The colour of money: Black or white?

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Background

With the intention of controlling black money, combatting the financing of terrorism and curbing the circulation of counterfeit currency in the economy, the Government of India (GoI) has undertaken various initiatives over the last five years[1], which include, amongst others:

- Appointing a Special Investigation Team (SIT)
- Implementing the 'Black Money (Undisclosed Foreign Income and Assets) Act, 2015' (The Black Money Act). A 90 day compliance window was provided within which the GoI allowed a person to make a declaration of undisclosed assets located outside India under the compliance provisions of the Black Money Act.
- Implementing the Pradhan Mantri Jan Dhan Yojana (PMJDY) scheme, licensing of 'Payment Banks'/ 'Mobile Wallets' as measures of 'Financial Inclusion'
- Linking bank accounts with Aadhar and subsidies through Aadhar-linked bank accounts
- Requiring the disclosure of bank account details in income tax returns
- Implementing an income disclosure scheme (IDS) 2016
- Withdrawal of legal tender character of the existing bank notes in denominations of INR 500 and INR 1000 issued by the Reserve Bank of India (RBI) till 8 November 2016, or commonly referred to as "demonetisation".

While the GoI might undertake other measures in the future to address the black money concern, corruption and counterfeit currency, the demonetization initiative stands out as one of its boldest measures so far with a far-reaching impact.

Analysing the impact of demonetisation on money laundering:

The impact of demonetisation has been observed across the political and economic environment in India and according to our research, it has largely impacted the counterfeit currency circulation, alternative remittance system such as 'hawala' and parallel networks of illegal money changers such as 'hundi', 'angadia' etc.

It is also expected to have a widespread impact on inflation and availability of liquidity with the banks, which could affect lending rates. In the short term, cash availability in sectors such as real estate, agriculture and other cash-based industries has been impacted, and there have been many reports in the media about the inconveniences caused to the lives of common people.

The GoI has announced heavy penalty for the deposit of cash which does not match the income tax returns filed by the individual,[2] and to end-run these provisions, various money hoarders and facilitators are resorting to widespread and innovative methods. In our research, we have attempted to:

- collate various methods which individuals and entities are using to convert unaccounted cash, and list the impact which these methods may have on money laundering
- provide an overview of the modifications to the existing AML system that should be considered to identify these innovative methods of money laundering. These measures are largely applicable to bank branches of commercial banks and regional rural banks/co-operative banks.

In addition, some of the measures suggested here could also be adapted by the other cash exchange centers specified by the RBI in its 'Frequently asked questions' on the 'Withdrawal of Legal Tender Character of the existing Bank Notes in the denominations of INR 500/- and INR 1000/-'. These include:

  - 19 offices of the Reserve Bank of India
  - The head Post office and Sub post offices.

1. Various circulars of Reserve Bank of India, Income Tax Department and Ministry of Finance, Government of India

2. http://economictimes.indiatimes.com/wealth/personal-finance-news/deposits-above-rs-2-5-lakh-to-face-tax-penalty-on-mismatch/articleshow/55337775.cms

Figure 1. According to our research, some of the identified methods being used to convert unaccounted cash into bank deposits are as follows:

Source: KPMG in India's analysis, November 2016

Besides, other sophisticated methods could also include creating multiple legal persons (e.g., companies/ LLPs/fake business entities), misuse of dormant accounts and opening multiple bank accounts to avoid threshold limits prescribed by the government (i.e., resorting to schemes such as structuring and smurfing). This is especially true because there is still much to be done in terms of streamlining the current framework for transparency in the beneficial ownership of legal persons, as well as in terms of transparency and beneficial ownership of legal arrangements in India.

On the basis of probable modus operandi that might be used, the following section covers potential mitigation steps that banks could undertake while conducting transaction monitoring to spot those needles in the haystack. They could then report the same to the relevant authorities through Suspicious Transaction Reports (STRs), Cash Transaction Reports (based on Ministry of Finance (MoF) circular dated 15 November 2016 (notification no. 104/2016)) and also Counterfeit currency reports.

Transaction-monitoring: Potential methods to spot red flags

The Ministry of Finance (MoF) in its circular dated 15 November 2016 (notification no. 104/2016) has specified the limits of old notes deposit, beyond which deposits would be monitored from the perspective of income tax. Banks have been instructed to report total cash deposits during 9 November, 2016 to 30 December, 2016, pursuant to change in Income Tax Law announced on 17 November 2016.

