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Article

Consideration of the peculiarities of analyzing financial transactions subject to financial monitoring in times of war

Reference: Vovchak, Olha/Yendorenko, Liubov (2023). Consideration of the peculiarities of analyzing financial transactions subject to financial monitoring in times of war. In: Technology audit and production reserves 3 (4/71), S. 37 - 41.
<https://journals.urau.ua/tarp/article/download/284222/278665/656043>.
doi:10.15587/2706-5448.2023.284222.

This Version is available at:
<http://hdl.handle.net/11159/631571>

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**Olha Vovchak,
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CONSIDERATION OF THE PECULIARITIES OF ANALYZING FINANCIAL TRANSACTIONS SUBJECT TO FINANCIAL MONITORING IN TIMES OF WAR

The object of the research is the financial transactions that are subject to financial monitoring. Today, financial monitoring is an integral part of the activities of Ukrainian banks, especially during the period of martial law, since it is through banks that the process of laundering proceeds from crime most often occurs.

The article discusses the peculiarities of analyzing financial transactions subject to financial monitoring in wartime. In particular, the author outlines the trends in the banking system. Given the current challenges, in particular, martial law in Ukraine, the author analyzes the dynamics of submission by banks of reports on financial transactions subject to financial monitoring, including in terms of financial monitoring features, and investigates the factors that affect their number. A forecast of the volume of reports is made. The author analyzes the recommendations of the State Financial Monitoring Service of Ukraine (SFMS), which contribute to the improvement of customer service processes in banks in order to counteract money laundering and terrorist financing. The authors also provide the main tools used for money laundering, terrorist financing, etc. during the war. The author describes the impact of money laundering and terrorist financing on the financial security of the state.

The military aggression of the Russian Federation against Ukraine has had a significant impact on money laundering, terrorist financing, and the financing of the proliferation of weapons of mass destruction. Due to untimely/non-operational or inefficient/poor quality analysis and appropriate response of banks to financial transactions that are subject to financial monitoring, this direction in the activities of banks requires special attention. In the current situation, there are new challenges and threats that have signs of criminal acts and fraud:

- financing of war and terrorism/separatism; laundering the proceeds of corruption;*
- embezzlement of budget funds and funds of state enterprises;*
- laundering of proceeds from crimes related to fraudulent acquisition of funds of citizens and legal entities by deception, including under the guise of assistance to the Armed Forces of Ukraine.*

The authors propose to improve the legislative and regulatory acts in the field of financial monitoring and to introduce penalties for bank employees for improper performance of their duties at the legislative level. The authors also focus on the proper automation of processes in banks.

Keywords: financial monitoring, financial transactions, bank activity, martial law, money laundering, terrorist financing.

Received date: 12.04.2023

Accepted date: 06.06.2023

Published date: 30.06.2023

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How to cite

Vovchak, O., Yendorenko, L. (2023). Consideration of the peculiarities of analyzing financial transactions subject to financial monitoring in times of war. *Technology Audit and Production Reserves*, 3 (4 (71)), 37–41. doi: <https://doi.org/10.15587/2706-5448.2023.284222>

1. Introduction

Due to the wide range of activities carried out by banks, a large number of financial transactions are conducted through them, and therefore they are intermediaries in the process of cash flow both within one country and in international settlements. Due to the specifics of their activities, banks are often used for legalization (laundering) of illegally obtained funds and for terrorist financing, especially now. Therefore, the issues of preventing and counteracting money laundering and terrorist financing have become particularly relevant and require significant

attention. In Ukraine, due to a number of unfavorable circumstances, there is still insufficient financial control and monitoring of financial transactions.

Experts estimate that from 150 to 500 billion US dollars of criminally acquired funds are introduced into the legal financial circulation annually worldwide [1].

The main purpose of financial monitoring is fight against money laundering, the financing of terrorism and the financing of the proliferation of weapons of mass destruction. This actualizes the study of problematic aspects aimed at analyzing and solving the issue of effective state intervention in the economic sector in the conditions of Ukraine.

