AN ANALYSIS OF THE STANDARDIZATION OF ANTI-MONEY LAUNDERING COMPLIANCE REQUIREMENTS AND THE EXISTING DIGITAL LENDING PAYMENT METHODS UTILIZED IN INDIA'S MSME

Krishn A. Goyal, Jai Narain Vyas University
Sudha Bishnoi, Jai Narain Vyas University

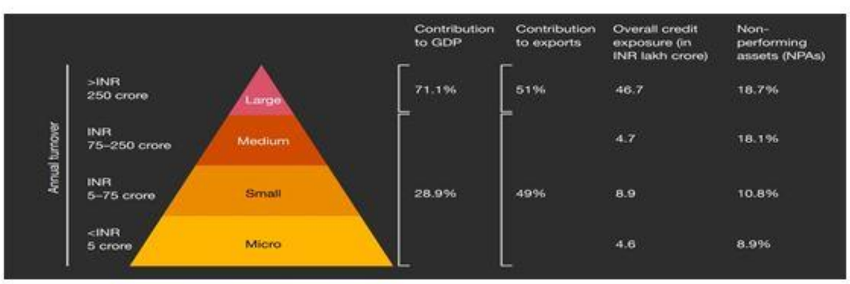
ABSTRACT

The emergence of financial technology (FinTech), particularly in the micro, small, and medium-sized enterprise (MSME) market in India, has altered the financial environment. In the context of the FinTech-based MSME sector, unique challenges arise due to the speed, scale, and anonymity associated with digital transactions. This necessitates a comprehensive regulatory framework that addresses the specific risks and vulnerabilities associated with this sector. However, the increasing adoption of digital platforms and online transactions has also opened doors for money laundering activities, posing a significant challenge to the integrity of the financial system. This abstract explores the regulatory measures required to combat money laundering specifically within the FinTech-based MSME sector in India. Effective anti-money laundering (AML) regulations are essential to safeguard the integrity of the financial sector and prevent illicit financial flows.

Keywords: MSME, Digital lending payment (DLP), Fintech, Anti-money Laundering (AML), Regulatory Framework, India

INTRODUCTION

One of the Fintech markets with the quickest growth is India. The Indian FinTech sector is anticipated to be worth $50 billion in 2021 and $150 billion in 2025, according to the National Investment Promotion & Facilitation Agency. The FinTech-based micro, small, and medium enterprise (MSME) sector in India has experienced significant growth in recent years, bringing numerous benefits and opportunities. In the Fig 1 the sectoral position of India MSME sector has been shown. According to the RBI, as of June 2020, India had a total commercial lending volume of $919.1 billion (Anti-money laundering market size and share. (2023). MSMEs received only 25.3% ($232 billion) of the overall lending. The predicted $219 billion loan requirement for MSMEs exceeds the financing available from the formal industry, which is severely uneven (Kumar, 2023)



Source: Reprint from "FinTech for underserved - Future of FinTech and payments to drive financial inclusiveness" by PwC (2021), pp 9

FIGURE 1
SHOWING SECTORAL OVERVIEW AND SIGNIFICANCE OF MSMES

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On the contrary, increased use of digital platforms and online transactions has also presented challenges in terms of anti-money laundering (AML) regulations. 365 fintech and their non-banking financial firms (NBFCs) partners were the subject of a protracted money laundering probe by the Enforcement Directorate (ED), which is reported to have turned up over Rs 800 crore in illicit gains (Rajput & Bhalla, 2022).

So to regulate and control this advance technological innovations in AML are creating a secure path in Digital lending payment (DLP) process. The integration of advanced technologies, such as blockchain, can enhance the transparency, traceability, and auditability of financial transactions which reducing the opportunities for money laundering. Additionally, the development of RegTech solutions tailored to the FinTech sector can automate compliance processes, making it easier for MSMEs to meet regulatory requirements. As a result, this study examines the digital lending environment of India's MSME sector as well as the AML problems it faces. This report will also recommend a number of essential regulatory steps to improve AML practises in the FinTech-based MSME sector.

REVIEW OF LITERATURE

The MSME sector has expanded over the past fifty years to become a very vibrant and active component of the Indian economy. The nation's entire industrial output, employment, and exports are significantly impacted by the MSME sector. It is credited with producing the greatest number of job opportunities and significantly boosting exports and industrial output (Zanjurne, 2018).

