

What faster payments means for anti-money laundering compliance

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ABSTRACT

The global phenomenon of faster payments is having an impact on operational issues related to anti-money laundering (AML) compliance. Faster payments are a response to the need to modernise current payment settlement networks as a result of market, technology and demographic trends. Faster payment networks provide benefits to the three major participant groups: corporations, consumers and financial institutions. AML compliance operations have traditionally been designed to operate in a batch mode, holding and reviewing potential suspicious transactions in a queue prior to release. The pressure to release transactions in a faster payments environment is significantly higher, potentially affecting customer service level agreements and the need to comply with established AML review procedures. There are opportunities to improve AML compliance procedures by re-examining processes used, staffing approaches and optimising technology tools.

Keywords: faster payments, real time payments, compliance, anti-money laundering, terrorist financing

DEVELOPMENT OF FASTER PAYMENT NETWORKS WORLDWIDE

Definitions

Faster payment networks have gained traction globally, driven by the inherent demand from businesses and consumers looking for real-time ability to make payments and settle between the originator and beneficiary. To date, there is no universal definition of faster payments, also being referred to as real-time payments, instant payments, immediate



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payments and the like.¹ In the USA, National Automated Clearing House Association's (NACHA) Payments Innovation Alliance defines 'a real-time payment as an immediate, irrevocable, interbank account-to-account transfer that utilises a real-time messaging system connected to every end user through a financial institution, third party or another real-time system'.² The definition goes on to include: 'Funds are available for use by the receiver and real-time confirmation is provided to both the sender and receiver in seconds.'³ The Bank for International Settlements Committed on Payments and Market Infrastructures defines faster payments as 'a payment in which the transmission of the payment message and the availability of "final" funds to the payee occur in real time or near real time on as near to a 24 hour, seven day basis as possible'.⁴ For the purposes of this paper, faster payments are meant to include all versions of more frequent and real-time payment schemes.

Examples from around the world

Various iterations of faster payment schemes have been deployed around the world. In Europe, the Euro Banking Association (EBA) has developed a payments infrastructure platform that allows for instant payments and settlement across the Single European Payments Area (SEPA), scheduled to go live in November 2017.⁵ The platform is available to payment service providers in the European Union to develop various payment services to businesses and consumers alike. The Central Bank of Mexico has deployed the Interbanking Electronic Payment System (SPEI), which clears low value transactions every 20 seconds during working hours. SPEI was designed to clear and settle large payment volumes in real time to address safety and convenience issues for customers and provide efficient liquidity management for bank participants. In Singapore, the Fast and Secure Transfer (FAST) service provides

the ability for participating banks and customers to transfer Singapore dollars between bank accounts, credit and debit accounts almost instantly, with deferred settlement twice a day.⁶ Fidelity National Information Services, Inc. (FIS), a payments services provider, has indicated 19 faster payment schemes are operational around the world, with five to be deployed very soon and four on the radar.⁷

Focusing on the USA, various private sector payment solutions are being developed. The Clearing House, a bank-owned private consortium that operates the Clearing House Interbank Payment Systems (CHIPS) and Electronic Payments Network Automated Clearing House (EPN) ACH clearing networks, is looking to deploy its real-time payments network that allows for businesses and consumers to send and receive payments instantly, directly from their accounts similar to the Singapore FAST service.⁸ NACHA, another bank-owned private consortium, launched the Same Day ACH capability in September 2016, allowing the capability to process and settle all types of ACH payments twice a day.⁹

BENEFITS OF FASTER PAYMENTS TO CORPORATIONS, CONSUMERS AND FINANCIAL INSTITUTIONS

Faster payment networks provide real benefits to participants. Benefits can be viewed based on the three user communities: corporations, consumers and financial institutions. Cash flow management is crucial for all three user communities. For corporations, funding of ongoing operations allow for day-to-day payments of suppliers. Treasury departments typically factor in a period of float time when issuing payments to suppliers resulting in idle cash tied up in bank accounts waiting to be cleared. This period of float can be anywhere from a few days for a domestic payment, to a few weeks for cross border payments. Typically, the exact time period when funds are cleared

is imprecise, forcing treasury departments to maintain cash reserves. Faster payment networks provide the option to make ‘just in time’ payments to suppliers and credit the funds to the account upon issuing the payment as the expectation that the funds will be cleared instantly. This is also especially useful where, due to government regulations, payroll funds need to be remitted to terminated employees the same day. Conversely, when a corporation is receiving payment over a faster payments network, funds are credited instantly. There is less reliance on short term credit facilities to ‘bridge’ the float. Treasury departments have improved control and can more effectively manage their cash positions anytime and optimise their limited cash flow.

Service levels between customers and the corporation can also see significant improvement as a result of faster payment networks. Consumers anxious to receive goods or services bought from a vendor are assured that their payments have been received and cleared instantly, resulting in the provisions of said goods or services. There would be less need for customers to call to inquire if their payments were cleared and the goods had been shipped. Vendors also see benefit from faster payment networks, with the ability to check their accounts in real time for payments received prior to delivering the required goods or services. Ride sharing drivers look to be paid immediately after completing a trip. ‘Non-sufficient funds’ (NSF) conditions would no longer be a factor between consumers and vendors, helping to reduce risk levels associated with first time commercial transactions. The concept of same day payouts becomes an attractive value proposition for suppliers requiring immediate liquidity. The overused expression ‘the cheque is in the mail’ is no longer relevant.

Financial institutions, particularly banks, also see benefits from faster payment networks. Banks can provide improved customer

satisfaction by providing additional value with financial services based on faster payment networks. These value added services can include mobile applications that provide convenient, real time payment transfer capabilities linked across a customer’s debit and credit accounts. 24 by 7 by 365 payment functionality can also be an attractive proposition for consumers looking for flexibility in their banking services. Services that provide the ability to monitor account balances in real time can also be attractive service offerings that banks provide to their customers.

In the USA, NACHA provides justification for the drive towards faster payments.¹⁰ Same day payrolls, especially for hourly workers plus the flexibility for late and emergency payrolls, provides employees with faster access to their salaries. Bill payments can be expedited, enabling customers to make bill payments on due dates and allowing for faster credits for late payments. Business-to-business payments can also be expedited, allowing for faster settlement of invoice payments as well as faster account to account transfers for both businesses and consumers.

Other non-bank payment service providers can also improve the payments experience by providing additional information, services or bridge connectivity to other financial networks. In Europe, the introduction of the Payment Service Directive 2 (PSD2) sets the foundation for open banking systems. PSD2 was adopted in November 2015 by the European Parliament and required banks to provide third party payment providers access to their customer data and payments infrastructure, ostensibly to provide additional financial services not previously provided by banks.¹¹ Faster payment networks drive customer expectations for faster settlement times and when combined with an open banking platform, can result in a competitive financial services marketplace that can significantly improve the financial lives of EU citizens.

TRENDS DRIVING FASTER PAYMENTS

To understand the global drive towards faster payments, it is useful to recognise market, technology and demographic trends acting as enablers. These trends include: (1) changing buying patterns; (2) increasing mobility; (3) change of traditional banking models; (4) changing economic balance; (5) changing demographics; and (6) changing regulations.

Changing buying patterns

New technologies enable more convenient buying experiences for consumers. Merchant point of sale systems are increasingly able to accept near field communication (NFC) and contactless modes of payment, reducing the 'friction' typically associated with the in-store buying experience. E-commerce merchants provide omnipresent 24 hour consumption options within their online stores that include 'In-App' purchases, loyalty programmes, low cost rapid delivery, and safe and convenient check out services, which are all designed to encourage purchases while on the site. A new generation of 'sharing' e-commerce merchants design solutions removes the friction of paying for services altogether once rendered. Uber only requires riders to enter payment details once during initial set up, with charges for rides automatically deducted from their accounts without the need for explicit confirmation. As a result of these changing buying patterns, consumers expect their back end banking services to match the front end experiences, including the capability to pay and settle their financial transactions 'friction free'. Faster payment systems provide the capability to match these expectations.

Increasing mobility

The advent of powerful mobile phones and low cost data networks provides the communication infrastructure to deploy sophisticated online payment solutions that consumers can use to conduct financial

transactions anytime, anywhere. Mobile phone and network providers see the commercial value of utilising their equipment and networks for online commerce to attract and retain a loyal customer base of both users and merchants. Mobile payment solutions such as Apple Pay, Samsung Pay, Google Wallet and M-Pesa provide convenience and low cost solutions to settle payment transactions with reduced reliance on cash for even the smallest transactions. Faster payment networks on the back end provide the opportunity to further develop consumer and merchant friendly solutions that allow mobile phone and network providers to commercialise these additional payment services to drive increased profits.