In-depth research is also needed to identify problems and possible solutions, and to develop recommendations for improving the situation in the field of financial monitoring in conditions of uncertainty.

For Ukraine, building an effective system to prevent and combat money laundering, terrorist financing, and the financing of the proliferation of weapons of mass destruction remains an important issue, as it will reduce costs for banks and the country's economy as a whole.

An analysis of the literature and recent publications shows that certain problematic issues regarding the organization of the financial monitoring system in Ukrainian banks and minimization of risks associated with money laundering and terrorist financing still remain unresolved [2–4].

Based on this, *the aim of the article* is to study the peculiarities of analyzing financial transactions subject to financial monitoring in wartime, to analyze the current state and to search for areas for improving the financial monitoring system. Identification of patterns and factors used for money laundering and terrorist financing, including during martial law, will allow formulating proposals and directions for improving this process in Ukrainian banks, and, based on statistical data for previous periods, modeling the forecast of the volume of financial monitoring reports to be provided by Ukrainian banks to a specially authorized body.

2. Materials and Methods

The following research methods were used during the research: analysis and synthesis of the theoretical base, statistics, structuring, systematic approach, graphical and comparative methods. Also, in the process of research and problem solving, general scientific and analytical methods were used.

3. Results and Discussion

The main and currently valid regulatory acts that regulate the implementation of financial monitoring in banks of Ukraine are:

- Law of Ukraine «On Preventing and Counteracting to legalization (Laundering) of the Proceeds from Crime, Financing of Terrorism and Financing Proliferation of Weapons of Mass Destruction» No. 361-IX dated December 6, 2019 (hereinafter – Law No. 361-IX) [5];
- Regulation On Financial Monitoring by Banks, approved by the Resolution of the Board of the National Bank of Ukraine No. 65 dated May 19, 2020 [6].

At present, Ukrainian legislation in the field of financial monitoring, including:

- introduced a risk-based approach and the procedure for its application;
- describes the measures necessary to detect suspicious financial transactions (activities) of clients;
- defines the signs according to which the bank client should receive a high and unacceptably high level of risk;
- introduces enhanced customer due diligence measures, etc. [5].

As for the structure of the financial monitoring system of Ukraine, according to Law No. 361-IX, it is two-level and consists of the primary (banks and other

legal entities) and state levels (the National Bank of Ukraine, the State Financial Monitoring Service of Ukraine (hereinafter – SFMS), etc.) [5].

The banking sector plays an important role in the functioning and development of the economy of Ukraine, and is an important subject of primary financial monitoring (hereinafter – SPFM). The dynamics of the number of operating banks in Ukraine over the past 10 years is shown in Fig. 1.

According to Fig. 1, since 2014, there has been a decrease in the number of banks due to global economic imbalances, hryvnia devaluation, political instability, and the outbreak of war in eastern Ukraine, which contributed to the accumulation of problems in the Ukrainian banking system [8].

The National Bank of Ukraine implemented restructuring measures and started the process of withdrawing insolvent banks from the market, as a result of which many banks were liquidated.

Domestic banks constantly cooperate with the SFMS. They provide the SFMS with information on threshold and suspicious financial transactions (activities). Bank report on the following discrepancies between the information on the ultimate beneficial owners of the client contained in the Unified State Register of Legal Entities – Individual Entrepreneurs and Public Organizations and the information on the ultimate beneficial owners obtained by the bank as a result of due diligence of the client. In addition, in case of notifications from the SFMS, banks are obliged to provide the necessary information, etc.

Thus, Fig. 2 shows the share and number of reports on financial transactions subject to financial monitoring submitted by banks to the total number of reports received by the SFMS from other SPFM in 2013–2022.

Considering the share and number of reports on financial transactions subject to financial monitoring submitted by banks in the total number of reports registered by the SFMS from other SPFM during 2013–2022, it can be stated that the banking sector accounts for the largest share of financial transactions compared to non-bank financial institutions and organizations (ranging from 96.4 % to 99.5 %).