The new limits for cash deposits in old bank notes between the aforementioned period are as follows:

- INR twelve lakh fifty thousand (12.5 lakh) or more, in one or more current accounts of a person.
- INR two lakh fifty thousand (2.5 lakh) or more, in one or more accounts (other than a current account) of a person.

As per our analysis, most of the transaction monitoring alerts will have to be redesigned based on above limits provided by the MoF for both existing accounts and new accounts opened during the period 9 November 2016 to 30 December 2016.

Besides, we have provided factors below, which could be evaluated for transaction monitoring for the probable methods of converting unaccounted money into accounted money, evading the tax liabilities listed in the previous section.

For ease of understanding, we have segregated the red flags pertaining to non-money mule activities and money mule activities.

Figure 2. Some non-money mule related red flag indicators are as follows (this is not an exhaustive list):

Gold purchases
- Spurt of activities in accounts of gold traders, their associates & family members
- Multiple cash deposits in home branches, other branches and multiple branches
- Evident attempts to structure deposits to bypass monitoring thresholds
- Round tripping of funds in select customer accounts of the trader

Temple hundis
- Sudden increase in cash deposits in temple trust accounts as deposit of offerings
- High-value investments and random high-value commodity purchases in accounts
- Opening of new accounts in the name of trust associates (beneficiaries, authorised signatories)

Backdated fixed deposit
- Large amounts of FDs booked in the last three months (prior to 9 November 2016)
- Pending or inadequate KYC documentation for new FDs
- High encashment of FDs in the next three months
- High number of loan foreclosures prior to announcement of Demonetisation

Payment of advance salaries
- High value and third-party cash deposits in the accounts of employees of a specific organisation
- Creation of multiple salary accounts of one employee
- Increase in third party cheque issues from the salary accounts (both new and existing)

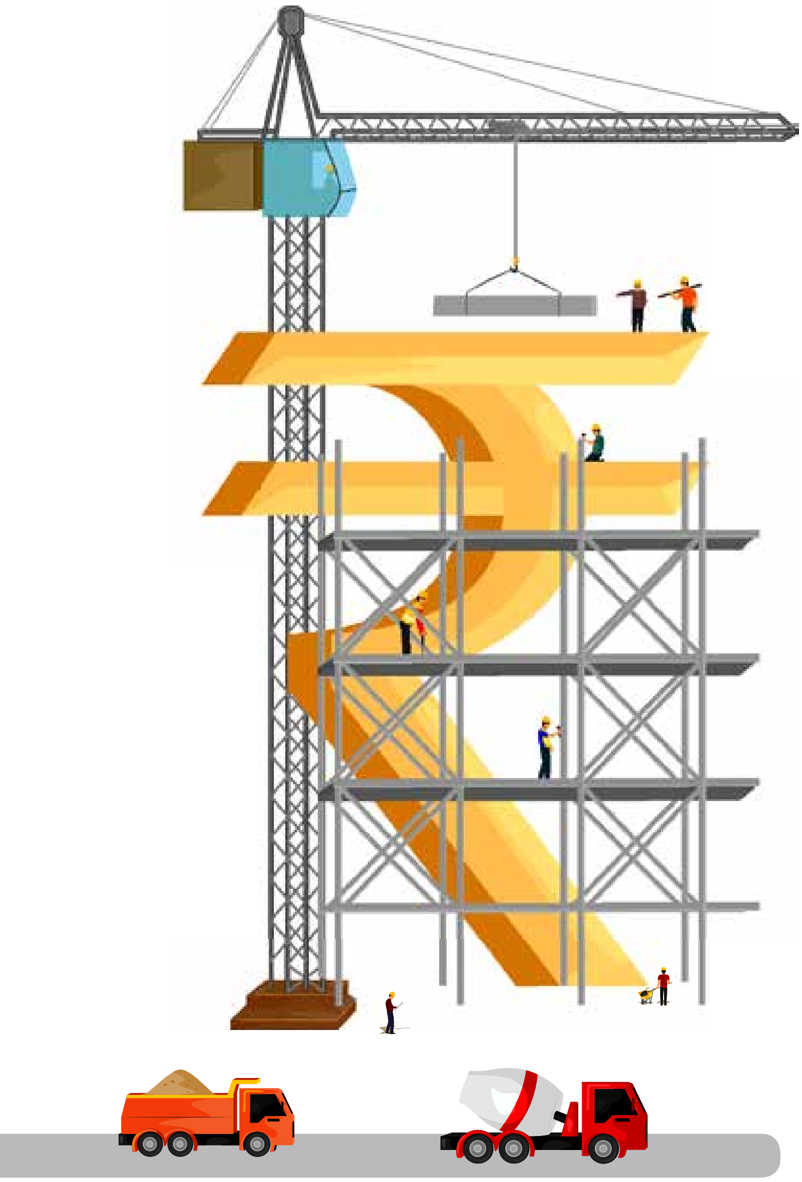
Agricultural income
- Opening of new accounts with high volumes of activity (deposit and withdrawals)
- Third-party cheque issues from the account
- Profile mismatch of customers claiming to have earned agricultural income for the current financial year

