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The year of Covid and Brexit: What has 2020 meant for financial crime prevention?

The end of 2020 is finally within sight, and what a strange year it has been. In terms of financial crime prevention, 2020 has been a mixture of continuing to deal with known issues and progressing improvements, but against the backdrop of Brexit and a pandemic.

*In this year's review, **Emma Radmore** of Womble Bond Dickinson looks back on the key legal and regulatory priorities for the UK authorities and the year's relevant enforcement actions. As usual, we then look at initiatives that will be progressing over 2021.*

Covid-19

The pandemic brought with it challenges to every aspect of life and work. Financial crime prevention was not alone in having to adapt to the demands. From a UK perspective, the regulators, particularly the Financial Conduct Authority (FCA), made its expectations clear early on. It understood that firms were facing unprecedented pressures in unaccustomed ways of working. It urged them to prioritise areas of the most risk, while trying also to keep up with business as usual.

On the one hand, firms had to be alert to new types of fraud and financial crime, and not let their suspicion reporting slip in terms of any of timing, quality and quantity of suspicious activity reports (SARs). There were also new fraud risks arising from the government schemes to help businesses. On the other hand, firms had to adapt to new working practices and appreciate that their clients needed to do so too. FCA appreciated that firms may need to reprioritise or delay some activities.

Key challenges included:

- Customers who were unused to online banking needing to start using it and potentially leaving themselves vulnerable to fraud;
- Doing appropriate due diligence when onboarding a new customer, for whom the norm would have been face-to-face verification – FCA has started to encourage the use, for example, of selfies being sent by the customer. Of course, there were already many firms whose business model had evolved to deal only in the online world, but more traditional businesses struggled;
- Whether to delay regular monitoring of customer due diligence (CDD). This was something FCA was prepared to accept, but most firms considered this too risky and tried to stick to their regular cycles; and

December 2020/January 2021
Volume 23 • Issue 10

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- Similarly, FCA suggested firms could place more reliance on the diligence of others, but this has never been popular and, again, firms would have been reluctant to use this route at all and, if they did, would have wanted to verify all information first hand as soon as possible in their remediation measures.

Added to this were the operational and HR challenges. FCA was clear that it would not expect key managers and senior management function holders to be furloughed, and in many firms it would have been surprising if large numbers of compliance and operational staff had been furloughed. Firms would have wanted to ensure their systems and controls for keeping track of their customers and their activities remained appropriate. Part of this would include making sure staff working at home were properly supervised and, where appropriate, trained.

By now most, if not all, firms will have reached and adapted to a new normal. Any that did let their usual standards slip should by now have embarked on a programme to fill any gaps, and have in place systems and controls to ensure consistent compliance for as long as the pandemic affects them.

Brexit

The UK has, of course, spent much of the year wondering whether there will be any form of deal as it finally reaches the end of the Brexit transition period on 31 December. The legislators have been busy making laws that will, variously:

- Freeze EU requirements that applied before 31 December at that point of time, for future reference;
- "Onshore" EU Regulations, which had not needed to be transposed into UK law, by making a UK equivalent, amending terminology as appropriate to reflect the fact that the UK will not be in the EU;
- Amend existing legislation that implemented EU laws to reflect the fact that the UK will not be in the EU;
- Make new laws using new powers; and
- Amend regulatory rules and guidance.

The key pieces of primary legislation remain more or less unchanged. The money laundering and terrorist financing offences in the Proceeds of Crime Act 2002 and the Terrorism Act 2000 do not change, and nor does the Bribery Act 2010. But the Terrorist Asset Freezing etc Act 2010 will be replaced by two separate sets of regulations, one for the domestic and one for the international regime.

The Sanctions and Anti-Money Laundering Act 2018 (SAMLA) was one of the earliest pieces of Brexit-related legislation introduced to the statute books, and the UK regulators had already been using it to make UK autonomous financial sanctions. Powers will now be used more extensively to account for the panoply of EU sanctions previously having direct effect in the UK. The Money Laundering Regulations will remain, with appropriate onshoring amendments. And the UK was never going to implement the Sixth Money Laundering Directive anyway. The EU's list of High Risk Third Countries will apply frozen in time at the end of the year, and the UK will in future make its own list.

The Office for Financial Sanctions Implementation (OFSI) has been providing guidance to firms throughout the period, including noting the work already carried out by the Foreign, Commonwealth and Development Office in laying regulations before Parliament for over 30 regimes in preparation for Brexit. It cautions, though, that the new regulations will not necessarily be identical to the old, and that firms should check the precise scope of each regime, paying particular attention to those that have been merged, separated or renamed. UK Finance has produced a lengthy guide to help firms see which regimes may be subtly different next year.

The Consolidated List that OFSI maintains will be updated at 11pm on 31 December and, as a result, firms may need to screen all designations under SAMLA as new fields will be added. It's not all bad news, though, because in principle licences issued by OFSI under EU regulations will remain valid until they expire or are revoked – although there will be changes to the licensing process going forwards.

Finally, the Department for International Trade has published a UK version of the retained Blocking Regulation, which continues to protect UK persons trading with countries affected by the extraterritorial application of certain laws – specifically US sanctions against Cuba and Iran.

Enforcement

There were some major enforcement actions and cases over the year.

Bribery

On the bribery front, the main publicised Serious Fraud Office (SFO) actions were two deferred prosecution agreements (DPA), with very different entities. The first, published in February, with Airbus SE, saw the company agreeing to pay a fine and costs totalling €991 million as part of a €3.6 billion global resolution. The action related to five counts of failing to prevent bribery in the commercial and defence and space divisions and across five jurisdictions between 2011 and 2015. Part of the reason for the DPA was that once SFO was engaged (although the company could have acted more quickly to do so), it cooperated fully and had new leadership that put in place a programme of corporate reform and compliance.

The second was with Airline Services Ltd, published in November. The company won three contracts to refit commercial airliners for Lufthansa, using an agent who was a Lufthansa employee and used his knowledge to get the company a competitive advantage. The company fully self-reported, and accepted responsibility for three counts of failing to prevent bribery. Evidence showed that it had decided not to take advice it had sought on how to implement the Bribery Act and had not communicated any procedures to staff. As a result, it was not compliant with the Bribery Act for around four years. The company is dormant but is remaining in existence in order to fulfil the terms of the DPA, which require overall payment of nearly £3 million, of which nearly a third represents disgorgement of profits.

Sanctions

In an interesting court case on sanctions, a consortium of reinsurers had tried to trace funds owned by the Syrian state and its agents which were frozen and which, if found, they planned to ask the government to release an amount to satisfy a judgment debt which they were owed.

The reinsurers believed that Treasury knew where the funds were, but Treasury stated that it was not permitted to tell them. It said that information it received must be used only for the purposes for which it was provided to it, one of which is "facilitating compliance", but it said that did not include facilitating the release of funds in these circumstances. The court thought otherwise, and the judge said there should be a balance between the punitive measures in sanctions and derogations and exceptions to moderate their impact. The judge felt that conceptually, the reinsurers were in a similar position to civilians deprived of supplies because of sanctions and felt that Treasury would not be prevented by regulations from providing the information the reinsurers sought.

Elsewhere, the Court of Appeal upheld the ruling that a borrower UK bank was entitled to withhold repayments under a loan where the ultimate beneficial owner of the lender was a Specially Designated National (SDN) by US OFAC. Cynergy had borrowed £30 million as Tier 2 capital and when, three months after signing the facility, the beneficial owner of the lender, Lamesa Investments, became an SDN, Cynergy said the Ukrainian Freedom Support Act would allow the US to ban Cynergy from operating a USD correspondent account if it had "knowingly facilitated" a financial transaction on behalf of an SDN.

At first instance, the judge said this was a mandatory provision of law and was not the less so simply because it created a risk of a penalty or sanction rather than actually requiring or prohibiting an action. The judge had also noted that the parties were both aware of the likely designation at the time of signing the facility, so would not have been likely to have intended to limit the words "in order to comply" in the facility agreement to only an express statutory prohibition, given that they would understand the potentially "ruinous" effect of secondary sanctions on Cynergy's business.

The High Court found that the judge had perhaps overlooked some relevant factors – specifically that the clause in question was a standard term in common usage, so a detailed consideration of the parties' intention in using it may not have been appropriate. The judge said the process of interpretation should be a unitary exercise, starting with the words and relevant context, and then an iterative process checking each suggested interpretation against the provisions of the contract and its commercial consequences.

He said the "relevant context" in this case was that the court was considering a standard provision in a loan agreement used for Tier 2 capital and that the facility agreement made it clear the capital was required under "Capital Regulations" including capital requirements directive 4. He said non-payment provisions for loans of Tier 2 capital are not of the kind seen in ordinary loan agreements because the loans are subordinated and repayment events controlled.

The original borrower had been the UK subsidiary of a Cypriot bank, which was subsequently sold to the Cynergy group. It appeared to the Court of Appeal that the relevant clause was drafted, in principle, to deal with possible future events beyond sanctions, and that the High Court had lost sight of this. The key, said the Court of Appeal, was that the relevant clause did not extinguish the entitlement to be repaid, but that if the proviso is engaged, there would be no default and therefore the lender could not seek to wind up the borrower. He concluded the context to the clause was a balance between the desire of the lender to be paid timeously and the desire of the borrower not to beach any laws.