Change of traditional banking models

Technology and market trends have resulted in the development of alternative financial solutions that disrupt traditional banking functions in the areas of payments, lending, investing, trading and mortgages. Non-traditional financial institutions, primarily financial technology (fintech) firms have led the way in disrupting the traditional banking model by providing 'app'-like solutions that address a specific financial requirement.¹² Typically, a request for a loan is obtained through a bank; however, options exist today that allow for loan requests from specialised firms that only deal with loan origination for specific categories or amounts. Crowd-funding platforms can benefit from faster payment networks relying on investors to deposit funds almost immediately in the event of a secured loan. In Kenya, M-Pesa is a mobile phone based money transfer and micro-financing service operated by Safaricom, a mobile network operator who saw opportunity to increase customer loyalty and service fees by providing financial services on its phone network.¹³ One of the reasons for its success was the high costs of money transfer using the traditional banking system. Consumers saw M-Pesa as a safe,

convenient and low cost method to transmit funds to their families by simply using the mobile phones that they already have.

The advent of distributed ledger technology (DLT) (also known as Blockchain), is also seen as a disruptor to the traditional banking model.¹⁴ DLT allows for point-to-point transfer of value using zero to low cost payment units (such as Bitcoins or some other digital currency). This technology continues to evolve rapidly with limited production ready, enterprise scalable solutions currently available. DLT could represent an alternative to the current global cross border correspondent banking network operated by SWIFT,¹⁵ which currently is a batch oriented clearing and settlement system. Any new technology that provides real time point-to-point value transfer and settlement would require a faster payments network to facilitate financial transactions.

Changing economic balance

The projected world population by 2030 is estimated to be 8.5 bn, with the fastest growth occurring in developing countries.¹⁶ By 2100, Asia and Africa will have 83 per cent of the world's population of 11.2 billion.¹⁷ These global macro trends highlight the shifting economic power to regions of high population density, reflecting changes in payment flows as well. Overseas workers look to remit earnings to their families in the safest, quickest and most cost effective manner. Chinese consumers are willing to shop online, driven by shopping incentives provided by leading online commercial vendors. The Alibaba Group hosts its annual Singles Day on 11th November and in 2016 saw its highest volume of online sales of US\$17.8 bn.¹⁸ To put this in perspective, online sales in just one day in China are more than Brazil's total projected e-commerce sales for all of 2016.

Social media platforms are also increasingly used for mobile payments, with Asian

providers such as WeChat (owned by Chinese conglomerate TenCent) offering cross border payment solutions across international currencies. These solutions allow for purchases by overseas customers in local currencies, facilitating international commerce in addition to messaging.¹⁹ US-based Facebook also offers payment solutions through its Messenger application, looking to compete with other online payment competitors such as Venmo, Google Wallet and Square Cash.²⁰

Changing demographics

The rise of Millennials can arguably be considered the most significant trend in the drive towards faster payments. Millennials are born between 1980 and 2000, and currently represent the largest living generation, surpassing baby boomers in 2015.²¹ By 2030, Millennials will represent 75 per cent of the workforce.²² Millennials are comfortable using mobile technology solutions for every aspect of their lives and expect to use them for communications, work and financial transactions. Millennials expect to pay for goods and services, conduct online banking and consider their phones as mobile wallets. Millennials, while they do have traditional banking relationships, are also willing to use alternate financial services providers for their financial needs.²³ Always on, real time and constant availability are minimal requirements for these consumers, with the expectation of a real time payments infrastructure to support these requirements.²⁴

Changing regulations

Governments around the world recognise the value of faster payment schemes and have introduced guidance and regulations to encourage the development of these services. In Europe, the Revised Payment Services Directive (PSD2) lays the foundation for improved payments experiences by establishing open access standards (through the use of open application programming

interfaces (API)) between banks that maintain customer accounts and payment service providers that offer financial services. The Directive introduces two new segments into the payment landscape: Account Information Service Providers (AISPs) that can access a customer's bank account, and Payment Initiation Service Providers (PISPs) that initiate payment transactions on behalf of the customer. The Directive comes into force in 2018 with the expectation that innovative payment solutions are offered to the market. AISPs and PISPs are able to offer financial services on top of a bank's data and infrastructure. Social media apps can access a user's bank account to enable payments or analyse your spending patterns to suggest ways to optimise savings; these are just some examples of applications that PSD2 looks to encourage.