Thus, banks are the most active SPFM, due to the fact that banks have a large customer base that is growing every year, and, accordingly, a significant array of transactions and amounts for which customers carry out the transactions they need. In addition, this is due to the fact that banks have a wider range of banking products/services, which have attractive conditions for attracting potential and existing customers and the ability to accept larger payment amounts.

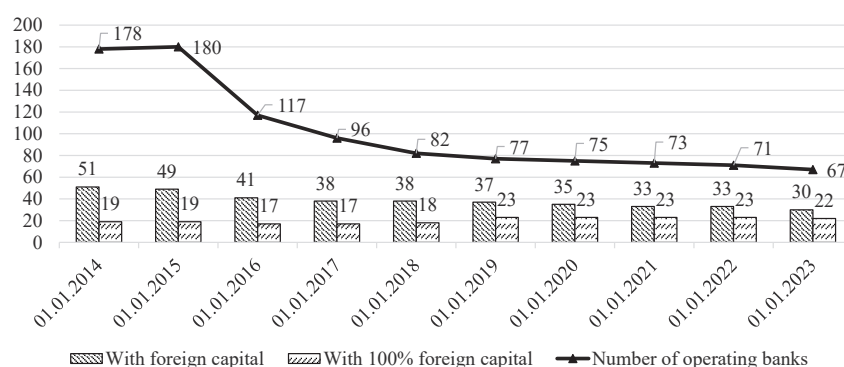


Fig. 1. Dynamics of the number of operating banks in Ukraine in 2013–2022, units (compiled by the author on the basis of official statistical data of the National Bank of Ukraine [7])

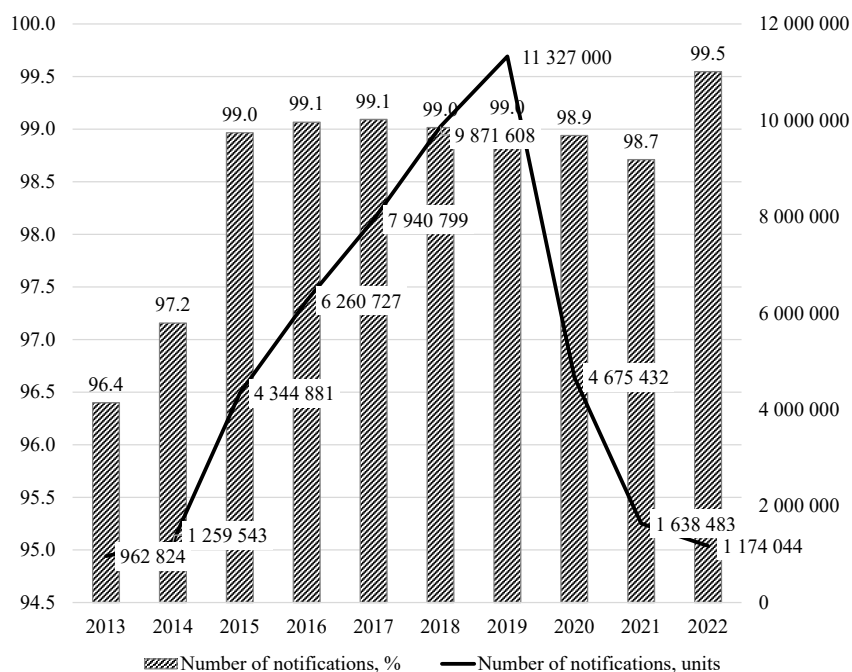


Fig. 2. Share and number of reports on financial transactions subject to financial monitoring submitted by banks to the total number of reports registered by the SFMS from other SPFM during 2013–2022, %, units (compiled by the author on the basis of official statistical data of the SFMS [9])

Quantitatively, the tendency for the period under study has a dynamic growth until 2019, due to the following main factors:

- an increase in the number of suspicious financial transactions aimed at legalization of illegal proceeds, terrorist financing or financing of the proliferation of weapons of mass destruction;
- expansion of the list of financial transactions with signs of mandatory and internal financial monitoring;
- changes in legislation.