Then the court considered what a "mandatory provision of law" would mean in the context and concluded it was possible to give it different meanings – either compliance with a statute or, more broadly, that it can relate to actual or implied provisions of law. In this case, Cynergy was relying on the EU Blocking Regulation wording which, in a different context, uses similar language to prevent compliance with US statutes that impose secondary sanctions. Ultimately, the judge felt that the clause had been drafted by those who understood the nature of international sanctions, and the effects of US secondary sanctions, so the drafter must surely have intended the borrower to be able to seek relief in these circumstances.

All in all, although the Court of Appeal did not necessarily agree with all the reasoning of the High Court it agreed with the order.

FCA enforcement action – AML

In June, FCA fined Commerzbank AG London Branch nearly £38 million for AML systems and controls failings spanning a five-year period to September 2017. The bank benefited from a 30 per cent discount for early settlement.

Many of the bank's global customers use products and platforms managed through the London branch, which acted as a hub for sales, trading and due diligence processes for a significant number of global customers. The failings started in October 2012 and FCA raised specific concerns in 2012, 2015 and 2017 and was at the time also publishing guidance about its expectations on firms and taking enforcement action against a number of firms for AML failings. Additionally, the US regulators had taken action against the bank in 2015 for AML failings (which did not involve the London branch). Nevertheless, the failings in the bank continued.

The failings included:

- Shortcomings in its financial crime controls applicable to introducers and distributors, specifically in the use of group introduction certificates;
- Instances where identification and risk assessment of a politically exposed person was inadequate;
- Failure by certain business areas to comply with the London branch policies on verification of beneficial ownership;
- A lack of full process for terminating a client relationship because of financial crime concerns;
- Failure to have a clear articulation of risk and issue owners;
- Failure to conduct timely periodic due diligence on clients. Many clients were as a result overdue on updated checks, and of those many were able to continue dealing with the branch under an improperly controlled or overseen exceptions process – both senior branch management and compliance lacked understanding and awareness of this process. FCA commented that by the end of 2016 this was "out of control";
- Failure to address long-standing weaknesses in its transaction monitoring tool – which, among other things, it was noted, in 2015 lacked 40 high-risk countries and over 1,000 high risk clients; and
- Failure to have adequate CDD policies and procedures in place.

FCA commented that its expectations on financial crime prevention controls include expectations on branches of overseas firms. The failings meant the bank was open to being used for financial crime although there was no evidence that it was in fact occasioned or facilitated by the breaches.

Some of the failings were due to understaffing at key times – with the financial crime team in compliance consisting of only three full-time staff in 2016 (this was increased to 42 in 2018).

FCA found Commerzbank had conducted a significant remediation exercise to bring its controls into compliance, which were being tested by a skilled person, and has also looked back to identify suspicious transactions. The bank had also agreed a VREQ, which included temporarily stopping taking on high-risk customers, ceasing new business with existing high-risk customers who were overdue a review, and suspending all new trade finance business activities. The remediation period is now complete and the bank is requesting a lifting of the restrictions.

What next?

So what can we look forward to in 2021? It seems like the Brexit-related changes may not be too hard to adapt to, so in some ways the challenges and changes will relate more to business as usual.

We see the statistics of rising SARs, especially defence SARs, and we see a continuing theme of financial crime in skilled persons reports. We know it takes quite some time for FCA concerns to result in publicised enforcement decisions, and we are also seeing a pattern of fewer, but harsher, decisions. We can surely expect at least one large enforcement action with a focus on financial crime prevention systems.

Firms will continue to get used to the changes that the Fifth Money Laundering Directive has brought, such as the additional obligations for trusts and the reporting of beneficial ownership discrepancies.

Meanwhile, the bank account portal which was due to take effect in September 2020 has been delayed. When it takes effect, credit institutions and providers of safe custody services will need to use it to respond to requests for information from enforcement agencies.

Otherwise, the spectre of the "failure to prevent" offence is ever present. The government's response to its call for evidence on corporate liability for economic crime identified several possible reform options, including a failure to prevent offence like the Bribery Act one, or a variant on it.

It feels as if we are not much further forward than we were some years ago – everyone agreed at the time the Bribery Act was made that the previous framework did not provide sufficient deterrent to corporate misconduct, and that the "identification" doctrine inhibits holding companies to account. Currently, the Law Commission is working on the options and aims to publish a paper in late 2021. So, it seems we won't be seeing any early reform.

On the supervisory review side, the FCA is likely at some stage to focus on firms' response to the effects of the pandemic, looking at how they coped with compliance during it, what new risks they identified and what they have done to remedy any issues that they could not deal with adequately during lockdown. Financial crime prevention, both in terms of risk detection and assessment and business as usual, is likely to be high on the list.

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The bank resolution regimes of China: A comparative assessment

by **Zhirou Li**

In a competitive financial market, banks should be allowed to fail if they cannot survive. A sound legal system should be equipped with a thorough bank crisis management regime, in order to offset negative impacts on domestic and international financial markets. Encompassing bank crisis management, bank resolution is a significant tool for maintaining financial stability and strengthening market discipline. However, bank resolution in China is still at an early stage and there are some gaps in its legislation and regulatory provisions. The aim of this paper is to compare China's two resolution regimes, propose potential solutions to their residual issues and discuss the feasibility of these approaches.

The bank resolution authorities in China are the China Banking and Insurance Regulatory Commission (CBIRC), local government, and the Deposit Insurance Fund Management Company. According to the law of the People's Republic of China on commercial banks and the law of the People's Republic of China on enterprise bankruptcy, when a commercial bank is facing or likely to face a credit crisis, the banking regulatory authority may take over, in order to protect the interests of depositors and restore the normal operating capabilities of the bank. The creditor-debt relationship of the bank does not change due to the receivership. The period of receivership is up to two years, if the bank has recovered its normal operating capacity earlier, or it has been merged or declared insolvency, the receivership can end earlier. On the other hand, when a commercial bank is insolvent, the CBIRC may apply to the court for restructuring or liquidation of the institution.

Additionally, China introduced regulation on deposit insurance in 2015, with maximum payment of RMB 500,000 (approximately £54,825). However, it lacks the rigorous practical procedures required of bank insolvency and resolution, and is not connected closely enough with other bank resolution regulations. Although the deposit insurance institution has been endowed with early intervention and risk resolution functions, the regulations do not clarify under what circumstances it can act as a receivership entity.

In general, the current provisions of bank resolution are relatively vague, lacking specific regulations for practice. There is a lack of quantifiable standards for the intervention of problematic banks, and there are no specific guidelines for when to initiate the receivership procedure, when to rescue, and when to liquidate, which makes it more likely to miss the best timing for resolution.[1]

Additionally, many insolvent banks are rescued through administrative means, which usually involves local government. For fear of endangering social stability, governments are reluctant to allow a failing bank to fail. This makes the resolution neither transparent nor efficient. Because governments usually focus on social stability and the protection of local firms, they are reluctant to actively expose existing problems and submit the bank to resolution in a timely manner. The regulatory authorities are worried that the failure of financial institutions would be considered a regulatory failure, so they tend to postpone the resolution after the risk arises. Together with the problem of lacking a coordination mechanism, the bank resolution procedure is very inefficient.

However, it can be seen from the development of legislation that bank crisis management in China is gradually being marketised. In the meantime, regulations on insolvency risk resolution for commercial banks is being drafted in accordance with the requirements of the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions.

Failed banks in China

The first failed commercial bank in China was Hainan Development Bank, which was controlled by the Hainan provincial government. In 1998, it was closed for liquidation because it was severely insolvent. The deposit insurance regime was not in place then, so the central bank designated the Industrial and Commercial Bank of China (a large state-owned bank) to pay for the deposits and interest. In response to the run-on Hainan Development Bank, the central bank, provided about RMB 4 billion (approximately £438.6 million) for re-lending funds; the local government provided nearly RMB 700 million (approximately £76.8 million) and temporarily refunded RMB 28.77 million (approximately £ 3.2 million) taxes to it. However, when the People's Bank of China (PBoC) stopped its liquidity support, the bank completely lost its solvency.

The negative impact of government intervention cannot be ignored. If PBoC did not merge 28 failing local credit cooperatives into Hainan Development Bank and designate it to take over the credit and debt of five insolvent credit cooperatives, Hainan Development Bank may have had more time to solve its own liquidity problems. Although these interventions temporarily stabilised the financial market in Hainan province, they indirectly caused the crisis of Hainan Development Bank.

While the central bank's function as LOLR was effective in alleviating the liquidity crisis and eliminating public panic, the cost was too high, and it weakened market discipline, brought serious moral hazard, and damaged the long-term competitiveness of the financial system. Moreover, excessive administrative intervention – such as forcing a bank to take over the debts of other failing banks – only postponed the crisis. It failed to fundamentally solve the problem and may yet trigger a new and more serious crisis.

