

Óbuda University

PhD thesis booklet



The interrelations between banking and insurance systems in the prevention of international financial abuse

by

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1. The background of the research

The subject matter of this thesis is financial abuse. As this type of abuse goes beyond the state boundaries, i.e. the international aspect of financial frauds, this research will predominantly address the phenomenon of money laundering, as a dominant type of international financial abuse, and particularly due to its high correlation with terrorism financing, which is one of the major challenges of modern civilisation. Virtually entire international legislation, recommendations and laws related to the area of financial abuse are directly linked to these areas.

The modern financial systems, typical of the current human development stage, consist of a combination of a number of institutions and participants (central bank, commercial banks, savings banks, savings-credit associations, pension funds, investment funds, insurance companies, intermediary organisations), financial markets (foreign currency market, money market, capital market etc.) and financial instruments (debt instruments, equity instruments, derivatives – derivative instruments).

Within such financial systems, banking and insurance are two particularly important segments, but also the two sectors with the highest exposure to the risks of abuse and fraud. Their roles in the economic system are irreplaceable. All the vital financial functions flow through the channels made available by the banking and insurance sectors – the function of payment, money creation, liquidity, crediting, savings, risk prevention, macroeconomy, transfer of resources through space and time, international payment transactions, foreign currency transactions, information providing and the like. Each one of these points carries a risk of errors, weaknesses, harmful actions, abuse, fraud or theft.

The most relevant features of modern financial systems are as follows:

- dynamics,
- openness and
- complexity.

Dynamics comes as a result of the fact that the economic and financial systems are constantly experiencing changes and new events, thus exposing the system to temporary states of balance and imbalance. Financial system is not a static one and set for good. Modern financial systems are continuous, and operate 24 hours a day, 7 days a week, 365 days a year.

The **openness** comes as a result of the necessity of operations in the global market, i.e. the companies' natural need to embark on various forms of cooperation with business partners, outside the boundaries of their national economies. Banking and

insurance, as well as the financial system as a whole, achieved a global character long ago. The international flows of financial assets and capital are at such scale that it is almost impossible to live and operate isolatedly from the international community.

Complexity of the financial systems comes as a result of the circumstances in which they comprise a large number of sub-systems and a series of participants, and are regulated by complex legislation, both at the national and international level, and they share the same fate and the consequences of the events at the global level.

Under the impact of the events at the international level, the emergence of the economic crisis and novel trends in the corporate world, there has been a rapid surge of financial frauds in the previous decade, which has forced the companies, international institutions and organisations to establish the new mechanisms, instruments, strategy and institutions to tackle the issues.

In the first line, these were directed towards domestic entities, aimed at increasing the efficiency of internal oversight, achieving the credibility of financial reporting, establishing the efficient external control, with a view to closing the channels for the leakage of funds, preventing the money laundering and disabling the direct financial crime, but the one craftily implementing the state-of-the-art technology as well. The abuse in this area has directly undermined the economic stability of the countries, slowed down the economic growth, increased the unemployment, encouraged political conflicts and intensified the social tensions. The accurate data is not available, yet it is estimated that thousands of billions of dollars have been withdrawn from the legitimate flows in these ten years, and transferred into the narcotics market and arms trade, trafficking in human beings and terrorism.

The second objective of actions against the financial frauds was directed towards the development of international cooperation, creation of new regional and universal institutions, upgrading the specific financial regulations and forming the global defence mechanism for the prevention of financial abuse. After the 9/11 events when the twin towers were destroyed in New York, the world realised that the terrorist actions, global crime and numerous conflicts around the globe were backed by the enormous financial resources, moved from the legal financial flows through the illegal channels, abuse, corruption and frauds in order to form their own interests, ambitions, armies, even territories.

In this respect, the prevention, suppression and hindering the financial abuse at the international scale has become a critical issue for the entire international security, and thereby for the protection of stability, integrity and independence of each international community member state. The leading international organisations, and primarily, the United Nations, the European Union, other regional organisations and

institutions, specialised professional, expert and security associations have undertaken a series of activities to this end, but the financial abuse with the both global and individual effect has not been suppressed yet.

With the fast **development of information technology**, and the liberalisation of all kinds of communication and transport, with the development of new products in the banking and insurance industry, the additional room emerges wherein the individuals, groups and organisations with bad intentions seek to obtain illegal profit and commit frauds of all kinds. The entities and institutions involved in money laundering and terrorism financing attempt to abuse the free movement of capital and provision of financial services, which is a threat to the stability of every country's financial system.