In the USA, the drive towards faster payments received a significant push with the introduction of Same Day ACH from NACHA.²⁵ NACHA is the National Automated Clearing House Association that provides the rails connecting financial institutions (particularly banks and credit unions) to allow for payment transactions to transfer and settle between each other. Previously, transactions could take 2 to 4 days to settle with one limiting factor that ACH transactions could only be settled once a day. This means that if an ACH transfer was initiated after the daily processing window closed, there was a minimum of a day's window before it was settled, assuming there were no account or numbering errors associated with the transaction. The Same Day ACH rule allows for payments to be processed and settled within the same day that the ACH transfer is submitted. In phase 1, rolled out in September 2016, the ability to process same day credits became mandatory.²⁶ Two new processing windows with settlement times have been introduced — 1:00 pm and 5:00 pm ET. In phase 2, scheduled for September 2017, the ability to process same day debits will become mandatory. Finally,

in phase 3, scheduled for March 2018, a third settlement window will be introduced.

IMPLICATIONS FOR ANTI-MONEY LAUNDERING COMPLIANCE

AML compliance is typically a linear, batch oriented process requiring screening of transactions to determine if there is potentially high risk suspicious activity related to money laundering. All financial institutions are legally required to conduct due diligence on their customer accounts against pre-established compliance screening procedures. In the USA, the Bank Secrecy Act²⁷ was enacted in 1970 requiring banks to detect and report potential money laundering or terrorist financing activities. In Europe, various money laundering directives have been introduced with the latest Fourth Anti-Money Laundering Directive requiring a broad range of financial institutions to report on terrorism financing and to combat money laundering.²⁸ Many countries around the world have similar customer identification/know your customer (KYC) programmes designed to achieve similar objectives. Typical programmes match customer and transaction information against sanction and high risks lists to determine possible matches. These sanction lists are typically provided by government authorities (Office of Foreign Assets Control (OFAC) Specially Designated Nationals and Blocked Persons List in the US²⁹ and Her Majesty's Treasury Financial Sanctions List in the UK³⁰). If there is a match, the transaction is held, the account is blocked and reported to the relevant authorities. Financial institutions may also screen against a high risk list that includes politically exposed persons or government officials that are exposed to possible corruption opportunities based on their positions. Based on their risk profile, they can choose to limit these transactions internally to minimise potential risk and reputational exposure to these accounts.

Typical screening solutions can result in a high rate of false positive matches. Muhammad is the most common name in the world³¹ and also appears frequently on sanction and high risk lists. Screening solutions may inaccurately flag customer accounts with these names. Sanction lists also include sanctioned countries like Cuba, which may cause matches if there is reference to the country. For example, Venmo, a popular money transfer service flagged payments that referenced ‘Cuban sandwich’ and held the payment pending review.³² While this is clearly a false positive match, the example highlights the challenges in accurately matching truly suspicious transactions and the batch oriented review process that can hold up high volume (and potentially lower value) AML compliance screening.

There are several approaches to consider to optimise the AML compliance screening process in a faster payments world. They can be categorised into process, people and technology.

Process

The AML compliance review process can be clearly communicated to internal and external stakeholders to establish understanding of the required turnaround. Typically, AML compliance reviews are mandatory and established by compliance departments with a focus on legal requirements over customer satisfaction. This legal focus can lead to sub-optimised customer service level experiences in the event of potential match review. The downstream impact of potential reviews in the event of matches should be laid out clearly, including communication of potential suspension of banking privileges during the review process. Certainly the AML compliance team would attempt to clear the transaction in question as quickly as possible; however, delays can occur especially where volumes may be high. Communicating turnaround times is important in maintaining customer service levels.

Another process approach to consider would be to set maximum transaction value limits from enhanced compliance due diligence processes. Typical AML compliance processes seek to isolate significant high risk transactions that are more harmful to the financial system. These high risk transactions may be (but not always) higher in monetary value. An option is to allow low value payments that flag screening solutions to be automatically released due to their lower risk to the financial system. Compliance screening could be triggered only after transaction limits are reached within a set time window. Compliance departments can still consider reviewing these transactions ‘after the fact’ and if deemed a positive match can freeze the account and seek alternative redress from the customer. While there still is a risk that the bank violates AML compliance requirements, the risk of significant impact would be low given the low value of the payment.

Compliance departments can also prioritise their case flow based on the importance of their customers. VIP customers, whether high net worth or profitable to the bank, would have priority in the event of an AML compliance review, with commitments from the compliance department devoting additional resources to make final decisions within a shorter window and to provide regular updates to affected customers. While AML compliance processes are mandatory for banks, managing expectations is also important in maintaining customer satisfaction to ensure ongoing profitability.