The resolution of Baoshang Bank is the most thorough one in the past 20 years, because its equity, assets, and liabilities have been completely restructured. Baoshang Bank was submitted to a joint receivership by the PBoC and the CBIRC due to its severe credit risks. Its resolution included acquisition by a newly established bank and reorganisation. The deposit insurance fund provided financial support to Mengshang Bank (a newly established bank whose shareholders are the Deposit Insurance Fund Management Company and other state-owned capital) and Huishang Bank, which also shared the asset impairment losses of Baoshang Bank. The intention was to facilitate Mengshang Bank and Huishang Bank to purchase and undertake the assets, liabilities, businesses and personnel of Baoshang Bank, which helped to maintain the continuation of financial functions.[2]

Compared with the case of Hainan Development Bank, the resolution of Baoshang Bank had more legislation as legal support. It provided more protection to depositors, financial customers, and small creditors, and strengthened market discipline to some extent. This resolution is more market-oriented, but state-owned capital still plays a dominant role.

The drafting of the regulations on insolvency risk resolution for commercial banks started in 2017 and is still in progress. In practice, the government usually plays a dominant role in bank crisis management, and there is limited experience of bank resolution.

Rationale for improving the resolution regime in China

The banking system in China is very different from in the UK. Most of the big banks in China are state-owned, some of them are not only systemically important in China, but also systemically important in the global market, according to the 2019 FSB list of global systemically important banks (G-SIBs). However, the issue of TBTF remains unresolved in China. If these big banks face crises, people tacitly assume that the government will bail them out. This not only breeds moral hazard, but is also harmful for market discipline. In such circumstances, the management, shareholders and creditors of large banks are not fully responsible for the risks they take, relying on implicit guarantees of state support. This further incentivises them to take excessive risk, which increases the likelihood of requiring further public support. This might make them fall into the TBTF trap.

In recent years, there has been a trend of mixed operation in China's financial industry. The banking sector is not only highly interconnected, but its reliance on the capital market has increased significantly. The barriers between the banking system and the insurance and securities sectors have gradually broken down. Many big financial institutions are not only entirely state-owned, but are shareholders of each other. For instance, BOC Insurance and BOC International (investment bank) are wholly owned by Bank of China (a systemically important commercial bank). Chinese banking supervisors are aware of the risks of excessive correlation, they realise that it causes the risk of an individual financial institution to be transmitted across markets and regions, making the financial system more likely to fall into a systemic crisis. In the past, due to authorisation restrictions, many banks chose to conduct securities business through subsidiaries in Hong Kong. Recently, it was confirmed that commercial banks are going to be authorised to conduct securities activities, which aggravates concerns about the problem of TBTF, because banks and the securities market will be more integrated, which poses extra risk for banks. Therefore, practitioners call for the adoption of a risk isolation mechanism. For example, requiring commercial banks to establish firewalls between banking and non-banking businesses. However, this is not enough to completely solve the problem caused by high correlation between the banking industry and other financial industries.

Shadow banking is still a big problem in China. Due to the regulatory crackdown on shadow banking, its size has decreased to RMB 59.6 trillion (approximately £6532 billion) in 2019, according to Moody's China shadow banking report. However, according to Moody's Quarterly China Shadow Banking Monitor (June 2020), China's "shadow banking assets increased by RMB 100 billion (approximately £11 billion) in the first quarter of 2020, led by the rise of asset management business funded by wealth management products", which was the first increase since 2017. Scholars argue that the shadow banking sector in China should be divided into banks' shadow and traditional shadow banking,[3] because many activities are conducted by commercial banks, who intended to turn on-balance sheet transactions into off-balance sheet transactions in order to circumvent regulatory restrictions. As a consequence, commercial banks have huge hidden risks of non-performing loans, not to mention China's unique problems of huge local government debts and excessive real estate loans. In fact, the risk of bank crisis in China has always existed.

Although it is undeniable that the shadow banking sector in China supports micro and small companies and meets the financing needs of the real economy to some extent, it hides the credit risk of banks, which should not be ignored, because the risk of shadow banking could be detrimental to the sound performance of commercial banks. For instance, when some on-balance sheet loans are converted to off-balance sheet wealth management products, it is difficult for the authorities to distinguish banks' liquidity problems from repayment problems. This affects resolution authorities' judgment on the financial difficulty of the bank, which may severely delay the timely resolution of a bank crisis.

Another potentially risky phenomenon is that internet enterprises are engaging in banking-like activities through their financial service group and payment platforms, namely taking deposits and making loans. For example, Ant Financial Services Group, which is a related company of the Alibaba Group, uses Yu'E Bao to attract clients to invest in funds. The low investment thresholds, higher rate of return and flexible redemption rules of Yu'E Bao help it to absorb deposits quickly. Moreover, Ant Credit Pay makes instalment credit available for consumers. These functions are all available on Alipay, a huge third-party payment platform owned by Ant Financial Services Group. However, these activities are not regulated and supervised as traditional activities of commercial banks, while third-party payment systems also face liquidity risks. A potential issue is how to resolve huge third-party payment platforms when they encounter liquidity problems or other financial difficulties, which have not been covered by the current resolution regime.

The Covid-19 pandemic reminds people of the importance of an effective banking crisis management regime in responding to black swan events. Although the economic crisis caused by the pandemic did not originate from the financial market, it inevitably has negative impacts on the banking and financial industry. For example, the pandemic hit the supply chain in China, the operational risks and default risks of some companies which rely on overseas supplies have increased, all of which may also be reflected in the quality of bank assets in the future. It can already be seen that non-performing loans in the banking industry have increased. Fortunately, after the global financial crisis of 2007–2009, generally banks have been better capitalised. Even so, the bank crisis management regime is particularly important in preventing the pandemic from causing more serious financial crises.[4]

Due to the opening up of the domestic financial market, the competition between local banks and foreign banks will become increasingly fierce. The globalisation of financial markets will further increase the risks of China's banking industry. From the perspective of long-term financial development, since China intends to open up its financial market, it should have a matching financial regulation capability. Correspondingly, the bank resolution regime should be able to meet the needs of the cross-border market, and it should have an efficient coordination mechanism and practical adaptability. A resolution regime that can provide adequate protection and predictable results for shareholders, creditors and counterparties will help to attract more international investors. On the contrary, the lack of a coordinated cross-border resolution regime will lead to disorderly collapse, devaluation, and cross-border spread of financial instability, which was one of the lessons learnt from the global financial crisis. However, the capability of cross-border bank regulation is insufficient, the coordination with authorities of host countries is very limited and a sound legal system of cross-border resolution has not been established in China.

Furthermore, the development of the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) also needs a harmonised bank resolution regime for its cross-border banking activities, which has not yet been established. If the risk of a failing bank cannot be resolved in a timely and effectively manner, the risk in the GBA may affect financial markets in other parts of mainland China, Asia, and even the world. An effective resolution framework would help the GBA to develop into a truly coordinated and integrated financial centre, thereby enabling the GBA to attract international banks and financial institutions to settle.

Overall, all the issues above are the rationale for China to build a more effective and efficient bank resolution regime, which should be more market-based and aligned with international standards.

Bank resolution residual issues

Similar to China, the banking system in the UK is highly related to the real economy and is led by large institutions. Therefore, it is significant for both China and the UK to have sound bank resolution regimes. Although the UK's SRR is a commendable response to the Northern Rock crisis, it is still not perfect.

Not only are Chinese resolution provisions considered too vague, but the British resolution regime has also been criticised for lack of certainty. For instance, the trigger timing and conditions are not clear enough, which may affect its long-term effectiveness in practice. The lack of clear expectations for PRA's resolution actions undermines people's confidence of a timely resolution, it has also presented hidden dangers of abuses of intervention power. The relevant "meaning, structure, responsibility and operation of the system for maintaining core financial stability within the UK" should be further clarified.[5]

Another concern is the potential excessive intervention to private property and contractual rights and interest, which may severely damage the bank capital market in the UK, and also conflicts with the long-standing policy of open market. A resolution regime with worrisome excessive intervention cannot achieve the objective of protecting confidence in financial stability. Although the problem of excessive administrative intervention in China is different from that in the UK, they could be solved similarly by restricting the interventionary powers of the authorities. In the UK, this is related to the previous problem to some extent, they both show the importance of certainty. The clearer the trigger conditions of the resolution regime, the less likely there will be unexpected excessive interference.

The UK resolution system confers different resolution options on different authorities, and require them to consult with each other. On the one hand, it is to establish a decentralisation mechanism, on the other hand, it is the result of political games among relevant agencies. Their coordination mechanism does not necessarily improve the economic efficiency of bank resolution.[6]

From the perspectives of law and economics, having only one authority responsible for bank resolution would improve economic efficiency, but this regime does lack any meaningful check on its authority, which in turn may cause excessive intervention. Although the decentralisation and coordination mechanisms can solve the previous concern, it is inevitable there will be potential conflicts of interest between authorities, which cause additional time and economic costs which are particularly important for the effectiveness of resolution. The legal pros and cons and economic efficiency of these two approaches should be fully considered and weighed up. In the case of multiple resolution agencies, a separate institution that reports to Parliament could avoid the implications of conflicts of interest.[7]

Regarding the improvement of special resolution regimes for banks and other financial institutions, the UK and China are at different stages. The question for the UK to consider is whether the special resolution regime should be extended from banks to other types of financial institution, while the question for China is whether the coming special resolution regime should cover banks and other financial institutions at the same time.

The rationale behind this consideration is that many insurance companies and securities firms are also systemically important, and any type of financial institution may cause systemic risks. They have some similarities with banks, so extending the bank resolution to other financial institutions can reduce legislative costs and resolve them efficiently and effectively.