The Twelfth Five Year Plan for India states that credit is essential for promoting the expansion of the MSME Sector, particularly the MSE Sector, because of its limited access to alternative sources of finance. In an IFC and McKinsey & Company analysis, 11 to 17 million formal MSMEs (or about 45 to 55 percent) in the Emerging markets around the world do not have access to traditional institutional funding. The financial gap widens significantly when micro and informal businesses are taken into account; 65–72% of MSMEs (240–315 million) in emerging nations lack financing (Choudhury & Goswami, 2019).

The hitherto cash-based Indian economy has welcomed the opportunities presented by fintech, which have been primarily stimulated by an increase in E-Commerce and Smartphone use. With a five-year CAGR of 22 percent, the transaction value for the Indian fintech sector is predicted to surpass USD 33 billion in 2016 and reach USD 73 billion in 2020 (Vijai,2019).

Many banks have made it possible for current account customers to use digital banking to ask for an overdraft or short-term loan. Mobile financing provides SMEs with credit access and helps them satisfy their immediate business demands (Mararo & Ngahu, 2017).

In the wake of digital banking and the subsequent expansion of MSMEs, the ease of processing payments to creditors or suppliers saves both resources and time, which has a significant impact on MSMEs' revenue (Meher, Hawaldar, et al., 2021).

FinTech in India has the potential to provide sensible solutions to troubles confronted by conventional financial establishments, which include poor penetration, a dearth of credit score records, and a transaction financial system based on cash (Sreekala, Revathy, et al., 2023).

Most FinTech companies do not consider themselves to be financial service providers. Major regulations such as the Bank Secrecy Act (BSA) and the Organised Crime Act (OCA) play important roles in managing AML issues. However, most FinTech firms' offerings violate the existing legal framework and constitute a serious infraction (Wu, 2017). As a result, there is a significant need for a standard framework to address such big issues and maintain a stable ecology for MSME dealing with digital payment mechanisms.

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OBJECTIVE OF STUDY

1. To assess the state of the MSME sector both domestically (India) and internationally.
2. To examine the AML risk associated with the lending mechanism for digital payment based method.
3. To provide tailored AML regulations that addresses the specific challenges faced by the MSME sector.

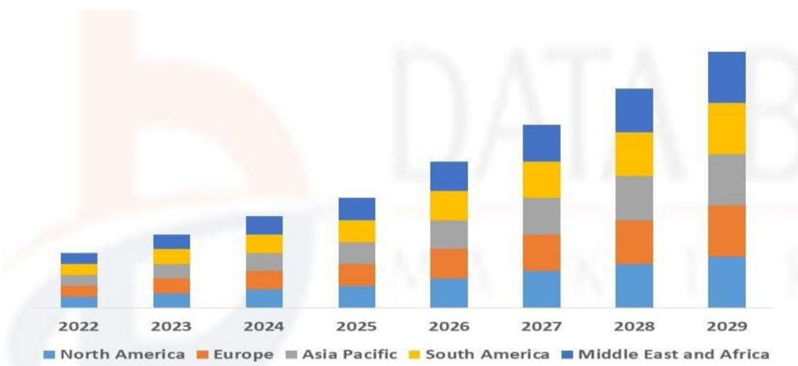
RESEARCH METHODOLOGY

To analyze the regulatory landscape and potential measures, data was collected from various sources. This included government reports, academic studies, industry publications, and official guidelines provided by regulatory authorities such as the Reserve Bank of India (RBI) and Invest India, etc. This data analysis aims to explore regulatory measures that can effectively address AML concerns in the FinTech-based MSME sector in India.

DISCUSSION

Global Digital Lending Scenario

The business environment has improved as a result of the global growth of financial technology (FinTech) solutions, particularly for the MSME sector. Financial institutions are adopting DLP (Digital Lending Payment) to boost output, income, and service velocity in response to changes in payment patterns. The market for digital lending platforms, which was predicted to be valued at USD 16930.68 million in 2021, is expected to grow at a CAGR of 19.4% from 2022 to 2029 and reach USD 69937.32 million, as shown in Figure 2 below from Data Bridge Market Research.



