving profits; uncertainty in forecasting the result; a situational characteristic of a bank's activity, reflecting the uncertainty of its result; banking activity related to overcoming uncertainty.

The carried out analysis of the definitions of the concept "banking risk" presented in literary sources indicates that most of them are similar, and the differences lie mainly in the chosen approach to understanding the essence of risk in general. In interpretations of the concept "banking risk", as a rule, attention is focused on its financial nature, which manifests itself in the form of possible consequences of a risk situation. Thus, the National Bank determines a banking risk by its effect on capital and revenue [22].

Thus, an overwhelming majority of researchers distinguish the financial component of banking risks and tend to think that banking risks are financial risks that result in losses. This conclusion is confirmed by the fact that when considering individual banking risks researchers once again emphasize, first of all, the financial component.

With the help of morphological analysis, the key aspects of the essence of banking risks are identified and their systematization carried out (table 4.1).

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Table 4.1. Results of the clarification of the essence of banking risk

Key aspect	Detailization of the key aspect	Clarification of the definition
Probability	of deviation of the volume, spatial and temporal parameters of a bank's financial flows from the expected ones	due to implementation of active–passive operations, their organization, the state of corporate governance and the influence of environmental factors
		which results from a purposeful action or inaction of interested stakeholders
	of an expected or unexpected event	which can have a negative impact on a bank's capital and / or revenue
	of loss of income or decrease in the market value of a bank	due to adverse effects of external or internal factors
Possibility	of losses incurred by a credit institution or deterioration in its liquidity	due to occurrence of adverse events related to internal or external factors
		in case of occurrence of unfavorable for the bank circumstances
	of occurrence of an adverse event	which can cause losses by a banking institution of some of its resources, lack of income, or additional costs resulting from its activities
	of lack of income or reduction in the market value of a bank's capital	due to adverse effects of external or internal factors
Threat	of losing by a bank its resources, lack of income, incurring additional expenditures	which can result from carrying out financial transactions
		which can result from rendering services to customer
Characteristics	of a bank's activity	which reflect the uncertainty of its (activity) result
Danger	of losses arising from the specifics of operations	which are carried out by credit institutions
Uncertainty	of the result of a bank's activity	which can cause adverse consequences in case of failure
Value	of a possible event	which can cause financial, or reputational losses

Source: compiled by the authors [126]

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As can be seen from table 4.1, banking risk can be considered as probability of deviation of the volume, spatial, and temporal parameters of a bank's cash flows from the expected ones, ability of a credit organization to experience losses or deterioration in liquidity, threat of loss of its resources, uncertainty of the result of its activity, risk of loss, event which can cause losses expressed in monetary terms, and characteristics which reflect its uncertainty.

Taking into account the results obtained, banking risk in the field of money laundering and terrorist financing can be interpreted as an action or inaction of authorized persons or clients which can lead to financial, operational, or reputational losses.

The most common in the economic literature is the classification of banking risks which distinguishes external risks, including: natural disasters, political, economic ones, etc., and internal risks, including: risks of management, organization and implementation of banking operations, financial risks [98; 145; 212]. Therefore, external risks are related to changes in the external environment of a bank and are not directly dependent on its activities. The impact of external risks on the performance of a bank is extremely high. Management of these risks is most difficult and sometimes impossible. For their evaluation, basically logical methods of analysis are used. Internal risks include those arising directly from activities of a particular bank. The existing risks are diverse and can be divided into corresponding categories. The versatility of the concept "risk" is due to the variety of factors that characterize both the features of a particular type of activity and specific features of uncertainty in the context of which banking activity takes place.

It should be noted that irrespective of the types and classes of banking risks, their influence is mainly manifested in financial losses of a bank due to disruption of the cyclicity and balance of inflows and expenditures in the structure of its financial flows at carrying out all types of its operations.

Considering the existence of the money laundering risk, the classification of banking risks can be generalized as follows (figure 4.1).

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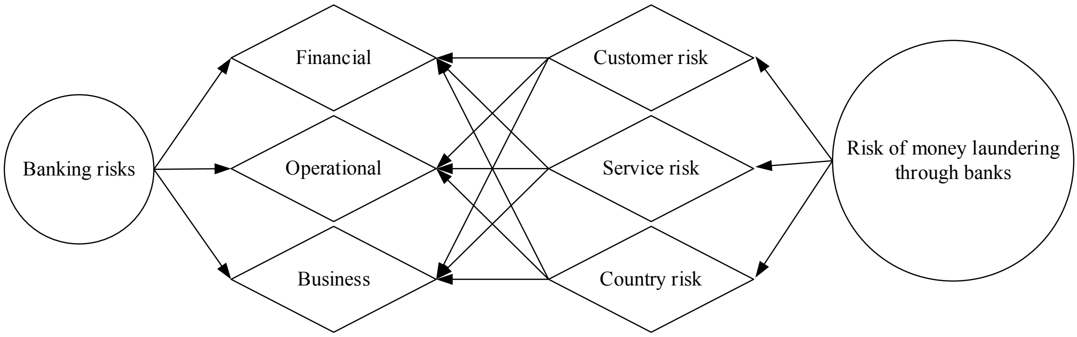

Figure 4.1. Classification of banking risks with consideration for the risk of money laundering
Source: formed by the authors [126]

Banking business is inherently related to risks which are generated by numerous factors (external environment, structure of assets and liabilities, other financial and functional factors) affecting their level and, consequently, the way of their analysis and methods for their measurement and mitigation. Understanding the nature of these risks, their correct evaluation and management allows to avoid or significantly reduce possible losses for banking institution, especially as a result of the impact of the current global financial crisis, the depth and duration of which turned out to be much stronger than expected. The importance of banks in the functioning market system, as well as the current crisis phenomena, necessitate an adequate evaluation of risks, their analysis and reflection in managerial information to ensure conscious management and control. The risk management process is continuous in nature, its stages alternating with each other. Mechanisms for protecting banks against risks consist of current risk management and methods for risk minimization.

In order to regulate banking activity on the basis of off-site surveillance to monitor activities of individual banks and the banking system as a whole, the NBU establishes prudential standards [124].

Table 4.2 presents the values of the main indicators of the prudential standards for the banking system of Ukraine in recent years [124].

The size of the regulatory capital of a bank should not be less than the minimum size of the regulatory capital of a bank (H1) established by the National

Bank of Ukraine. If the RC has a negative or zero value, then in the calculation of the ratios its conditional value – one hryvnia – is taken.

Table 4.2.Values of the prudential indicators for the banking system of Ukraine for 2015–2018

Indicator		2015	2016	2017	2018
H1	Regulatory capital (UAH million)	169 492,5	99 305,4	138 526,0	115 817,6
H2	Regulatory capital adequacy ratio (not less than 10%)	14,03	8,92	13,34	16,10
H4	Quick ratio (not less than 20%)	44,94	72,25	59,30	55,55
H5	Current ratio (not less than 40%)	81,38	78,76	87,40	108,08
H6	Short-term liquidity ratio (not less than 60%)	83,85	88,82	91,01	98,37
H7	Ratio of maximum credit risk exposure per counterparty (not more than 25%)	22,64	23,13	21,37	20,29
H8	Ratio of large credit risks (no more than 8 times the regulatory capital)	306,58	551,47	321,28	208,31
H9	Ratio of maximum credit risk associated with transactions with insiders (no more than 25%)	-	63,72	28,80	17,89
H11	Ratio of investment in securities for each individual institution (not more than 15%)	0,01	0,002	0,001	0,0001
H12	Ratio of total investment (no more than 60%)	3,17	1,39	0,64	0,22

Source: summarized by the authors [126]

From table 4.2 it is obvious that in recent years Ukrainian banks have observed almost all of the prudential standards, except for:

the ratio of adequacy of regulatory capital (H2), which as of January 1, 2017 amounted to 8.92, i. e., was less than 10%. The obtained result indicates that banks do not cover the negative consequences of various risks that they assume in the course of their activities and ensuring the protection of deposits, financial stability and stability of their banking operations;

the ratio of maximum credit risk associated with transactions with insiders (H9), which must not exceed 25%, was 63.72% as of January 1, 2017 and 28.80% as of January 1, 2018. The results indicate that the risk which arises in the course of transactions with insiders may lead to direct or indirect impact on banking activity.

In general, it should be noted that during 2015–2018 all of the indicators demonstrate volatile behavior, which testifies to instability in the banking sector. To assess the degree of variation of the prudential indicators, the coefficient of variation [125] was used.

According to the scale for assessing the degree of variation, in the period 2015–2018 the indicators were grouped as shown in table 4.3.

Table 4.3. Scale for assessing the degree of variation of prudential indicators using the coefficient of variation (CV)

Coefficient of variation	Assessment of variation	Prudential indicators ranked by degree of variation
CV ≤ 10%	The aggregate of indicators is relatively homogeneous, and the degree of variation is low	H6 (6%), H7 (5%)
10% < CV ≤ 25%	The aggregate of indicators has an average degree of heterogeneity and variation	H1 (20%) H2 (20%) H4 (17%) H5 (13%)
25% < CV ≤ 50%	The aggregate of indicators has a high degree of heterogeneity and variation	H8 (36%)
CV > 50%	The aggregate of indicators has a very high degree of heterogeneity and variation	H9 (5 %) H10 (120%) H11 (83%)

Source: calculated by the authors [126]

From the results obtained, it is possible to conclude that the highest degree of volatility is observed with the ratios of short-term liquidity and maximum credit risk exposure per counterparty. In addition, the indicators demonstrate a positive trend, their values approximating those recommended by the standard. Taking into account the results of the study presented in [125], it should be noted that this trend has stayed stable since 2003.

The regulatory capital, the regulatory capital adequacy ratio, the quick and current ratios (H4 and H5) have an average degree of heterogeneity and variation, which is also a continuation of the trend which has been observed since 2003.

The ratio of large credit risks (H8) has a high level of variation, but during the period under review its value remains within the limits established by the standard.

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A very high degree of variation is characteristic for prudential indicators concerning investment (H11 and H12) and regulation of banks' operations with insiders (H9). Since during the period under review their values are within the established limits, such variations are an evidence of the reaction of the banking sector to changes in the economic environment and do not present a threat to its functioning, besides this situation has been observed since 2003 and is shifting towards improving the values of the indicators.

In accordance with the concept of monitoring based on risk evaluation, responsibility for controlling risks lies with the management of a bank and the supervisory board of the bank. And the system for assessing the money laundering risk is part of the system of risk-based financial monitoring. Such monitoring ensures quality management of the development of all the most important economic and financial parameters of banking activity and is extremely relevant under present crisis conditions. The system includes mechanisms for risk identification by the key areas: KYC – Know Your Customer, KTYC – Know Transactions of Your Customer, KCYC – Know Customer of Your Customer, KYBP – Know Your Business Partners, KYE – Know Your Employees, which are the practice of international standards of managing risks related to money laundering through the banking system.

Most definitions of the concept "financial monitoring", which have been proposed in recent years in works of domestic and foreign economists, comprise the following main components: presence of a complex of actions, determination of funds and goals. Based on the results obtained, it can be concluded that financial monitoring is a persistent and continuous process that includes observation, analysis, evaluation, and forecast of financial transactions which reveal signs of laundering of criminal proceeds or terrorist financing. Only after that appropriate measures are taken regarding the assets and participants in the financial transactions they carry out.

In accordance with Article 5 of the Law of Ukraine "On Prevention and Counteraction to Legalization (Laundering) of Proceeds from Crime, or Financing of Terrorism", the system of financial monitoring consists of two levels: primary and state one [22].

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A bank which has separate divisions can create an intra-bank system for preventing the legalization of criminal proceeds and financing of terrorism, in accordance with which certain powers to maintain the register of financial transactions, make decisions on reporting to the State Financial Monitoring Service of Ukraine on financial operations in a certain region will be exercised by authorized by the bank separate divisions and their responsible officers.

Among financial transactions that fall under the criteria of financial monitoring, there are the following:

- transfer of funds in cash to an account with their subsequent transferring to another person on the same business day;
- transfer of funds to or their withdrawal from the current account of a legal entity or a sole proprietor if the operations on the specified account have not been carried out since the day of its opening;
- transfer of funds abroad in the absence of a foreign economic agreement (contract);
- transfer of funds to the current account of a legal entity whose period of activity does not exceed three months from the date of registration;
- withdrawal of funds from the current account of a legal entity whose period of activity does not exceed three months from the date of registration.

The consideration of the main subsystems of financial control organizations in the monitoring structure allows to conclude that Ukraine is implementing a mixed model of financial monitoring. For its part, the NBU in terms of legal support develops proposals for improving the legislation of Ukraine, makes amendments to the existing legal acts and adopts new ones; in terms of methodological support provides recommendations on the application of certain norms of legislation, responds to questions of banks, places relevant information on the official website of the NBU.

It should be noted that significant work has been done in Ukraine in the direction of ensuring legal support for the prevention, detection, and suppression of such unlawful activities.

The current legislation regulates the administrative and legal status of subjects of such countering, the order of their coordination and interaction, the main measures that they take in this area, the order of bringing perpetrators to justice. A further reform of the domestic legislation should be carried out with regard to the international efforts taken. Thus, at the international level, the Financial Stability Board (2009) and the European Systemic Risk Board (ESRB) (2010) were created. Moreover, in 2010 the Basel Committee on Banking Supervision approved the Basel III, and in 2013 the Capital Requirements Regulations (CRR) and the Capital Requirements Directive (CRD IV) were adopted. The above mentioned documents, among other things, introduce macroprudential instruments. The ESRB has published recommendations for macro-prudential policies, which include expanding the mandates of central banks to ensure financial stability, and setting up inter-agency councils/committees on financial stability.

After the economic crises, the banking system of Ukraine demonstrates stable trends, functioning under conditions of tighter regulation by the state. In 2017–2018, with the aim of ensuring financial stability, the NBU continued to improve its approaches to banking regulation and the relevant regulatory framework.

The fundamental changes in the field of banking regulation are as follows:

- Change in the procedure for evaluating credit risks, which makes it possible to qualitatively update the processes of formation of reserves and identify the imbalances in their evaluation.
- Change in approaches to measuring the size of bank capital based on stress testing, which in the future will facilitate the capitalization of banks.
- Transformation of the standard regulating the restrictions on insider transactions by introducing new criteria to define insiders and increasing the transparency of the ownership structure and the identification of final beneficiaries.
- Change in the method for identifying non-performing assets, which allows to more objectively determine the quality indicators of banks.
- Preparation for introducing and testing the new prudential standards, in particular, the indicator LCR – a new tool for regulating bank liquidity, the new requirements for the structure of bank capital, etc.