This is the reason why the institutional and legal frameworks are constantly upgrading, at both the national and international levels, where it is becoming more and more evident that only through a closer cooperation, a more solid organisation and uncompromising relationship towards the perpetrators of abuse can this threat be defeated. The frauds in banking are predominantly in the sphere of identity theft and breaching the electronic security of bank accounts, while the insurance is increasingly dominated by a variety of false claims and fraudulent actions related to risk claims.

As a part of further activities against the financial frauds, the states should first establish the cooperation with the neighbouring countries, regardless from their political differences and enmity, and afterwards at the regional level, so that they could use this standpoint to form a common ground for global security aimed at combating the financial abuse. The countries must not forget that the criminals and criminal organisations are only limited by their own imagination, and not by international boundaries. Therefore, if the countries remain oriented towards their own laws and state borders, they will fail to undertake measures against the financial abuse of the international nature.

The countries must direct their joint efforts towards a comprehensive, theoretical and practical research of the methodology and techniques of financial abuse, reviewing and expanding the indicators related to wrongful acts, development and innovation of typology of frauds, identification of all forms of financial crime in banking and insurance, finalising the legislation, supplementing the criminal legislation, advancing the police and investigative methods, harmonising the penalty and judicial policy in this respect, and a series of other measures possessing both the legal and economic dimension, as the financial frauds undermine every country's legal system as much as they undermine the country's economic being. The countries must network their institutions for combating the financial abuse, and particularly the ones in the area of banking and insurance.

2. The aims of the research

The main research objectives are:

- Exploring, detecting, defining preventive operations concerning financial sector and insurance companies.
- The goal is to determine protective systems by getting to know concrete misuse cases, which prevent further realization.
- This way we strengthen the security of the financial sector and reduce the danger to minimum.

Additional research objectives are:

- Overview and systematisation of the normative and institutional frameworks required for combating financial abuse
- Studying through the main typologies and indicators for the financial frauds in the banking and insurance sectors
- Highlighting the importance of international cooperation in combating the financial crime
- Studying through the examples from the practice
- Highlighting the importance of certain activities not sufficiently emphasised in combating the financial crime, such as: staff training and improvement, communication and propaganda, organisation and coordination

3. The methods of investigation

For developing this thesis, the following scientific methods were applied:

- The first part of the thesis makes use of the collection method and the analysis of the existing scientific results and achievements,
- The analysis of the secondary sources (the analysis of documentation) has been applied to a large extent.
- For developing the Chart of the system for preventive actions in cases of financial abuse (hereinafter the Chart), the following were used - the case study method, the best practices techniques, process approach, process analysis, business intelligence techniques, and risk analyses.

- The methods for Chart development, collection and data analysis methods were used.
- For the implementation of the Chart, the statistical research methodology was used, along with the appropriate methods and techniques: data collection, data processing and analysis method, concluding method.

The research results are presented in a narrative, descriptively, and through a number of tables, figures and graphs with the comparative results. The research is interdisciplinary, as it involves the methodology, criminology, information science and other areas of science.

Based on the analysis of the thesis, it may be concluded that the applied scientific methods and techniques are suitable, in terms of their relevance and structure, for the topic and the research performed.

4. Scientific hypotheses

The main assumptions which are the basis for the thesis research

- It is possible to develop a uniform, systemic solution to the efficient fight against financial abuse. This solution must be based on clearly defined, science-based, methodological principles.
- Prevention is the most efficient form of protection of the financial sector (primarily the banks and insurance companies) from frauds and abuse.
- The main methodological principle the system is based on for the purpose of preventive actions in cases of financial abuse is that it must be based on risk-assessment. The system Chart, apart from the assessment of the risk of exposure to financial abuse, also implies the risk classification, within the existing fraud typology, as well as its materialisation in the form of suspicious transactions.
- International cooperation is a necessary condition for the efficient prevention of financial abuse.

Additional hypotheses:

- The use of ICT facilitates combating the financial crime
- All the employees tasked with the prevention and fight against the financial frauds need to undergo continuous training

- The awareness of the general public needs to be raised in terms of the importance and consequences of financial abuse, so as to ensure the preventive actions

5. The new scientific results

The thesis has achieved its primary goal: it has examined the exposure of the contemporary society to financial crime risk, identified characteristics and the extent of financial abuses, particularly money laundering and its modalities, and suggested the Chart system for preventive action. The thesis has particularly focused on banking and insurance, by presenting the main types of frauds in these sectors.