Donations to political parties
- Sudden surge in cash deposits by political parties and corresponding investments
- Rise in random high-value purchases of assets/commodities followed by sale
- Multiple and large withdrawals post 30 December 2016 for purposes not related to elections

Cash deficit firms
- High value cash in hand, declarations and deposits
- Formation of mergers or new subsidiaries reporting high revenue
- Clearance of bank overdrafts in cash
- Subsequent cash out or redrawing reduced overdraft balances

Source: KPMG in India's analysis, November 2016

Figure 3. Some money mule related red flag indicators are as follows (this is not an exhaustive list):



Source: KPMG in India's analysis, November 2016

Short-term loans

- Trend of cash deposits by multiple individuals into their own accounts from the same locality, household, club, party or firm below the threshold
- Withdrawal of funds immediately or with a gap of a few weeks
- Possible Politically Exposed Person (PEP) links

Bank note mafia

- Trend of multiple cash deposits by the same individuals from the same locality, club or party, just below the threshold, at various branches of the same bank
- Subsequent withdrawal of funds of a lesser amount
- Possible PEP links

Pradhan Mantri Jan dhan Yojna accounts

- Sudden spurt of activities in the account (deposits and withdrawals)
- Multiple cash deposits in the same branch or different branches away from the locality of the account holder
- Multiple cash deposits in other banks
- Multiple cash deposits by the same set of individuals or the same individual (third party or parties) in the account
- Subsequent withdrawal of all funds

Farmer accounts

- Sudden spurt in activities without the knowledge of the account holder
- Multiple cash deposits in other banks
- Multiple cash deposits by the same set of individuals or same individual (third party or parties) in the account
- Subsequent withdrawal of all funds

Potential next steps for banks

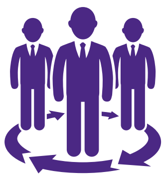
Based on the methods and the money laundering indicators listed in the previous section, the banks would be under a substantial load to modify their existing Anti Money Laundering systems and processes.

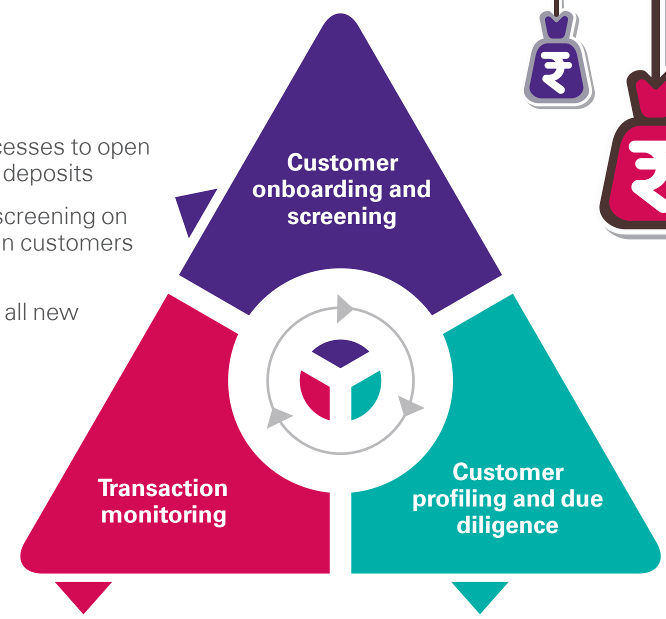
Considering that the GoI and the Income Tax Department have requested high vigilance from the banks[3], it is likely that there will be a surge of alerts triggered by the transaction monitoring system and the same would result in an increase in the filing of Cash Transaction Reports (CTR), Counterfeit currency reports (CCR) and Suspicious transactions reports (STR). However, with the recommendations from the regulator the banks would require to be even more careful regarding the supporting information they would provide to the FIU for STRs and CTRs.