Transaction limits for money services business and alternative remittance service providers (like Venmo) could also be assessed to better understand their operational impact on AML compliance. These financial services providers typically have lower average transaction values per transaction; however, have transactions originating from low risk to high risk countries (eg money remittances from the USA to Latin America). Compliance departments within these providers can also

factor in the degree of country risk relative to the operational costs of money transfers prior to lowering the maximum transaction value limits that trigger enhanced compliance due diligence processes.

People

Faster payment systems imply a more rapid throughput of payment transactions to be processed. This directly impacts AML screening processes and the staff levels and disposition required to review transactions. Faster payment systems also imply that transactions are settled within a shorter window. If banks are looking to maintain service level agreements with customers, this means that compliance departments have to increase their staff and ensure they have sufficient knowledge and authority to be available to review transactions quickly. Consistent review processes should also be implemented. Staff may also need to be available 24 by 7 by 365 days to avoid potential disruption to current payment processes. Formal AML compliance training is typically provided on a regular basis as part of a regulatory requirement. This formal AML training can be enhanced to include greater understanding of the implications of faster payment throughput and the need for more proactive review and dispositioning. Review processes can be further segmented with clear escalation processes to facilitate high throughput. Low value payment transactions could be reviewed by specialised compliance groups. Training for the payments business unit can also be considered to educate them on the challenges of AML compliance review processes and help identify true 'red flags' in a payments transaction. This helps provide optimal understanding of AML processes and effective review and escalation.

Technology

Financial institutions rely on technology to help meet their AML compliance screening

requirements, integrating sophisticated matching engines into their back end payment systems. With the introduction of faster payment solutions, the need for matching engines that can accommodate these solutions is crucial to ensure continued operations. Typical high false positive match rates (anywhere between 2 per cent to 15 per cent of total transaction volumes) become challenging to maintain in a faster payments environment, especially for financial institutions with high volumes. These high false positive match rates can continue to be optimised by introducing more sophisticated matching engines that include additional data qualifiers which accurately match customers and transactions. For example, if 'Cuba' is included in an address field other than a country field, the matching engine can automatically disqualify the transaction as a false positive. This would be the case if the address for the payment referenced the town of Cuba in New York (zip code 14727) instead of the country Cuba. The term 'Cuban sandwich' could also be programmed to be ignored if included in a reference field for a payment transaction. Various logical rules can be included to optimise the matching engine.

Data analytic techniques can also be adopted in AML compliance screening engines to reduce false positive matches. Real time learning algorithms that proactively review the transactions and additional data elements can 'learn' the intended purpose of the payment transaction to flag true matches.

The advent of new financial technology (fintech) firms can also make a positive impact on faster payments processes and compliance technology solutions. Fintech firms bring a fresh approach to faster payments, driving down costs, increasing transparency and speed of cross border transactions. New payment service providers (PSPs) have introduced alternative cross border transfer and settlement processes that do not rely on intermediaries, setting up direct transfers between accounts. Both fintechs

and PSPs recognise the need for increased market reach as corporations widen their distribution channels and supply chains and look for channels to make payments and settle financial transactions faster. Fintechs and PSPs look for ways to minimise the impact of AML compliance processes both from a process and technology perspective. Finally, the advent of DLT brings the promise of point to point payment transactions and settlements, facilitating 'pre-screening' transactions to alleviate the need for intermediary screening by other financial institutions.

CONCLUSION

Faster payments continue to make inroads globally, driven by market, technology and demographic trends. Irrespective of trends, the threat of money laundering and terrorist financing continue to be major issues that affect the reputation of the financial system. Ongoing AML compliance processes to screen payments are a legal obligation, with the very real possibility of large fines and reputational damage to the financial institutions that violate these requirements. AML compliance departments, however, need to adapt in order to meet both their legal requirement and customer expectations. There are opportunities where AML compliance can be optimised by systematically reviewing the process, people and technology aspects in order to ensure optional deployment of faster payment solutions. When reviewing processes, communications between internal and external stakeholders in establishing service level assignments (SLAs) are key. Training is a key element related to the people aspect, recognising that the demands for screening payments becomes a 24/7 requirement in the faster payments world. Finally, technology has a pivotal role to play in ensuring operational efficiency, helping to manage costs while providing the best possible customer experience.

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