Moreover, whether it is in the UK or China, it is difficult to separate the banking industry from the entire financial industry. This can be seen from their regulatory frameworks, there is no specific regulator/supervisor for each financial sector in the UK, and China also merged the regulatory authorities of the banking and insurance industries. Therefore, extending bank resolution to other types of financial institutions can protect financial stability more comprehensively and help to achieve resolution objectives.

However, although the financial industry is increasingly showing a trend of mixed operation, the specialities of banks make them different from other financial institutions in some key ways, so some bank resolution approaches may not be appropriate for other financial institutions. For instance, insurance companies divide and distribute their risks by reinsurance. It is doubtful that whether they would be willing and capable of paying additional money for a resolution fund. Furthermore, it is unlikely that there would be a run on the insurance company. Different from deposits, certain conditions must be met in order to make claims.

Nevertheless, some resolution approaches for banks could be extended to other financial institutions, such as resolvability tests, RRP, bail-in, and so on. In fact, the SRR has applied to systemically important investment firms in the UK, and the PRA requests all UK insurance companies to have RRPs. For the UK, it could explore the feasibility of more bank resolution tools in other financial institutions' resolution regimes.

China has not introduced a special bank resolution regime yet. From the perspective of law and economics, the social cost of special bank resolution regimes cannot be ignored, because creditors will request higher interest rate for higher burden of risk. This will increase the financing cost for banks, which will transfer the burden to customers, which will decrease the competitiveness of the local banking sector. Moreover, under special bank resolution regimes, it would be detrimental to shareholders if authorities could economically benefit from closing a still-solvent bank sooner. Similarly, if supervisors could personally benefit from resolving banks, for example, by obtaining a senior management position under the receivership regime in China, they will be incentivised to intervene more in bank resolution, which may not be conducive to bank development.

However, the specialities of banking determine that the special resolution regime can better protect financial stability. If the bank collapses in a disorderly manner, it will cause even more social losses and greater damage to the competitiveness of the local banking industry. For instance, UK bank resolution has gone through a process from normal corporate insolvency law to SRR, its effectiveness can be seen from the case of Dunfermline Building Society.

If China makes the resolution regime cover banks and other financial institutions simultaneously, it will further delay its introduction. From the perspective of crisis prevention, at this stage, China should speed up the introduction of regulations on insolvency risk resolution for commercial banks to be prepared for the potential banking crisis in the post-pandemic era. Next, China should also consider extending the bank resolution regime to other financial institutions.

As mentioned before, TBTF remains unresolved in China's banking sector. Big banks in crisis in China are always bailed out by the government, which is out of consideration for financial and social stability. In the short term, this approach is quick and effective. However, in the long term, bank managers will have more incentive to speculate. The resolution cost is huge, which would undermine the stability of the entire financial system. Bail-outs may cause fiscal tightening, which is absolutely undesired, especially during the economic crisis caused by the pandemic. Therefore, the problem of TBTF needs a long-term effective resolution mechanism.

In order to resolve TBTF, the UK authorities adopted several resolution tools, RRP is one of them. One of the main causes of the TBTF status is the information asymmetry between the authorities and the bank. Therefore，UK banks are requested to prepare and regularly update their recovery plans and resolution packs, while authorities prepare resolution plans accordingly. These RRPs could help the authorities to quickly decide which resolution tool should be used, and effectively reduce information asymmetry.

The RRPs are considered as the "living wills" of the firms, allowing all firms, including the largest banks, to be prepared for extreme financial difficulties. This requirement clearly states that no firm can solely rely on public funds for resolution, which significantly reduces the moral hazard. Ex-ante planning is beneficial for banks to identify and mitigate failure and to decrease contagion. The further development of RRPs allows systemically important banks to be resolved in an orderly fashion without using too much public funding.

However, some potential issues may damage the effectiveness of RRPs. Banks might try to hide some non-compliant confidential key details, which would make the RRP less meaningful, because it neither reduces information asymmetry nor is it practical when crisis comes. Additionally, the RRP is just a plan under disclosure requirements, rather than a binding regulation that can substantially end TBTF, because its effectiveness also depends on the level of supervision.

Nonetheless, having a plan is the first step to mitigating the problem of TBTF. Generally, the RRPs are beneficial to groups in terms of their structure of operation, finance, legal, and organisation. Its effectiveness can also be seen from its functions of improving the bank's risk management and corporate governance, it also provides better understanding for senior management and the authorities of their responsibilities. Thus, Chinese banks should also be required to prepare RRPs, and there are no technical difficulties for this. More importantly, if RRPs could be implemented successfully, banks could reduce their reliance on the central bank's liquidity support, which would strengthen market discipline. As for the problem of hiding key information, it could be prevented by challenging banks on the credibility of their RRPs.[8]

Furthermore, the senior management of the bank should be personally accountable for the RRP's comprehensiveness and authenticity. The level of supervision should also be enhanced, supervisors ought to have the competence to implement RRPs appropriately in practice. Additionally, the UK's resolvability assessment could also be referred to, it could be complementary to the RRPs, which pave the way to remove them under the direction of the resolution authority.

It is widely recognised that bail-out is likely to increase moral hazard, but the UK and China have different attitudes toward the use of public funds in bank crisis management. Avoiding using public funds is clearly stated in UK's resolution objectives, while China's attitude is more vague. There are neither encouragements nor prohibitions in its resolution regulations. In practice, in addition to the central bank's liquidity support, it also uses state-owned capital to invest in the shares of the failing bank to resolve it, like it did for the Baoshang Bank. In the UK, according to The Bank of England's approach to resolution, bail-in is likely to be applied to the largest and most complex firms, while China has not adopted any legal regime for bail-in.

The principle of bail-in is to use "internal resources already provided by shareholders and creditors of the bank in order to absorb its losses and recapitalise it". Although it cannot totally replace bail-out, its introduction has positive effects in strengthening market discipline, reducing moral hazard and avoiding use public funds. The rationale behind bail-in is that the shareholders and creditors can decide whether to take risks when buying shares and lending money to banks, and shareholders have the duty to oversee bank's misbehaviour.

However, bail-in may cause contagion and financial instability. On the one hand, in order to make bail-in effective, banks should hold enough bail-inable debt, on the other hand, the regulators oblige banks to minimise their bail-inable liabilities, because an excessive use of bail-in may lead to contagion.[9] If a large amount of unsecured debts were written down, the creditor financial institution might also be at risk.

It is also notable that bail-in might cause moral hazard of supervisors. Supervisor or resolution authority may put the losses on the shoulders of shareholders and creditors, while the losses were caused by supervisor's negligence. Although the resolution authority and the banking supervisor are not necessarily within the same entity, they both represent the interests of the government.

Although it is hard to move from bail-out to bail-in, it is necessary. The innovation and advantages of bail-in should be considered. However, given the different banking structure in China, the feasibility of introducing bail-in in the Chinese banking industry should be assessed.

First of all, there are some reasons for the Chinese authority to adopt bail-in. For instance, with the opening up of the domestic financial market, there would be more foreign banks joining the competition. In this scenario, the government may no longer be willing to use public funds to rescue banks, especially for newly established private and foreign banks.[10] Additionally, bail-in could be a deterrent for other state-owned banks' management and stakeholders. When they realise that they will absorb the losses of the failure, they will be incentivised to be more prudent.

However, the issue is whether bail-in would be meaningful if the money for bail-out and for bail-in come from the same source. Scholars argue that bail-in can be applied to systemically important banks in China,[11] but these banks are owned by the state, which means the shareholder that would suffer is the state. Thus, bail-in might be meaningless for those largest banks which have the TBTF problem. For example, the four global systemically important banks in China all have the same largest shareholder, namely Central Huijin Investment Ltd. It is a wholly state-owned company, representing the state to exercise equity investment in important financial institutions. If the authority bails-out one of these banks, the government loses money; if the authority bails-in the bank, the government not only loses money (because the capital of Central Huijin Investment is from the government), but also loses the control of the bank, which would not be desired by the government. Therefore, it is highly doubtful that whether the authorities would be willing to apply bail-in to systemically important banks in China.

For small and private banks, bail-in could be feasible, but it is unfair for these non-systemically important banks, given that they are already in a disadvantaged position in competition with state-owned large banks. Small and private banks might be crushed by bail-in, and as such, bail-ins could be said to be less a self-rescue tool, but instead, suicidal in their effect. However, it is prudent to treat systemically and non-systemically important banks differently for the sake of financial stability, while seeking to maintain a competitive market is also important.

The cross-border resolution of banks is a residual issue over the world. The main difficulty is the arrangement of burden sharing among jurisdictions. Despite the fact that cooperation is significant for an effective global resolution framework, stakeholders may fall into the prisoner dilemma while cooperation is mutually beneficial for them. Game theory and resolution practice both proved that national authorities always act in the interest of domestic taxpayers, while a broader view of public interest should be considered.

The SRR in the UK also applies to UK subsidiaries of foreign banks and branches outside the UK, but it is not designed for cross-border banking resolution. British authorities deal with this task through crisis management groups and resolution colleges. The single resolution mechanism and the Bank Recovery and Resolution Directive (BRRD) make cross-border resolution feasible in the EU. Although the common deposits guarantee scheme is not in place yet, the single resolution fund could provide addition financial support for banks in crisis. The mutual recognition provisions of the BRRD partially harmonised resolution frameworks at EU level, but Brexit may bring complexity and uncertainty for its continuing application in the UK. Additionally, the joint resolution strategy between the UK and the US is a good example of ex-ante cooperative arrangement, its resolution approaches would enable the continuity of critical functions and avoid affecting the overseas operations.

