Part 1

An AML RegTech Ponzi Scheme?

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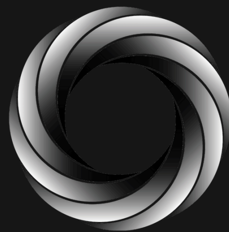

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Although a distant memory for some, the taxpayer-funded bailouts triggered by the 2008 financial crisis highlighted how government financial services regulators were caught off guard and completely unprepared in their response.

The public anger that ensued was substantial. It may have been a knee-jerk reaction or an attempt by governments to assert authority, but it led to the financial industry facing sweeping changes almost overnight. The reforms included a staggering 492 percent surge in regulatory announcements over the subsequent seven years [1].

As Anti-Money Laundering (AML) regulators exerted their enforcement powers, levying hefty penalties on banks with unsatisfactory compliance measures – fines began to make headlines. In 2012, HSBC was fined $1.9 billion for laundering $15 billion from Russia and $7 billion from Mexico [2]. In the same year, Standard Chartered Bank was fined $340 million for laundering $250 billion for Iran and Libya [2]. Not only were these fines seen as significant, but they exposed to the average person, the value of dirty money passing through the world's leading banks.

In the decade following the 2008 financial crisis, AML enforcement actions continued to make headlines. Notably, in 2015, global fines issued for AML and related issues topped $12 billion [3]. However, the absence of a publicly disclosed strategy to ensure that only responsible parties would be held accountable in the event of another crisis remained glaringly evident.

Costly compliance

With these fines came a global regulatory onslaught. In 2012, the financial services sector found itself paying an exorbitant $213.9 billion to meet AML compliance obligations [4]. In the UK, banks would spend an amount nearly equivalent to three-quarters of the nation's defense expenditure. In the fiscal year 2021/22, this amounted to a staggering £34.2 billion [5], up from £5 billion in 2015 [6].

What many did not realize was that these costs were not entirely the burden on banks. To maintain their financial viability, banks quickly began passing these costs on to their customers—us, the taxpayers. Banks needed to remain profitable, and as AML compliance costs continued to rise, the customer would need to pay more. This led to a series of "conditional sanctions" on certain customers, business areas, geographies, and industries that banks deemed too costly to monitor against stringent regulatory demands. Good customers would pay more, while risky customers would pay a great deal more or be asked to go elsewhere.

In Europe, Dutch banks began levying extra charges on businesses, non-profits, and religious institutions to offset the costs associated with money laundering probes [7]. The annual fee for an ING standard package account in the Netherlands would surge from €18.60 to €43.80 over the five years from 2019 to 2024 [9].

Today AML due diligence is known for exceeding a million dollars a year in many banks. Banks may decide not to on-board prospective clients because the risk is simply too great. Equally, they may decide to de-bank those deemed very high-risk. This was a fate experienced in 2023 by over 140,000 entities in the UK [8]. The worrying point here, is that the data for the 140,000 entities came from only five of the 300+ banks operating in the UK.

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Widening penalties

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The penalties are not always obvious to onlookers – but simply felt by many. Penalties now include protracted and burdensome account opening procedures, increased friction in banking services, reduced loan budgets, and restricted access to high-risk products; such as trade finance. A survey by the Asian Development Bank in 2023 [10] across 79 banks revealed a staggering 40% of Small and Medium Enterprises (SMEs) had their trade finance applications rejected. The only option left would be to limit growth or use less transparent methods to conduct their trade transactions; a situation that many saw as exposing further their risk to de-banking.

The result of AML compliance and burdensome regulatory demands – is a declining economy. The ongoing and uncontrolled risk of financial exclusion among SMEs, propelled by escalating compliance costs, drives economic impairment in both developing and mature countries. If SMEs are restrained or unable to trade, then the back bone of most economies is broken. In the UK, approximately 99% of businesses are small enterprises. Collectively this 99% contributes 34% to the country's turnover [11]. Yet it is they who face disproportionate growth disruption owing to burdensome AML regulatory demands. Demands which make little sense and have negligible impact on the flow of dirty money.

A technology driven government

With the UKs inevitable escalation of AML compliance costs, George Osborne, then Chancellor of the Exchequer in his 2015 budget included provisions to encourage investments in regulatory technology (RegTech) firms [12]. The response was significant –the Financial Conduct Authority (FCA) issued a 'Call for Input: Supporting the Development and Adoption of RegTech' [13]. At the time this was seen as a means to finding a solution elsewhere to a problem many would continue to misunderstand.

A subsequent 'Feedback Statement' [14] identified RegTechs as promising solutions to alleviate burdensome regulatory requirements through automation, thereby reducing false money laundering alerts and enhancing risk insights. To facilitate such widespread adoption, the FCA quickly launched a Regulatory Sandbox, allowing – perhaps desperately hoping – for firms to access tools and regulatory expertise for product testing. This initiative spurred similar efforts globally. A total of 73 unique regulatory sandboxes had been established across 57 countries by November 2020 [15]. From this point on, RegTechs had become part of the AML compliance picture.

Fostering foundations

Unbeknown to many, it was IBM that seized on the opportunity that laid before them. In November 2016, the company acquired Promontory Financial Group with the primary aim to harness its team of 600 regulatory compliance experts to train 'Watson' – IBM's massive artificial intelligence engine. The aim of 'Watson' was to address various back-office inefficiencies and streamline AML compliance tasks [16].

IBM's prominent step was significant. This single move heightened RegTech's appeal to investors, seemingly opening the floodgates to what now appears to be an endless stream of funding. