CLEANING UP MONEY LAUNDERING

BANKS NEED LESS EXPENSIVE AND MORE
RELIABLE WAYS TO DETECT ILLICIT TRANSACTIONS

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Last year, financial institutions in the United States filed almost 5 million "suspicious activity" reports (SARs), identifying transactions with potential links to fraud or money laundering. That figure, already alarming, represents a shocking increase of 2,000 percent in just five years, in part because banks have gotten better at ferreting out illicit transactions, but mostly because money laundering, despite the best efforts of governments and financial institutions, is one of the great growth industries of our times. (See Exhibit 1.)

It's also a remarkably innovative industry. Where a few years ago, a money launderer might do little more than break large piles of cash into smaller piles to escape reporting requirements ("smurfing") or funnel illicit funds through cash-based businesses like car washes and casinos, today's far more sophisticated criminal enterprises conceal the way they move their money by using online instruments, digital payments, and dizzying numbers of global transactions. And when banks block one strategy, the launderers devise another, staying one frustrating step ahead.

For these reasons, financial institutions need to revamp their anti-money laundering methods. Most need to go much further than the first steps they've already taken. To stop money laundering, institutions need to adopt more strategic, end-to-end processes that take advantage of recent innovations in data analysis. Most important, they have to replace the familiar check-the-box compliance mindset in favor of full-on engagement.

SLIPPING THROUGH THE CRACKS

Until recently, incremental improvement ruled the day. The tools already at banks' disposal were acceptable to regulators, if not ideally effective, and few institutions saw the point of undertaking the expense, labor, and regulatory risk of creating a new system that no one had asked for.

But now, it's clear that banks need to undertake bigger changes. On average, less than one in 10 warnings currently generated by transaction monitoring systems lead to the filing of a suspicious activity report; an estimated 90 percent to 95 percent are false positives. That means in 2016 when the industry is estimated to have filed 4.7 million suspicious activity reports, banks first had to manually investigate 50 million to 90 million notifications, costing the banking industry billions of dollars.

Moreover, the current system virtually guarantees that some offenders, thanks to rudimentary modeling techniques, overloaded investigative operations, and lack of a holistic risk-management approach, will slip through the cracks. That is a risk that financial institutions cannot take. A bank discovered inadvertently aiding an illegal gambling operation 40 years ago would have been embarrassed. A bank found inadvertently supporting a terrorist attack against the United States today might suffer irreparable damage to its reputation (especially considering the obvious moral duty that banks have in their role as the systemic first line of defense against such activities).
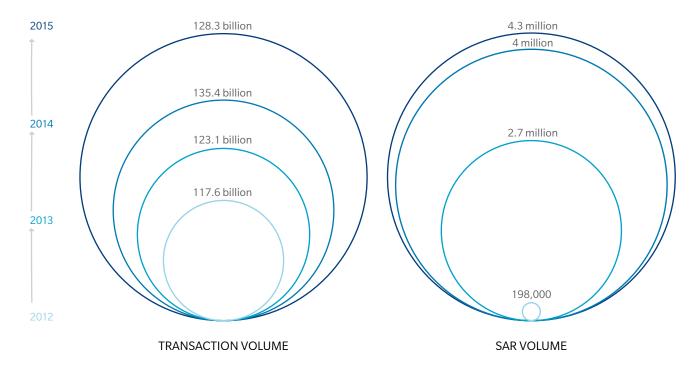
ADVANCED ANALYTICS

Advanced analytical tools are familiar in many areas of risk management, but financial institutions have only recently started using them to detect money laundering. These statistical techniques can reduce both false negatives and false positives (in some cases, false positives have fallen by 50 percent or more), and they can help institutions respond rapidly to emerging threats. Quasi-autonomous machine learning can make analytics even more effective – but it won't achieve its full potential until banks

EXHIBIT 1: RECENT TRENDS IN TRANSACTION VOLUMES AND SUSPICIOUS ACTIVITY REPORT FILINGS

The US has seen a shocking increase of 2,000 percent in just five years

2015 — 128.3 billion
2014 — 135.4 billion
123.1 billion
2013
117.6 billion
2012

TRANSACTION VOLUME

4.3 million
4 million
2.7 million
198,000

SAR VOLUME

Sources: BIS Committee on Payments and Market Infrastructures. Statistics on payment, clearing and settlement systems in the CPMI countries. Figures for 2015. December 2016; FinCEN, FinCEN SAR Stats. Technical Bulletin. March 2017 – Data includes reports for Money Laundering, Fraud, Mortgage Fraud, Casinos, Identification Documentation, Insurance, Securities/Futures/Options, Structuring, Terrorist Financing, Other suspicious activities

learn how to solve the crucial challenge of explaining to regulators the logic behind what the machine has learned on its own.

ROBUST CLIENT DATA

Analytics, of course, are only as good as the data they're applied to. And though financial institutions track transactions well, they need to raise the bar on generating high-quality and well-organized client data that is comprehensively sourced, consistently verified, standardized, and regularly updated. Without it, data analysis is forced to rely just on transaction data, which is important, but not enough. Obtaining customer data is not primarily an IT challenge – the trick is to get

bank employees who interact directly with customers to understand the urgency of consistently asking for and recording a full range of information that will support the analytics program.

DYNAMIC PROCESSES

Finally, banks need to use appropriate risk-management discipline and techniques. Analytics are a wonderful tool – but they aren't much help if they're employed without a strong understanding of what you're trying to catch and why. Banks need to deeply understand how criminal organizations are attempting to exploit them and what new trends are emerging. Money laundering is a

dynamic, constantly evolving form of criminal activity, and financial institutions need to create a dynamic, constantly evolving system for responding to it.

PRACTICING SELF-DEFENSE

Money laundering is vital to the sort of enterprises society would be better off without: terrorist networks, drug cartels, and other disruptive criminal organizations. The penalties and reputational risk faced by banks that fail to identify laundering have never been greater, and the challenge of catching the launderers is escalating constantly. We're at a point in time, however, when new tools are available to help the financial industry detect illicit transactions, and regulators seem to be increasingly willing to let banks put them to use. It's time for banks to remove the shackles and defend the integrity of their industry – and the future of their institutions.

2,000%
How much the number of suspicious activity reports have soared in the past five years

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