Though greater harmonisation could be helpful for cross-border resolution, it is very difficult to have an international resolution regime applied to every jurisdiction. It would be more feasible to have ex-ante burden-sharing plans without discriminatory terms against foreign creditors, and national authorities should try their best to be consistent and cooperative both domestically and internationally.[12]

In terms of the cross-border resolution in the GBA of China, it can be seen that the financial institution resolution regime in Hong Kong is very similar to the British one, while the main legislation of bank resolution in Macao is its Deposit Guarantee Regime. A cross-border resolution regime has not been established in the GBA, but some resolution tools could be beneficial and feasible.

RRPs are a tool for cross-border firms to have an ex-ante resolution agreement, and should include arrangements of fiscal burden-sharing and a common insolvency framework. It could promote an orderly resolution and be a complementary approach for early intervention. However, the precondition is that the supervision should be effective, consolidated and constant with information-sharing agreements. Another available tool could be CoCos, their contractual characteristics provide wide international legal acceptance. Therefore, authorities could request cross-border banks in the GBA to prepare RRPs and issue CoCos, these tools would allow the authorities to prevent cross-border bank crisis without significantly modifying their resolution regimes.

GBA could also adopt a trilateral memorandum of understanding to plan for ex-ante burden-sharing and information-sharing. The central bank, banking supervisors, and the deposit insurers should be involved in this work. If there was a joint bank supervisory committee for the GBA, this committee could also oversee cross-border resolution, equipped with the above resolution tools.

In the future developments of the GBA, more experience of cross-border resolution in the EU could be explored. There are some similarities between the EU and the GBA, for instance, they both contain jurisdictions of common law and civil law, and they both have multiple currencies in circulation. These similarities might make the EU resolution approaches beneficial and feasible for the GBA. In particular, the single resolution mechanism and the resolution approaches in the BRRD are worth learning for cross-border resolution in the GBA.

Conclusion

In conclusion, bank resolution is significant for maintaining financial stability and strengthening market discipline. The implementation of the SRR significantly improved the British bank resolution regime. It not only protects financial stability without relying on taxpayers' money, but also safeguards the interests of individual stakeholders. While China's bank resolution development is still at an early stage. Banks in crisis are usually submitted to receivership. In practice, in addition to the liquidity support from the central bank, state-owned capital is also used to invest in the shares of a failing bank in order to resolve it. However, bank crisis management in China is gradually being marketised. Residual issues like TBTF, shadow banking, and the development of GBA are a rationale for China to improve its bank resolution regime.

The residual issues in the British resolution regime, such as lack of certainty and excessive intervention, could be resolved by restricting the interventionary powers of the authorities and further clarifying the resolution trigger conditions. Additionally, the economic efficiency and legal pros and cons of its coordination mechanism should be weighted.

Moreover, given that the SRR for banks has been established in the UK, extending bank resolution to other financial institutions can reduce legislative costs and protect financial stability more comprehensively. Currently, China needs to have a special resolution regime for banks first, in order to be prepared for a potential banking crisis in the post-pandemic era. Next, China should also consider extending it to other financial institutions.

The first step to resolve the problem of TBTF in China could be requesting banks to prepare RRPs, because RRPs allow systemically important banks to be resolved in an orderly manner without using too much public funding. Furthermore, it is hard to move from bail-out to bail-in, but it is necessary. However, for China, the issue is whether bail-in would be meaningful if the money for bail-out and for bail-in come from the same source. Because if the authorities bail-in the bank, the government not only loses money, but also loses control of the bank. Therefore, it is unlikely that the authorities would be willing to apply bail-in to systemically important banks. For small and private banks, bail-in could be feasible, but it may be detrimental to market competition in the banking sector.

In terms of cross-border resolution, the key is to have ex-ante burden-sharing plans and information-sharing agreements, and the authorities should act in a cooperative manner. RRPs, CoCos, and trilateral memorandums of understanding could be beneficial and feasible for the cross-border resolution in the GBA, because these tools are effective and they do not need significant modification in their resolution regimes.

Overall, in the dynamic financial market, both the UK and China should swiftly identify residual issues in their bank resolution regimes and then find appropriate ways to resolve them, in order to maintain financial stability and strengthern market discipline.

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The FinCEN Files

How anti-money laundering (AML) procedures can identify and reduce the money laundering risks facilitated through the purchase and sale of precious metals, stones and jewels

by **Ehi Eric Esoimeme**

The Financial Crimes Enforcement Network (FinCEN) Files have pulled back the curtain, revealing how criminals launder proceeds of crime through the purchase and sale of precious metals and stones. Gold companies are involved in roughly a quarter of all suspect transactions across the FinCEN Files, a global investigation based on secret documents that shed light on how banks and regulators have failed to stop the flow of dirty money.[1] The wholesale purchase and sale of precious metals like gold presents elevated money laundering risks because such metals are easily transportable, highly concentrated forms of wealth that can be highly attractive to money launderers and other criminals.[2]

A year-long investigation into the FinCEN files has established that a Lebanese owned Liberian registered gold firm, Golden Vision Trading, suspiciously sent and received at least US$11 million to and from Kaloti, a Dubai company. The Liberian company's transactions took place when Kaloti Jewellery Group was one of the targets of a money laundering investigation carried out by the US Drug Enforcement Administration. The US investigation occurred between 2011 and 2016. Specifically, US investigators suspected that a company in Benin, Trading Track Company, and other companies doing business with Kaloti Jewellery Group were involved in laundering drug money through gold.[3] Further investigation conducted into Golden

Vision Trading suggests that the company was buying gold from illegal miners, mostly ex-combatants operating in protected areas in violations of mineral development law of Liberia. However, illicit miners operating in the Gola Forest, a protected area near the Liberian-Sierra Leonean border west of the country, alleged that they usually sell to Golden Vision Trading; while miners in Western Gbarpolu County corroborated that the company was funding some gold creeks at several mining sites in the county.[4] The investigation came to light in a batch of secret bank filings that describe the flow of more than US$2 trillion in suspicious transactions through the global banking system. JPMorgan Chase, Deutsche Bank and other financial institutions flooded the Treasury Department's Financial Crimes Enforcement Network with warnings about Kaloti, flagging as suspicious thousands of transactions worth $9.3 billion, that occurred between 2007 and 2015, the reports show.[5]

Beyond the Golden Vision Trading case study, law enforcement has long seen the gold trade as a key vulnerability in the global fight against money laundering. Drug gangs and armed militant groups use gold to launder money and fund conflicts. In the process, they have supported illegal mining operations that destroy pristine rainforest and are hubs for sex trafficking and child labour. In Peru, Latin America's biggest gold producer and the world's second-largest cocaine supplier, the illegal gold trade is now twice as big as drug trafficking.[6] The worldwide trade of diamonds, jewels and precious metals varies from modern international transactions conducted through the financial system, to localised informal markets. Dealers range from very poor individuals in some of the most remote and troubled places on the planet, to the wealthiest individuals, to large multinational companies working in major financial centres. Transaction methods also range from anonymous exchanges of handfuls of stones or nuggets for cash, to exchange-based government-regulated deals.[7]

This article starts by briefly defining precious metals and precious stones before discussing the patterns of misuse of precious metals and stones in money laundering and terrorist financing schemes; and the possible criminal charges that may be filed against a dealer in precious metals, precious stones, or jewels. It will then examine the different mechanisms that dealers in precious metals, precious stones, or jewels and banks can employ to detect illicit funds.

Patterns of misuse of precious metals and precious stones in money laundering and terrorist financing schemes

This section starts by briefly defining precious metals and precious stones before going on to discuss the patterns of misuse of precious metals and precious stones in money laundering and terrorist financing schemes; and the possible criminal charges that may be filed against a dealer in precious metals and stones.

There is no unique definition of precious metals and stones (PMS). The scope differs from one country to another, but generally precious stones include diamonds, emeralds, sapphires and rubies and precious metals comprised of gold, silver, platinum, and platinoid metals.[8]

In the US, "precious metal" means:

1. Gold, iridium, osmium, palladium, platinum, rhodium, ruthenium, or silver, having a level of purity of 500 or more parts per thousand; and
2. An alloy containing 500 or more parts per thousand, in the aggregate, of two or more of the metals listed above.[9]

Precious stone means a substance with gem quality market-recognised beauty, rarity, and value, and includes diamond, corundum (including rubies and sapphires), beryl (including emeralds and aquamarines), chrysoberyl, spinel, topaz, zircon, tourmaline, garnet, crystalline and cryptocrystalline quartz, olivine peridot, tanzanite, jadeite jade, nephrite jade, spodumene, feldspar, turquoise, lapis lazuli, and opal.[10]

Jewel means an organic substance with gem quality market-recognized beauty, rarity, and value, and includes pearl, amber, and coral.[11]

Dealers in precious metals, precious stones, or jewels are persons in the US who are in the business of purchasing and selling covered goods and who, during the prior calendar or tax year: (i) purchased more than $50,000 in covered goods; and (ii) received more than $50,000 in gross proceeds from the sale of covered goods.[12] Covered goods include precious metals, precious stones, jewels, and finished goods that derive 50 percent or more of their value from jewels, precious metals, or precious stones contained in or attached to such finished goods.[13]

FinCEN has the authority to investigate dealers in precious metals, precious stones, or jewels for compliance with and violation of the US Bank Secrecy Act (BSA) pursuant to 31 CFR s1010.810, which grants FinCEN "[o]verall authority for enforcement and compliance, including coordination and direction of procedures and activities of all other agencies exercising delegated authority under this chapter". FinCEN has delegated to the Internal Revenue Service, through the Small Business/Self-Employed Division (IRS SB/SE), authority to examine dealers in precious metals, precious stones, or jewels for compliance with the BSA and its implementing regulations.