To counter the aforementioned, banks are recommended to strengthen their existing framework in several ways, including the following functions for example (this is not an exhaustive list):

Figure 4. Potential next steps for banks

Source: KPMG in India's analysis, November 2016





- Implement robust processes to open new accounts for cash deposits
- Incorporate adequate screening on new accounts or walk-in customers depositing cash
- Review documents for all new accounts opened

- Re-adjust thresholds as per customer profiles such as cash-intensive businesses and as per GoI directives
- Monitor sudden spurts in activity
- Pinpoint activity-profile mismatch
- Perform analysis of circular movement of funds for a period of at least six months
- Monitor transactions in PMJDY accounts and PEP accounts

- Perform extensive analytics for cash deposited by:
  - Existing customers in various branches
  - Walk-in customers for the purpose of old note exchanges in the same branch and various branches
  - Walk-in customers quoting incorrect account numbers or fake ids
  - Dormant accounts
- Link analysis of customer profiles across the same geography, households, organisations, PEP linkages
- Link analysis of cash deposits in the various products and services availed by customers for instance loans, credit cards and mutual funds
- Profile employee and vendor accounts
- Identify high risk occupations and businesses

3. http://www.business-standard.com/article/pti-stories/demonetisation-vigilance-to-track-chain-of-money-launderers-116111501378_1.html

Potential next steps for the government

While this initiative has a far-reaching impact, there remains measures to be taken to achieve the objectives of curbing black money. These include measures to:

- Bring transparency in the beneficial ownership of legal persons and legal arrangements
- Strengthen national cooperation and coordination among various agencies (inter-agency cooperation),
- Roll out customer due diligence, record keeping and reporting requirements to District Central Cooperative Banks (DCCBs)
- Bring the segment of designated non-financial businesses and professionals (DNFBP) which includes accountants, auditors, lawyers, trust and company service providers, jewelers in gold and precious metals, real estate agents, casinos, etc. under the purview of the enhanced due diligence measures of Regulated Entities.[4]

Conclusion

To help 'Demonetisation' achieve its desired objectives, macro-level measures also need to be undertaken such as implementing other relevant recommendations of the Special Investigation Team (SIT) instituted by the MoF, transparency in beneficial ownership, and bringing designated non-financial businesses and professionals (DNFBPs) under the purview of Enhanced Due diligence.

The SIT in its fifth report (14 July 2016)[5] had recommended two critical measures to control the black money in the economy:

- Ban on cash transactions above INR 3 lacs
- Imposing an upper limit of INR 15 lacs on cash holdings.

The SIT had also recommended the following key measures to control black money in the economy, in it's earlier reports[6]:

- Disclosure of foreign investment or purchases of assets to the income tax department
- control the generation of black money through the education system, religious institutions and cricket betting
- Additional courts to expedite pending cases under Income Tax Act, creation of the Central KYC registry, and empowering the Directorate of Revenue Intelligence to undertake investigations in financial crime-related cases
- Control money laundering through the misuse of exemption from long term capital gains
- Obtaining information on the 'beneficial ownership' of Promissory Notes to ascertain ownership and, hence, prevent their misuse.

The success of the demonetisation measure will depend on a number of factors, including the continued political will of the central government and rigor with which the scheme is implemented as per its stated objectives.

In our view, one of the key next steps in the fight against black money could be to mandate that the proceeds of gold sales must be credited to bank accounts above a certain threshold (for example INR 50,000) and make PAN furnishing mandatory for such transactions – this can help tackle the dilution of presently-hoarded black money and can also have transformational impact.

4. Regulated Entities as defined by RBI in its "Master direction-Know Your Customer (KYC) dated 25 February 2016
5. http://pib.nic.in/newsite/PrintRelease.aspx?relid=147082
6. Publication by Press Information bureau, GoI, Ministry of Finance, 'Recommendations of SIT on Black Money as Contained in the Third SIT Report' dated 24 July 2015; The 'Outlook Newswire' article dated 3 September 2015 entitled "Blackmoney issue: SIT recommends steps to curb money laundering")

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