Subsequently, there has been a decline in the number of financial transactions reports submitted by banks to the SFMS in 2020–2022, due to the spread of Covid-19 in Ukraine, the entry into force of Law No. 361-IX, which changed the approach to identifying financial transactions with signs of financial monitoring, and the introduction of martial law.

Today, it is important to categorize the notifications accepted for registration in terms of financial monitoring indicators.

Financial transactions with signs of mandatory financial monitoring, which are subject to internal financial monitoring, as well as those with grounds to suspect that they are related to, concerned with, or intended for the financing of terrorism or the financing of the proliferation of weapons of mass destruction, SPFM were required to be reported to the SFMS before the entry into force of Law No. 361-IX. Subsequently, with the adoption of the said law, threshold and suspicious financial transactions (activities) were subject to financial monitoring, which banks had to report to a specially authorized body.

Fig. 3 shows the distribution of reports registered by the SFMS in 2013–2022 by financial monitoring features.

Reports with signs of mandatory financial monitoring/threshold financial transactions account for the largest share compared to other reports (Fig. 3). Such a significant difference from other notifications is due to the fact that mandatory financial monitoring transactions (transactions where the amount of the transaction is equal to or exceeds 150,000 UAH or equivalent to 150,000 UAH)/threshold financial transactions (transactions where the amount of each transaction is equal to or exceeds 400,000 UAH or equals or exceeds the amount in foreign currency equivalent to 400,000 UAH), if the relevant signs provided for in Article 20 of Law No. 361-IX are clearly regulated and defined in the legislation and are subject to special supervision. Reports with signs of internal financial monitoring/suspicious financial transactions are determined by each SPFM independently, taking into account the client base and analysis of transactions.

Based on the statistical data of the SFMS, it is possible to make a forecast of the volume of reports submitted by the SPFM of Ukraine to the specially authorized body (Fig. 4).

The coefficient of determination (R^2) for building the model is 0.90 (Fig. 4). During the period under study, until 2019, there was an increase in the number of reports submitted by banks to the SFMS on financial transactions subject to financial monitoring, and later there was a decline in this quantitative expression.

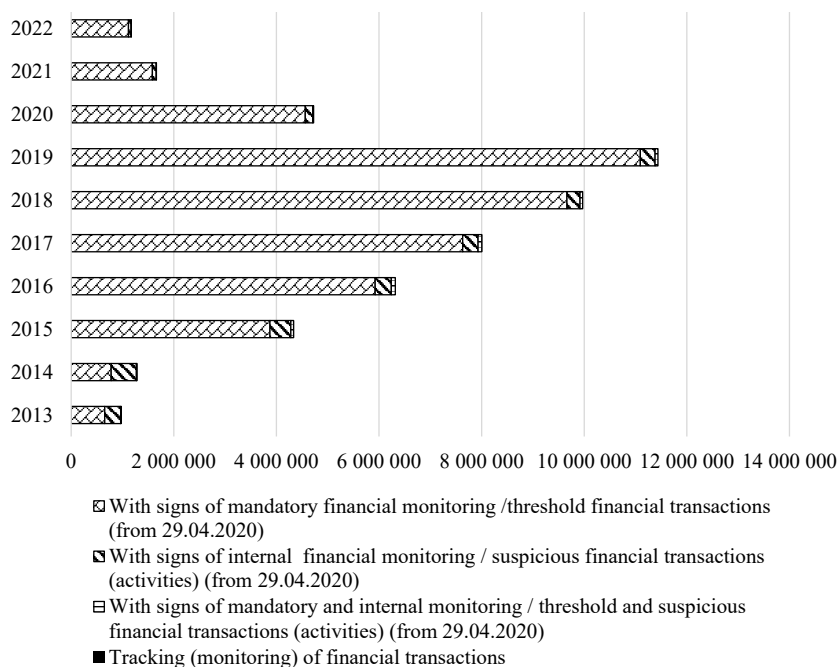


Fig. 3. Distribution of reports registered by the SFMS from SPFM in 2013–2022 by financial monitoring features, units (compiled by the author on the basis of official statistical data of the SFMS [9])