Patterns of misuse of precious metals and stones in money laundering and terrorist financing schemes: the FinCEN Files case study

First, as a source of illegal proceeds to be laundered, precious metals and stones have been smuggled from producer to consumer countries, including to finance armed conflicts or to avoid domestic taxation. In other instances, producers have refrained from declaring their production's real value to the authorities to minimise their tax exposure.

The FinCEN files have established that Golden Vision Trading was indirectly involved in the smuggling of gold from Liberia. One of the two men, whose names are registered under the company at the Ministry of Mines and Energy's Repository, Hassan Aidibi, was arrested on 4 February 2019 by customs officers at Liberia's international airport boarding a Royal Air Maroc Flight with a briefcase containing gold. Liberia Revenue Authority (LRA) said documents retrieved indicated that Aidibi was transporting the gold on behalf of Gold Business Center, a business duly registered under the laws of Liberia and licensed by the Ministry of Mines and Energy on 24 January 2017 and up to June 26, 2019. Aidibi was trying to evade taxes by falsely declaring the quantity of gold he was exporting. Aidibi declared 97.94 ounces of gold at a current market value of US$95,876 and made a 3 per cent royalty payment of US$2,876 into the Government of Liberia Revenue Account. Still, LRA anti-smuggling investigators found out that the actual gold he was exporting was 56 kilograms or over 1,900 ounces, valued at over US$2 million. The royalty on the gold was estimated at over US$50,000, a source at the LRA who is knowledgeable of the incident said.[14]

The second type of activity is where illicit precious metals and stones (eg stolen/robbed gold or diamonds, or gold and diamonds received as a form of payment for drugs) will be laundered by selling or trading the gold or diamonds, by cutting/re-cutting and polishing the illicit gold or diamonds etc.' so as to conceal their illicit source.[15] In 2014, the Dubai-based Kaloti Jewellery Group, one of the largest gold traders and refiners in the world, was seen as a key cog in the dirty gold trade buying the precious metal from those suspected of money laundering by a US Drug Enforcement Administration-led task force. At around the same time, as many as 152 transactions of Indian companies with Kaloti were red-flagged as suspicious to US Treasury's FinCEN, according to Suspicious Activity Reports (SARs) investigated by *The Indian Express*.[16]

This summer the NGOs, Global Witness and Swissaid, accused Kaloti of accepting gold from areas of civil war in Sudan. An advertisement that the Swiss gold refiners did not appreciate at all. Investigators spotted huge cash payments from Kaloti to a Dubai-based gold trading company, Salor DMCC. In 2012, Kaloti paid him $414 million in cash. Salor is part of the Sallaum group, which owns boats transporting used cars to Africa. He also controls several companies in Zurich, active in used cars trade after having done gold trading there.[17]

The third type of activity is where precious metals and stones are purchased with illegal funds, such as the proceeds of drug or human trafficking. On 8 August 2014, investigators led by the DEA drug agency submitted a damning report to the US Treasury Department. According to this document, Kaloti and Salor "have established a significant capacity for the transfer of illicit funds [...]. Their ability to use gold for money laundering is central to this system".[18]

Possible criminal charges that may be filed against dealers

Money laundering is the criminal practice of processing ill-gotten gains, or "dirty" money, through a series of transactions; in this way the funds are "cleaned" so that they appear to be proceeds from legal activities.[19]

Money laundering requires an underlying, primary, profit-making crime (such as corruption, drug trafficking, market manipulation, fraud, tax evasion), along with the intent to conceal the proceeds of the crime or to further the criminal enterprise. These activities generate financial flows that involve the diversion of resources away from economically- and socially-productive uses – and these diversions can have negative impacts on the financial sector. They also have a corrosive, corrupting effect on society and the economic system as a whole.[20]

Money laundering takes many forms, including:

1. Trying to turn money raised through criminal activity into "clean" money (that is, classic money laundering);
2. Handling the benefit of acquisitive crimes such as theft, fraud and tax evasion;
3. Handling stolen goods;
4. Being directly involved with any criminal or terrorist property, or entering into arrangements to facilitate the laundering of criminal or terrorist property; and
5. Criminals investing the proceeds of their crimes in the whole range of financial products.[21]

An individual who launders the proceeds of crime through the sale or purchase of precious metals, precious stones, or jewels may be charged with the following offences:

1. Concealing criminal property;[22]
2. Disguising criminal property;[23]
3. Converting criminal property;[24]
4. Transferring criminal property;[25]
5. Removing criminal property from jurisdiction.[26]
6. Acquiring criminal property;[27]
7. Using criminal property;[28]
8. Having possession of criminal property;[29] and
9. Attempt, conspire or incite another to commit the above offences.[30]

Measures that dealers can employ to detect illicit funds

The US Bank Secrecy Act (BSA) and its implementing regulations require dealers in precious metals, precious stones, or jewels to develop, implement, and maintain an effective written anti-money laundering (AML) program that is reasonably designed to prevent the dealer from being used to facilitate money laundering and the financing of terrorist activities.[31] Dealers in precious metals, precious stones, or jewels are required to implement an AML programme that, at a minimum: (a) incorporates policies, procedures and internal controls to assist them in identifying transactions that may involve use of the business to facilitate money laundering or terrorist financing; (b) incorporates policies, procedures and internal controls to enable them file currency transaction reports; (c) designates an individual responsible for assuring day to day compliance with the program and BSA requirements; (d) provides training for appropriate personnel including training in the detection of suspicious transactions; and (e) provides for independent review to monitor and maintain an adequate programme.[32]

Reasonable inquiries

Dealers in precious metals, precious stones, or jewels are required to incorporate policies, procedures, and internal controls to assist them in identifying transactions that may involve use of the business to facilitate money laundering or terrorist financing, including provisions for making reasonable inquiries to determine whether a transaction involves money laundering or terrorist financing, and for refusing to consummate, withdrawing from, or terminating such transactions.[33] In high-risk transactions, dealers in precious metals, precious stones, or jewels must make reasonable inquiries in response to specific red flags when determining whether to complete a transaction. Where a dealer in precious metals, precious stones, or jewels purchases pure gold worth $1,000 or more from a new walk-in customer, they must inquire as to the origin of the gold or otherwise make attempts to understand the customer's background and business purpose. They must not just rely on the fact that the customer was referred to them by another customer who was a longtime family friend.

Dealers in precious metals, precious stones, or jewels must ensure that they use application programming interfaces (APIs) during the customer onboarding process. Traditional rule-based know your customer (KYC) technology necessitates significant dependence on manual efforts, particularly in the alert investigation stage, which can be time-consuming, labour-intensive, costly, and error-prone. In order to overcome these considerable and lingering challenges, it has now become imperative that dealers in precious metals, stones, or jewels leverage new-age smart technology solutions.

KYC API offers a single source for information and documentation to support due diligence and help financial institutions focus on decision-making rather than time-consuming and repetitive manual research activities. With KYC API, organisations can access information from a wide swath of sources from public records, private records, and governments. These include phone records, credit bureaus, DMV information, arrest records, utilities, court records, and business data, which can be accessed via APIs during the customer onboarding process.

Reports relating to currency in excess of $10,000 received in a trade or business

In the US, it is the law that any person who, in the course of trading in precious metals, precious stones, or jewels, receives currency in excess of $10,000 in one transaction (or two or more related transactions) shall make a report of information with respect to the receipt of currency.[34]

Reports of transportation of currency or monetary instruments

Each person who physically transports, mails, or ships, or causes to be physically transported, mailed, or shipped, or attempts to physically transport, mail or ship, or attempts to cause to be physically transported, mailed or shipped, currency or other monetary instruments in an aggregate amount exceeding $10,000 at one time from the US to any place outside the US, or into the US from any place outside the US, shall make a report thereof. A person is deemed to have caused such transportation, mailing or shipping when he aids, abets, counsels, commands, procures, or requests it to be done by a financial institution or any other person.[35]

Each person who receives in the US currency or other monetary instruments in an aggregate amount exceeding $10,000 at one time which have been transported, mailed, or shipped to such person from any place outside the US with respect to which a report has not been filed under paragraph (a) of s1010.340, whether or not required to be filed thereunder, shall make a report thereof, stating the amount, the date of receipt, the form of monetary instruments, and the person from whom received.[36]

Designation of a compliance officer

Dealers in precious metals, precious stones, or jewels must designate an individual responsible to assure day to day compliance with the AML programme and BSA requirements. The compliance officer must: (1) implement effectively the anti-money laundering programme of the dealer; (2) update the programme to reflect changes in the risk assessment; and (3) ensure that the appropriate personnel (including himself) were trained as detailed under the regulation.[37]

Dealers in precious metals, stones or jewels must provide the necessary level of authority, independence and responsibility to their anti-money laundering compliance officers to ensure day-to-day compliance with anti-money laundering requirements.