The most important **scientific contribution** of the doctoral thesis is that it provides a systemic solution, i.e. it builds a Chart system for preventive action in cases of financial abuses that rests on a scientific approach, i.e. a clearly defined methodological procedure for detection of frauds and analysis of risk of frauds. The construction of this Chart started from the assumptions defined. Based on the analysis of components and the processes of the Chart, we arrived at the conclusion that the fourth component of the Chart – national institutions, particularly the competent FIU, shoulders the major burden. Continuous investing is therefore necessary, particularly in the FIU, police and the justice system. However, investing in institutions means investing in human resources (education and training with financial support so as to prevent the outflow of competent staff). Countries need to connect their institutions for the prevention of money laundering, particularly in banking and insurance, primarily by using advanced ICTs. Furthermore, it is important to further develop international cooperation, as the system cannot survive separately without interaction with the environment. It requires excellent organisation and perfect coordination of all components in the system.

Professional contribution of the thesis is a systematic, comprehensive and critical overview of regulations and institutional frameworks for fight against financial frauds, at both the national and international level.

Additional contribution of the thesis is that it points to further directions in the combat against financial crime – strengthening activities which are defined by processes P1 to P3 of the Chart. Particular emphasis is placed on the significance of international cooperation, education, promotional activities and the use of ICT, while proposing further steps and activities on this path.

6. Future research and recommendations

Eurostat, the statistical directorate of the EU adopted in 2013 the European System of National and Regional Accounts (ESA 2010), which is the newest internationally compatible EU accounting framework for a systematic and detailed description of an economy. The ESA 2010 was published in the Official Journal on 26 June 2013. It was implemented in September 2014; from that date onwards the data transmission from Member States to Eurostat is following ESA 2010 rules [42]. Among other things, ESA 2010 envisages presenting income from illegal activities in GDP, under the item “services”, whereby estimated revenues from prostitution are presented on the supply side, and drug trafficking on the demand side. Without looking into the motives of such a decision, it should be noted that in this manner European countries can represent higher level of their GDP.

As regards the challenges that the banking sector faces, the already cited publication, entitled Money Laundering Typologies in the Republic of Serbia has raised the following questions related to the banking sector: [80]

An increasing offer of services and products provided by the banks will change in the future. The development of infrastructure and technology will result in priority of the e-banking over conventional modes of banking.

There are two key reasons why banks are interested in e-banking:

1. Users' demographics - Internet and smartphones users are mostly young people with higher degree of education and higher income than an average client.
2. Internet and local wireless networks are a very efficient and cheap distribution channel.

Fighting for the clients, the banks expand the portfolio of their services and offer the products which rely more on Internet and mobile phones, therefore, the increased offer of services over so-called virtual counters is expected, as they are used today when applying for an online loan.

The PayPal system enables transactions, via Internet or by using bank cards, directly from a PayPal account, which is not subject to strict procedures for client identification and for determining the origin of funds, as well as sending money to anyone with an e-mail address.

Applications which are currently developed are moving into two directions: traditional ebanking systems (or internet banking), intended for desktop computer users,

and m-banking. Ebanking is a package of modern services which enables simple use of banking services by the clients, using the most common channels of communication – Internet, mobile phone, land phone. Major advantages of these services are their lower cost, significant saving of time and the possibility of performing transactions 24 hours a day, 7 days a week, 365 days a year. With the Mcommerce service, the client is able, at any time, using his mobile phone, to give an order to his bank to transfer funds in a small amount, from his account to a different one, from which the funds can be further transferred or withdrawn in cash or with a bank card. It is anticipated that m-banking will see a stronger expansion than e-banking. This is already coming true given that the number of mobile phone users by far exceeds the number of internet users.

However, it is these very characteristics, which come as an advantage for the clients that may cause potential danger of financial abuses, given that the client is spatially remote from the bank, thus hindering the identification procedure. This gives rise to new possibilities for money laundering, which should be timely foreseen, prevented or recognised.

The question is how banks will fight against alternative modes of payment via Internet, which already exist, such as “cyber cash”. A card with a chip contains cash which can be withdrawn by phone or from ATMs, and the cash can also be transferred from one card to another. There is no way to track down these card transactions, because there is no registry of transactions, as it exists with Visa or MasterCard credit cards.

When it comes to other financial sectors, and the insurance sector as well, the global economic crisis from 2007, which brought about the dramatic drop in value of shares worldwide, led to an increased demand for gold and other precious metals, which are currently very interesting for investments and trade.

There is also an opinion, advocated by large banks, that the future belongs to huge financial institutions which will provide investors with various services ranging from insurance, car loans, to airplane tickets. On the other hand, the lobby led by the giants of the ICT, such as Apple, Google and Microsoft, believes that the future belongs to the companies that will, with the development and application of new technologies, offer investors the maximum control over their finances, through sophisticated products that balance risk and profit. The idea behind the revolution in technology of banking is that technology and finances have become one and that the difference between the software and money is disappearing. [80]

Scientific statements connected to the thesis points

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