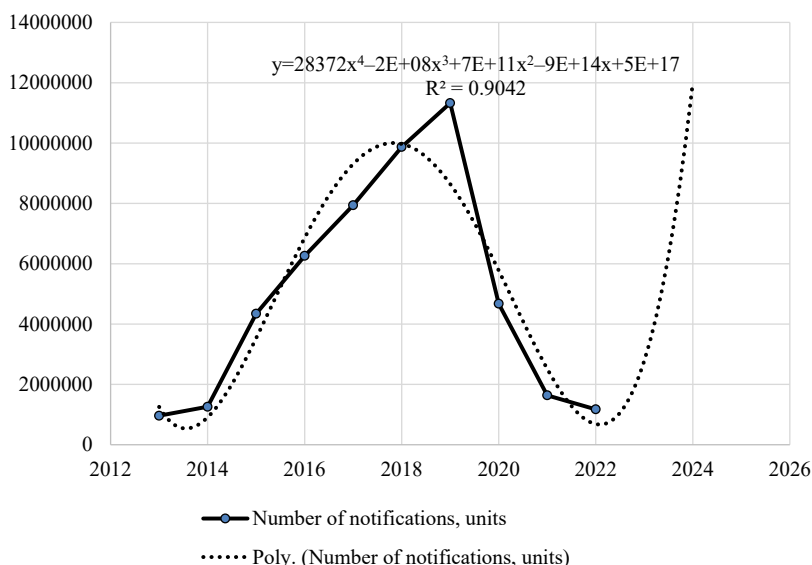


Fig. 4. Forecast of the volume of notifications submitted by Ukrainian banks to the specially authorized body for 2023–2024 (compiled by the author on the basis of official statistical data of the SFMS [9])

The projected values, which are shown by the dotted line in Fig. 4, have a positive trend. Such data may correspond to the reality in the future, since every year in the banks of our country the schemes for laundering (legalization) of proceeds from crime acquire a new character and are improved, depending on this, the legislation changes.

It should be noted that due to the military aggression of the Russian Federation and the threat to the national security of Ukraine, the SFMS prepared a typological study on «Financing Terrorism and Receipt of Criminal Proceeds from Other Crimes in the Context of Military Aggression of the Russian Federation». SFMS using its own practice and the practice of other participants in the national financial monitoring system has developed the following typological study [10].

In addition, in May 2022, the SFMS prepared and communicated to the PFMS updated Recommendations on the implementation of the requirements of the legislation in the field of financial monitoring for the period of wartime. These recommendations relate to the detection of suspicious financial transactions related to the aggressor country, and sent indicators of the riskiness of transactions and clients with the Russian Federation and the Republic of Belarus for use in their work [10].

The main tools used in illegal actions in the field of financial monitoring are:

- forgery of documents;
- falsification of sources of funds;
- loans and financial assistance;
- underestimation/overestimation of prices;
- prepayment for goods/works/services;
- non-delivery of goods;
- services whose value is difficult to assess;
- replacement of real producers of goods with transit companies, etc. [10].

Considering the long-term political and social crisis, which is accompanied by military operations, the growth of the shadow sector and a significant level of corruption, the issue of improving the effectiveness of financial monitoring is related to the financial security of the country.

It is worth noting that the serious economic and social consequences of money laundering include undermining the stability of the financial system, increasing the scale

of crime, «criminalizing» the economy, and reducing government revenues and weakening control [1].

Experts estimate that the level of shadow economy and corruption in Ukraine is among the highest in Europe and the world. Studies show that the volume of shadow flows in 2021 amounted to 32 % of the country's GDP. This situation requires strengthening state supervision and control over illegal financial transactions and taking decisive measures to combat money laundering [11].

The National Bank of Ukraine, in accordance with international documents, focuses on a risk-based approach (identification (detection), assessment (reassessment) and understanding of the risks of legalization (laundering) of proceeds of crime, terrorist financing and/or financing of the proliferation of weapons of mass destruction). The National Bank of Ukraine also focuses on taking appropriate risk management measures in a manner and to the extent that minimizes such risks depending on their level [5].