Training

Dealers in precious metals, stones, or jewels must provide for education and training of personnel regarding their responsibilities under the BSA and its implementing regulations.[38]

A dealer in precious metals, stones, or jewels' training programme should be commensurate with the bank's customer risk profile and services offered. A dealer's AML programme must provide for education and training of personnel regarding its responsibilities under the program.

Independent testing

Dealers in precious metals, stones, or jewels must provide for independent testing to monitor and maintain an adequate anti-money laundering programme.[39]

Dealers in precious metals, stones, or jewels are required to conduct an independent compliance testing that is commensurate with the bank's customer complexity and risk profile. By not conducting the required independent review, dealers in precious metals, precious stones, or jewels will be unable to identify vulnerabilities in their compliance programme and properly monitor the account activity of their customers to detect suspicious activity going through the bank.

Measures that banks can employ to detect illicit funds from the bank accounts of dealers in precious metals, precious stones or jewels

Banks should develop and implement written AML programmes reasonably designed to assure and monitor compliance with the BSA. Banks are required to implement an AML programme that, at a minimum, provides for: (a) procedures for using all available information to determine and verify name, address, social security or taxpayer identification number, and other identifying information for a person, to the extent determining and verifying the information is otherwise required under the BSA; (b) procedures for using all available information to determine the occurrence of any transactions or patterns of transactions required to be reported as suspicious; (c) procedures for using all available information to determine whether any records must be made and maintained pursuant to the BSA; (d) independent testing of the bank's AML programme; (e) training of personnel; and (f) the designation of an individual or individuals responsible for assuring day-to-day compliance.

Requirement to develop and implement an adequate customer identification programme

As part of its AML compliance programme, a bank must implement a written customer identification programme appropriate for its size and type of business. The programme must include risk-based identity verification, recordkeeping and retention procedures. In general, the minimum information a bank must obtain prior to opening an account is the customer's name, date of birth, and a residential or business street address.[40] A customer identification programme helps a bank determine the risks posed by a particular customer, allowing the institution to ensure that it has the proper controls in place, including suspicious activity monitoring procedures, and to monitor and report on the risks of a particular client.

A bank must incorporate its customer identification programme into its internal controls, including transaction monitoring. For a customer identification program to be effective, a bank must incorporate customer files into its transaction monitoring processes.

Banks must ensure that they use application programming interfaces (APIs) during the customer onboarding process. KYC APIs will help an organisation streamline the collection of financial counterparty KYC data and due diligence documentation, and maintain a holistic view of a counterparty using accurate intelligence that's updated regularly and confirmed by primary sources to ensure quality. Before using an organisation's KYC API for digital identities, electronic or digital identity verification, or trust services, Banks should be satisfied that information supplied by the provider is considered to be sufficiently extensive, reliable, accurate, independent of the customer, and capable of providing an appropriate level of assurance that the person claiming a particular identity is, in fact, that person.

Requirement to report suspicious transactions

The US BSA requires banks to report transactions that involve or aggregate to at least $5,000, that are conducted "by, at, or through" the bank, and that the bank "knows, suspects, or has reason to suspect" are suspicious.[41] A transaction is "suspicious" if the transaction: (a) involves funds derived from illegal activities, or is conducted to disguise funds derived from illegal activities; (b) is designed to evade the reporting or recordkeeping requirements of the BSA or regulations under the Act; or (c) has no business or apparent lawful purpose or is not the sort in which the customer normally would be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.[42]

Banks should ensure that they have strong automated monitoring systems that can detect highly suspicious transaction patterns including possible layering schemes and transactions not commensurate with the business's purpose.

Requirement to file currency transaction reports

The US BSA and its implementing regulations impose an obligation on Banks to report currency transactions that involve or aggregate to more than $10,000 in one business day.[43] A bank must file a currency transaction report (CTR) within 15 days after the transaction triggering the reporting requirement is conducted.[44] Reports required by s1010.311 shall be filed on forms prescribed by the Secretary of the Treasury and "all information called for in such forms shall be furnished."[45]

Bank insiders should not interfere with the duty and responsibility of compliance staff to file currency transaction reports.

Record keeping requirements

Banks must keep all records of the identification data obtained through the customer due diligence process (eg copies or records of official identification documents such as passports, identity cards, drivers' licences and similar documents, account files and business correspondence, including the results of any analysis undertaken such as inquiries to establish the background and purpose of complex and unusual large transactions), for at least five years after the business relationship is ended, or after the date of the occasional transaction.[46]

The rationale for record keeping is to facilitate the reconstruction of individual transactions and provide, if necessary, evidence for the prosecution of criminal activity.

Bank insiders should not interfere with the duty and responsibility of compliance staff to keep records.

Independent testing

Banks are required to conduct an independent compliance testing commensurate with the BSA/AML risk profile of the bank to monitor and maintain an adequate programme.[47] By not conducting the required independent review, a bank will be unable to identify vulnerabilities in its compliance programme and properly monitor the account activity of its customers to detect suspicious activity going through the bank.

Independent testing of the bank's AML programme should be conducted annually, unless the Bank does not execute transactions for customers or otherwise hold customer accounts or act as an introducing broker with respect to customer accounts, in which case independent testing must be conducted biennially.

Where a bank configures its automated transaction monitoring system to generate a certain number of alerts each month, the bank should conduct "below-threshold" testing to evaluate the extent to which the limits placed on alerts for queries is causing the bank to fail to investigate and file SARs on suspicious activity. The below-threshold test involves selecting a sample of alerts that occurred immediately below the alert limits to determine whether the limits should be adjusted to capture suspicious activity that occurred below the threshold. Where the below-threshold testing reveals that the bank's suppression of a substantial number of alerts it from investigating and reporting suspicious activity, the bank should address the numerical caps by adjusting the limits to capture suspicious activity that occurred below the threshold and hiring more employees and investigators in its AML department.

Training

A bank's AML programme must provide for education and training of personnel regarding its responsibilities under the program, including the detection of suspicious transactions.[48] A bank's training programme must provide BSA staff with adequate job-specific training. The Bank's training programme should not only focus on general BSA/AML requirements but also include topics on risks specific to the bank.

Banks should combine focused classroom training with online learning systems to deliver training. A one size fits all approach may not be appropriate since there will be classes of employees for whom the online learning system is not suitable.

Designation of a compliance officer

A bank is required to designate individual or individuals responsible for ensuring day-to-day compliance with BSA requirements.[49] The requirement extends beyond the actual designation of a person to fulfill this role. Appointing a BSA officer is not sufficient to meet the regulatory requirement if that person does not have sufficient authority, resources, or time to satisfactorily complete the job.

Banks must provide the necessary level of authority, independence and responsibility to its anti-money laundering compliance officers to ensure day-to-day compliance with anti-money laundering requirements. The bank's compliance officer and staff should be empowered with sufficient authority and autonomy to implement the bank's AML programme.

Conclusion

Dealers in precious metals, stones, or jewels and banks must implement adequate policies, procedures and internal controls based on an appropriate assessment of their money laundering and terrorist financing risks. The mechanisms/measures which have been extensively discussed in this paper will help dealers in precious metals, stones, or jewels and banks to identify, assess and understand their money laundering and terrorist financing risks as they relate to the purchase and sale of precious metals, precious stones and jewels and take commensurate measures in order to mitigate them.

Dealers in precious metals, stones, or jewels and banks must ensure that their APIs are powered by machine learning algorithms. Machine learning refers to the ability for software to learn and to become more accurate in its outcomes. Machine learning technology can take in large amount of data from public sources and connect it to customer information.

Machine learning can be used to analyse an API's dataflows. Once the information has been digested, the machine learning algorithms will match the information to each entity and look for any anomalies within the data that needs to be corrected. In using the KYC API and machine learning technology to verify a customer's identity, banks should ensure that they are able to demonstrate that they have both verified that the customer (or beneficial owner) exists, and satisfied themselves that the applicant seeking the business relationship is, in fact, that customer (or beneficial owner).

Banks should ensure that they have strong automated monitoring systems powered by machine learning algorithms that can detect highly suspicious transaction patterns including possible layering schemes through shell companies, and transactions not commensurate with the business's purpose. Dealers in precious metals, stones, or jewels planning to launder illicit funds could use shell companies to mask the beneficial ownership of account assets and this can make the tracking of funds movements more difficult for law enforcement and tax officials. Banks must develop sufficient policies and procedures to address the AML risks associated with providing financial services to shell companies, including the potential for straw ownership and risks related to the commingling of funds. Banks must have adequate procedures for detecting red flags relating to certain transfers of funds among accounts at the Bank. The bank must have a mechanism to detect large money movements with little to no securities trading, a commonly known red flag for potential money laundering in brokerage accounts. The bank must deal appropriately with this particular category of customers that are using securities-related accounts for the movement of funds.

