

## Conference Paper

# Construction of the system of internal control in microfinance organizations for AML / CFT purposes

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## Abstract

The article deals with the main characteristics of a microfinance market in the Russian Federation, reflects the main regulatory and legal framework for regulating the core activities of microfinance organizations and activities to counter money laundering and terrorist financing. The work shows the importance of internal control for AML / CFT. The purpose of the article is the development of a few activities that should be carried out by the internal control service in microfinance organizations for AML / CFT purposes.

**Keywords:** Microfinance organizations, regulation, control, terrorism, money laundering, legalization.

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## 1. Introduction

The Russian microfinance market is represented by microfinance institutions (MFIs) being legal entities that carry out microfinance activities in the form of a microcredit company (MCC) or a microfinance company (MFC) [1].

By the second quarter of 2017 2330 organizations were registered in the MFI's state register. During this period, 201 MFOs were excluded from the registry due to repeated violations of the legal requirements, and 69 organizations left the market on their own [2].

Moreover, an increase in the portfolio of MFIs for the year was 31.5% by the second quarter of 2016. As a result, the core assets of all MFIs, which represent the debt on the principal debt for the issue micro loans at the end of the reporting period, reached a volume of 104.1 billion rubles, in particular 49.2% of the participation in the MFC, despite the fact that they are less than 2% of the total number of MFIs [2].

A sufficient amount of capital is drawn on the microfinance market both for individuals and legal entities, and the number of MFIs exceeds by 4 times the number of

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credit institutions that have the right to conduct banking activities (on July 1, 2017), therefore, raises the problem of the need to regulate this market, and oversight for transparency of operations [3].

It is important to note that the requirements applicable to the microfinance market should not be similar to the requirements for credit institutions that are eligible for banking activities, otherwise, due to smaller volumes of the market, regulation will destroy it, and this can cause social instability [4].

As MFIs provide, as a rule, with credit funds, the population has low level of income that do not meet the increased requirements of banks by the criterion of creditworthiness.

Currently, the state focuses on regulating the activities of the financial sector, including the MFIs in combating the legalization (laundering) of proceeds from crime (AML / CFT). Regulation and supervision of the activities of MFIs is provided by the Bank of Russia.

Regarding the analysis of legislative acts, we analyzed the regulatory framework, which regulates the main activities of the MFI, and in the AML / CFT part.

The basic legislative act is Federal Law № 151 of July 2, 2010, "On Microfinance Activities and Microfinance Organizations," which, in Article 5 (4), formulates the necessary conditions for acquiring the status of MFIs, in particular the need for documents containing internal control rules developed for the purposes [1].

In continuation, these rules must be complied with in accordance with Federal Law № 115 of 07.08.2001 "On Counteracting the Legalization (Laundering) of Proceeds from Crime and Financing of Terrorism", which in turn refers to microfinance organizations, organizations, carrying out operations with cash or other property. This federal law distinguishes the main responsibilities of these organizations in the field of AML / CFT [5].

Also an important role in the activities of MFIs plays the Bank of Russia Directive No. 3484-U of December 15, 2014 "On the Procedure for Submission by Non-Credit Financial Organizations of Information to the Authorized Body of Information Provided by the Federal Law on Countering the Legalization (Laundering) of Criminally Obtained Incomes and the Financing of Terrorism" [6].

The allocated legislative base provides administrative, criminal liability. The MFI, as a legal entity, bears the administrative responsibility enshrined in Art. 15.27 of the Code of Administrative Offenses of the Russian Federation, so a violation of the

requirements of an MFI leads to a fine of 50,000 to 1,000,000 rubles, and suspension of activities up to 90 days [7].

In addition, criminal liability may be realized in the form of a fine of 120,000 to 1 million rubles or restriction of liberty up to two years, in accordance with Art. 174 of the Criminal Code [8].

Next, we consider the practice of applying these measures in terms of administrative responsibility. According to the portal on microfinance in 2016, the Bank of Russia fined 27 MFIs for a total of 6 million rubles, which is 16 organizations and 11.2 million less than in 2015 [9, 10].

As regards non-compliance with AML / CFT legislation (Part 1, Article 15.27 of the Code of Administrative Offenses of the Russian Federation), as well as the lack of rules for the provision of micro-loans, including on MFI websites (Part 2, Article 15.26.1), three fines were charged for a total of 170,000 as a result, these offenses took the fourth place in the number of fines awarded by the Bank of Russia to microfinance organizations [10].

Thus, MFIs need to maintain internal control, including that they must have approved internal control rules, which in turn should be developed in compliance with regulatory legal acts, the list of which is posted on the website of the Central Bank of Russia.

Internal control is necessary to ensure compliance with legal requirements, licensing requirements, and to identify and prevent violations in the activities of MFIs. Including internal control determines the causes of violations and perpetrators, because of which these violations occurred.

In accordance with the legal framework in the field of AML / CFT, microfinance organizations, as organizations that carry out transactions with funds or other property, are required to implement a few activities [5]:

- To develop the rules of internal control in order to counteract the legalization (laundering) of proceeds from crime and the financing of terrorism, and to carry out their regular updating, taking into account changes in the legislative base of the Russian Federation.
- A responsible person must be appointed to the organization that will be responsible for creating local provisions for AML / CFT purposes, as well as be responsible for the compliance of the internal legal framework with the AML / CFT legislation of the Russian Federation and be responsible for the implementation of these provisions.

- To conduct a qualitative analysis, identification of customers with whom it is planned to conclude contracts.
- To carry out regular updates of customer information.
- To be engaged in the identification of suspicious transactions and transfer of information about them to Rosfinmonitoring.
- To freeze (block) money or other property of clients, if it is involved or there is a suspicion that he is involved in extremist activities or terrorism, while informing Rosfinmonitoring.
- On a regular basis, clients should be monitored against which freezing (blocking) of funds or other assets should be applied. Also, Rosfinmonitoring should be informed accordingly about the inspections carried out.
- To pay an increased level of attention to transactions that are related to customers who have a registration, residence or location in a state that does not implement the recommendations of the Financial Action Task Force on Money Laundering.
- To carry out a number of declared measures aimed at identifying high-risk individuals among its clients, as well as the disclosure of foreign public officials (IPDL) and individuals replacing public and / or public positions in Russia with their clients. And also MFOs should implement a number of mandatory measures, established by the RF legislation on AML / CFT in respect of the above categories of customers.
- It is necessary to conduct both internal and external training of all employees of the organization in the field of AML / CFT in various forms (briefings, refresher courses, seminars) on a regular basis established by the requirements of the regulatory legal acts of the Russian Federation in the field of AML / CFT.
- To keep the necessary documentation (for at least five years from the completion of the contractual relationship) associated with the implementation of internal control in the organization for AML / CFT purposes.
- To observe the confidentiality of documents and other information in order to implement the AML / CFT rules.
- To conduct regular monitoring of the implementation of internal and external regulatory and legal acts for AML / CFT purposes, and drafting and reporting on the results of monitoring.
- MFIs must register with the Rosfinmonitoring portal and gain access to their Personal Office for remote interaction with Rosfinmonitoring.

Despite the requirements that oblige microfinance organizations to build a system of these AML / CFT activities, in the analysis of the market for microfinance companies following the results of 2016, in terms of "Top-10" in 9 microcredit organizations, there were no rules for internal control among open sources, that over the volume of the loan portfolio they accounted for 49% of the market at the end of 2016 [11].

## 2. Conclusion

The results of the conducted research clearly demonstrate the need to introduce effective work of internal control in microfinance organizations. For its implementation, it is necessary to implement a number of specific activities proposed below, which provide internal control over microfinance organizations in the AML / CFT area:

- Conducting trainings among all employees of organizations;
- Identification and in-depth study of the client, even if it is not suspicious in the field of legalization (laundering) of proceeds from crime and financing of terrorism by primary criteria;
- To manage risk for AML / CFT purposes;
- To record data provided by the Federal Service for Financial Monitoring on suspicious persons in the field of legalization (laundering) of proceeds from crime and financing of terrorism and to regularly monitor these data;
- To interact with consulting agencies to develop new products for AML / CFT purposes;
- To carry out internal investigations to establish the cause of the violations that have occurred in the work of the organization and the perpetrators, which caused these violations;
- To regularly inform Rosfinmonitoring on suspicious transactions, persons and other criteria, which are stipulated by the legislation of the Russian Federation in the field of AML / CFT;

In addition, we have developed indicators to assess the effectiveness of these items:

- The level of fully information about clients
- Maturity of the risk management system for AML / CFT purposes;
- Professional competencies of the employee ensuring the execution of activities for AML / CFT purposes.

As part of the process of digitalization of the economy, it is possible to use modern technologies, such as terminals or mobile applications for issuing microloans, which have the ability to identify appearance, scan documents and other functions, and carry out an automated check with electronic databases of state institutions and microfinance companies.

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