The purpose of introducing a risk-based approach is to:

- optimize the use of bank resources; increase the efficiency and effectiveness of measures;
- rationalize internal financial monitoring procedures;
- regulate the intensity of preventive measures in proportion to the identified risks;
- focus on risky financial transactions (including cash and scheme transactions, fictitious business carried out by politically exposed persons and bearing signs of terrorist financing, etc.) [12].

Therefore, with the introduction of martial law in Ukraine, simplified mechanisms for financial monitoring were introduced. An enhanced analysis regime began to be given to residents of the Russian Federation and the Republic of Belarus, as described in the Resolution of the Board of the National Bank of Ukraine No. 18 «On the operation of the banking system during the period of martial law» dated 24.02.2022 [13].

Thus, Ukrainian banks are trying to analyze their customer base and counterparties in an intensified manner, but a significant number of banks cannot avoid violations in the field of financial monitoring. In addition, banks implement a significant number of technical solutions using specially developed software or terms of reference.

Given that the Government of Ukraine, the National Bank of Ukraine, and the SFMSU during martial law drew attention to the risks of terrorist financing and introduced a number of restrictions and recommendations, certain segments of the analysis were in a relaxed control mode. Let's believe that special attention should have been paid at the legislative level to specific requirements rather than the use of risk-based approaches. The legislative requirements generally provide for decisive actions that bank employees do not take under a risk-based approach when analyzing financial transactions and customers conducting such financial transactions. In addition, in order to ensure that bank employees effectively fulfil their duties, it would be appropriate to introduce the practice of penalties for them, not just for banks.

In addition, banks, when implementing technical solutions to detect suspicious and risky financial transactions,

in some cases take a formal approach to this process. Of course, this may be limited by the bank's budget, as complex technical tasks are expensive. At the same time, in the presence of such difficulties, it is worth delegating certain tasks to employees for manual execution and exercising proper control over the tasks performed.

Even during the war, there has been no reduction in financial transactions subject to financial monitoring, given the introduction of simplified analysis measures by banks and, in some cases, a partial outflow of customers and capital.

If the proposed measures are implemented, banks will avoid significant risks of improper performance of their financial monitoring duties. Accordingly, banks will be subject to minimal enforcement actions in case the regulator detects minor violations.

Dilemmas and difficulties in the practical implementation of financial monitoring requirements arise precisely in the timeliness and effectiveness of banks actions to identify financial transactions subject to financial monitoring (suspicious) and to identify risks inherent in customers or their financial transactions due to imperfect legislation and internal bank documents.

In addition, given the European integration vector of Ukraine's development, the adaptation of domestic legislation to international requirements in the field of combating money laundering and terrorist financing in terms of the introduction of a risk-based approach is becoming a very urgent issue for Ukraine.

The existence of long-term terrorist activities on the territory of Ukraine poses a significant threat to the national security of Ukraine and requires active measures to stop them.

Prospects for further research are to argue for and create appropriate institutional conditions for the development of a system for preventing and combating the legalization (laundering) of proceeds from crime and to develop specific measures and mechanisms for implementing changes, given the importance of Ukraine's national security.

4. Conclusions

Thus, the problem of legalization (laundering) of the proceeds of crime has become particularly important during the war, as the consequences of inadequate financial monitoring may threaten Ukraine's economic security.

The article examines the peculiarities of analyzing financial transactions subject to financial monitoring in wartime, which allows concluding that financial monitoring in Ukrainian banks needs to be improved.

The results of the study demonstrate the need for close cooperation between the Government of Ukraine, the National Bank of Ukraine, the SFMS and Ukrainian banks, especially in the context of current military challenges and threats, with a view to promptly implementing diverse and effective solutions.

Conflict of interest

The authors declare that they have no conflict of interest in relation to this research, whether financial, personal, authorship or otherwise, that could affect the research and its results presented in this paper.

Financing

The research was performed without financial support.

Data availability

The manuscript has no associated data.

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