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The RBI-sanctioned moratorium on debt servicing in India: an analysis

by **Anish Mashruwala and Neelasha Nemani**

Earlier this year, India's apex financial regulator, the Reserve Bank of India (RBI) pre-empted the effect of the unprecedented spread of the Covid-19 pandemic on the Indian financial sector. The nationwide lockdown imposed by the Indian government to curtail the rise in Covid-19 infections put an expected strain on the viability of businesses and ability of borrowers to repay their debt. With a view to offer some respite to borrowers and mitigate their burden of debt servicing, the RBI issued a notification on 27 March 2020[1] (the Notification). However, the Notification was almost immediately met with criticism and what started out as a measure to ease the pressure of repaying debt immediately, ultimately threatened to bring the Indian financial system to a standstill. This article attempts to provide a brief insight into the attempted measures adopted by the RBI to avert financial stress amid the chaos of the pandemic and the resultant consequences of the same.

Salient features of the Notification

The Notification sought to provide an option to borrowers to avail a moratorium under term loans and working capital facilities from a wide range of lending institutions. Borrowers could take advantage of a moratorium in respect of payment of principal and interest instalments, equated monthly instalments and credit card dues falling due between 1 March 1 and 31 May 2020. This moratorium period was, by a subsequent notification,[2] further extended to 31 August 2020 (the Moratorium Period).

Pursuant to the moratorium, the repayment schedules as well as the residual maturity of the loans would be correspondingly shifted to immediately after the end of the Moratorium Period. The RBI also clarified that the asset classification of the loans would remain unaffected by the moratorium and be determined only on the basis of the revised repayment schedules. To clarify, since a borrower with a moratorium under this Notification may not make any payment of instalments during the Moratorium Period, lending institutions would not be permitted to classify such loans as special mention accounts[3] or non-performing assets (ie effectively distressed assets). Furthermore, the RBI also stated that the interest amount otherwise due during the Moratorium Period would continue to accrue and would be payable immediately after the end of the Moratorium Period.

Challenging the constitutional validity of the Notification

The Notification issued by the RBI was soon met with criticism by several Indian borrowers. Numerous writ petitions filed before the Supreme Court of India challenging the constitutional validity of the Notification were dismissed on grounds of locus standi. However, on 2 May 2020, a writ petition was filed by an affected party.[4] The applicant, Mr Gajendra Sharma, submitted that the nation-wide lockdown imposed by the government severely impacted his means to earn a livelihood. Therefore, he did not have the means to continue to make payments under a home loan availed by him from a bank. With no option left, he approached the bank to avail a moratorium on the repayment of the loan. While the applicant's request for availing a moratorium was accepted, the bank informed him that interest during the Moratorium Period would continue to accrue, in terms of the Notification. Aggrieved by this, the applicant submitted before the Supreme Court that the imposition of interest on the Moratorium Period defeated the purpose of the moratorium. Accordingly, to the extent that the Notification permitted accrual of interest during the Moratorium Period, it should be struck down as ultra vires.

Given that the constitutional validity of the Notification was now challenged by an affected party, the Supreme Court considered all similar writ petitions on the subject matter together. It observed that lending institutions were not only imposing interest on the amounts otherwise due during the Moratorium Period but were also imposing "interest on interest" on such unpaid amounts.[5] In other words, lending institutions were imposing compound interest on the unpaid amounts during the Moratorium Period, to make up for the interest they would have otherwise earned from reinvesting such amounts. Furthermore, the credit rating of borrowers was also being downgraded, which would in turn impact the overall credit score of such borrowers. On the other hand, however, the RBI and the banks continued to maintain a strong stand, highlighting the economic risks of permitting a complete waiver on interest during the Moratorium Period. Given this, the Supreme Court directed the RBI and the banks to submit their detailed responses.

Analysis of the Notification

Theoretically speaking, the Notification seems to reflect an intention to strike a balance between both the primary stakeholders in a lending market – the borrowers as well as the lenders.

One school of thought may argue that the Notification is a half-hearted measure. While the lifespan of the pandemic is no elephant in the room, this Notification only seems to address the problem of liquidity in the short term. Arguably, the RBI has not considered how borrowers would cough up accrued interest payments once the Moratorium Period expires. The adverse effect of the pandemic on business, and consequently on people's income is of course undisputed. Given this, it may be reasonably argued that from a public policy perspective, borrowers should be sheltered from the financial impact of the pandemic. It also appears that middle class salaried employees and the mom and pop businesses seem to be the worst affected by the pandemic and as of date, continuity of businesses is already in question. If this aspect is not carefully considered, several businesses in the market would have no option but to shut shop. To no surprise, India may then be faced with an exponentially high rate of unemployment, leave alone unpaid loans. Having said that though, the impact of a complete *waiver* of interest on the banking system can also not be ignored.

According to *Black's Law Dictionary*, a moratorium is "an authorised postponement, usually a lengthy one, in the deadline for paying a debt or performing an obligation". On this basis, the other side may logically argue that a moratorium under law cannot be equated to a "waiver". To that extent, the Notification is clear that if a borrower uses a moratorium on payment of instalments, such payments (including interest) will merely be deferred and not waived. Clearly, a waiver of interest was never contemplated under the Notification due to the far-reaching consequences it may have on the economy as a whole. However, whether recouping lost profit in the form of interest on interest is covered by the concept of moratorium is quite literally the billion-dollar question.

To begin with, the Indian economy has been saddled with a "bad loan crisis" for several decades. However, after reaching a peak of 11.5 per cent at the end of March 2018, the gross non-performing assets ratio of scheduled commercial banks had declined to 8.5 per cent by the end of March 2020.[6] Due credit is owed to the RBI for this. It has, year on year, introduced various reforms to contain the rise of stressed assets in the market. Further, the introduction of the Insolvency and Bankruptcy Code, 2016 has also lent a helping hand to lenders by providing them with a time-bound insolvency resolution process to recover their bad debts. Having now made some progress on this front, it is extremely important that the RBI as the financial regulator take necessary steps to ensure that this bad loan crisis is, at the very least, contained.

In its affidavit submitted to the Supreme Court, the RBI estimated a loss of a whopping two trillion Indian Rupees (1 per cent of GDP) if a complete waiver on interest during the Moratorium Period were to be granted.[7] If such waiver is in fact considered, it would be unfair to all other borrowers who have been making repayments under their loans as per schedule. That aside, if lending institutions are expected to absorb this loss, it is no surprise that the ultimate hit would have to be taken by depositors. This is because lending institutions typically pay interest on public deposits from the interest earned by them on loans. Naturally, if lending institutions are required to forego interest amounts on loans during the Moratorium Period, depositors receive little to no money on their savings. Due to the impact of the pandemic on the equity markets, conservative investors would look to lending institutions to safeguard their money from negative returns. A complete waiver of interest would therefore largely impact such investors as well. Given this, it would not be feasible for banks to absorb such losses without possibly taking down the entire financial system.

There are also several arguments to support the idea that lending institutions should be permitted to impose an "interest on interest" during the Moratorium Period. As the Notification seeks to provide the option to defer payments under loans during the Moratorium Period, the same comes at the cost of banks losing out on their income during such Moratorium Period. Undoubtedly, it is important that lending institutions also remain sound and profitable to prevent the financial system from destabilising. Therefore, logically, the option to postpone payments must come at some cost to borrowers. However, given that the Notification does not specifically provide for this, it is entirely possible that this argument may not hold water before the Supreme Court.

Conclusion

The verdict of the Supreme Court on this issue is still pending. It does appear that the Supreme Court is taking a soft stand on this matter and is being sympathetic towards the large chunk of small borrowers. However, the RBI and lending institutions also seem to be holding their ground.

What we need is a practical solution to ensure that while borrowers are provided some respite to tackle their reduced cashflow problems and remain afloat, lending institutions are also provided an opportunity to remain stable. To enable this, the RBI had, as a complementary measure, introduced a new framework on 6 August 2020 – the Resolution Framework for Covid-19 Related Stress[8] (the Framework). Under the aegis of this Framework, lenders are permitted to implement resolution plans in respect of borrowers whose cashflows have been affected specifically on account of the Covid-19 pandemic. Such resolution plans may include rescheduling of payments, conversion of accrued interest into another credit facility or providing a moratorium for a maximum period of two years. Since a "one size fits all" approach would not be a practical solution to this problem, this Framework allows banks to customise solutions based on the cashflows of each borrower. The benefit of availing the restructuring scheme under the Framework is that borrowers can defer their loan obligations for a period of two years until their cashflows improve. However, borrowers must also be cognizant of the costs associated with this. While each lending institution has formulated its own board-approved policy, what is necessarily being imposed by most banks is a higher rate of interest as well as a certain processing fee to implement such restructuring.[9]

To strengthen its case, the RBI has appointed an expert committee under the chairmanship of Rajiv Mehrishi, former comptroller and auditor general of India. This committee has been entrusted with the responsibility of assessing the impact of waiver of interest and compound interest during the Moratorium Period, on the Indian economy. For now, we would have to wait to see the final report and estimated figures to be laid out by this committee before the Supreme Court. It is quite likely that a complete waiver of interest on the Moratorium Period would not be provided, taking into consideration the overall impact on the economy. Having said that, we look forward to an approach that strikes a balance between providing relief to borrowers, as well as an opportunity to banks to contain their financial health to withstand the pandemic. It seems "Help Government!" is written large on all placards on both sides.

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