Source: Data Bridge Market Research Market Analysis Study 2022

FIGURE 2
SHOWING GLOBAL DIGITAL LENDING MARKET IS EXPECTED TO ACCOUNT FOR USD 69937.32 MILLION BY 2029

However, the rapid development of FinTech raises concerns about the global spike in anti-money laundering (AML) actions as stated in figure 3 which showing market size of AML at global level from the period o2018-2030. Money laundering is the process of making massive amounts of money earned unlawfully through trafficking in illicit drugs, terrorist activity, or other serious offenses that appear to have originated from a legitimate source. Since money laundering poses a threat to the nation's economy and political stability, it should

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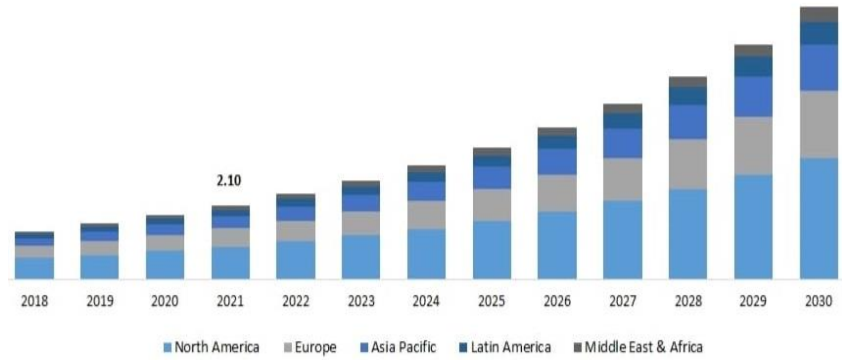
be banished totally.



Source: Market research report on Anti-money Laundering Market, Polaris market research analysis (2022)

FIGURE 3

SHOWING ANTI MONEY LAUNDERING MARKET SIZE, BY REGION, 2018-2030 (USD BILLION)

As a result, countries around the world must band together and work together to dismantle money-laundering networks through rigorous law enforcement. According to estimates, the value of the global AML (anti-money laundering) market in 2022 was USD 1.32 billion, and it is expected to grow at a 15.9 percent CAGR between 2023 and 2030. As more people use digital payments, the market for anti-money laundering (AML) products is rising. While more and more transactions are performed through the web, monitoring and detecting fraudulent transactions becomes ever more essential (Anti-money Laundering Market Size & Share, 2023). The following are some of the major challenges that businesses may face:

- Digital lenders need to invest a lot of money to comply with AML regulations. This entails paying compliance specialists, keeping up critical technology infrastructure, and spending money on external assistance.
- For digital lenders, the secure processing and storage of data is crucial. This is necessary, particularly for Know Your Customer (KYC) and anti-money laundering data.
- To prevent fraud and money laundering, digital lenders must adopt protective measures. This calls for a comprehensive AML compliance programme that is capable of identifying and halting suspicious activities.
- AML standards are continuously evolving, and digital lenders must keep up with the most recent criteria. It can be a challenging process, particularly for smaller digital lenders (like MSME units).
- Because many digital lenders lack the requisite resources, AML compliance is frequently mismanaged. It may result in insufficient compliance and potential repercussions for noncompliance.

An Indian Context for Digital Payments

The NSSO 73rd Round survey found that MSMEs increased significantly following the new economic strategy in 1991. After China, India now has the largest MSMEs base in the world, with 63.4 million units and more over 7,500 products. More than 90% of all businesses are MSMEs (Biswas, 2015).

The Fintech revolution in India has wreaked havoc in the MSME sector. MSME must recognise that the MSME landscape is changing and adapt in a flexible manner. According to the 2020 SMB Digital maturity research survey report, more than 68 percent of small and medium-sized enterprises (SMBs) want to digitally transform in the near term in order to introduce new products and services. COVID-19, on the other hand, is predicted to enhance the use of cloud software by 56% of SMBs.

But this does not stop here. The number of money laundering cases is increasing to an alarming level as

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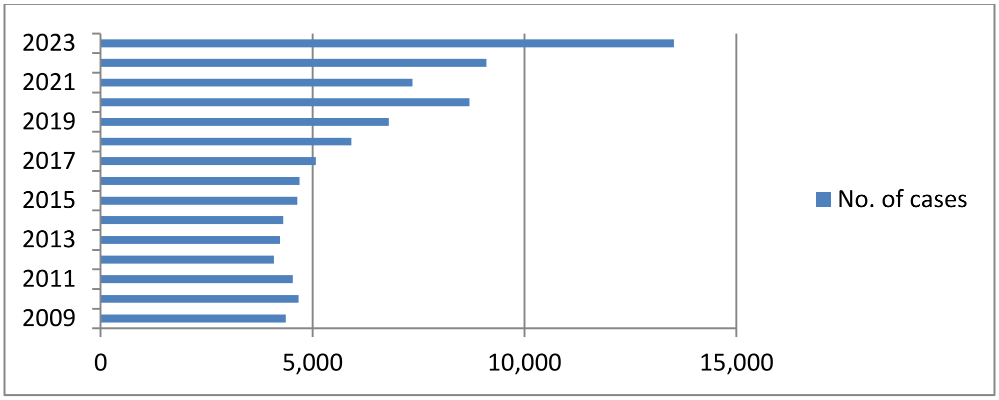
shown in Figure 4. The Reserve Bank of India (RBI) discovered bank fraud worth more than 302.5 billion Indian rupees during the 2023 fiscal year. This is a drop from the previous year's figure of more than 1.3 trillion rupees. Thus, the value of bank frauds overturned a ten-year trend in India that had seen a dramatic increase in both the total number of frauds and the value of frauds.



Source: Rathore, M. (2023). Value of bank frauds 2008–2023, Fianancial institution, statista.

FIGURE 4

SHOWING NUMBER OF BANK FRAUD CASES ACROSS INDIA BETWEEN FROM FINANCIAL YEAR 2009 TO 2023

The Prevention of Money Laundering Act, 2002, and the Financial Intelligence Unit-India serve as a firewall and keep a close watch on the AML ecosystem. A further statute used to safeguard against money laundering through both financial and non-financial entities is the Know Your Customer (KYC) principle. According to Boister's An Introduction to Transnational Criminal Law, this principle started with the American Bank Secrecy Act (BSA) of 1970. As a result, KYC ensures market and financial institution integrity.

WAY FORWARD

Money laundering is a global issue rather than a problem specific to one nation. Money launderers target nations with lax financial regulations, especially developing and emerging economies. Global adoption of strict financial controls and universal legal restrictions is crucial to avert the menace. A lack of strict financial control and a number of regulatory requirements are factors that drive money launderers. Following are the measures to combat illicit financial activities:

a) They must implement a risk-based strategy for on boarding new consumers and must monitor them frequently. Consumer risk profiling, verification of identity, and tracking of transactions are all part of this. Client risk profiling inspects the risk profile of the client, whereas verification of identification affirms that the customer is who they say they are.
b) Digital lenders should conduct the appropriate due diligence on their customers in order to accurately authenticate their identities and have proof of beneficial ownership of their accounts. As a result of these diligence efforts, stricter due diligence standards should be applied to high-risk clients.
c) On-boarding new customers and continuing monitoring procedures can be automated with the aid of AI and ML, which will improve their accuracy and efficiency.
d) In addition, digital lenders must ensure that their data security practises are up to date. This includes using strong authentication mechanisms such as biometrics and secure, encrypted communication routes.
e) In order to comply with evolving KYC and AML standards, digital lenders must stay current. This can ensure that their procedures are always in compliance with the most recent regulatory requirements.
f) Advanced analytics can assist digital lenders in identifying fraud and money laundering by examining client data. Additionally, these analytics can aid online lenders in properly forecasting potential dangers and better comprehending customer behaviour.

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g) To detect any money-laundering behaviour, digital lenders must monitor their customers' transactions. This could entail looking for anomalous transaction patterns or transactions involving high-risk countries.
h) It's crucial to inform MSMEs and FinTech consumers about the hazards of AML compliance. The necessity for awareness campaigns to encourage comprehension and adoption of AML controls was highlighted by data analysis. Training programmes should emphasise helping MSMEs build effective internal controls and AML policies to reduce their exposure to money laundering.

CONCLUSION

The study emphasized the necessity for a strong enforcement framework to guarantee adherence to AML legislation. When there are frequent audits, inspections, and fines for failure to comply, AML regulations are more likely to be followed in organizational culture. The integrity of the financial system must be preserved through quick enforcement. The Indian government and regulatory agencies can successfully resolve AML issues and create a secure environment for the FinTech-based MSME sector to flourish while upholding the integrity of the financial system by putting these measures into place.

Therefore, regulating anti-money laundering in the FinTech-based MSME sector requires a comprehensive and adaptive approach. By recognizing the unique risks and characteristics of this sector, policymakers, regulators, and industry stakeholders can collaborate to develop targeted AML frameworks. Combining effective risk assessment, strengthened collaboration, and innovative technological solutions will contribute to a more secure and resilient financial ecosystem for MSMEs in the digital era.

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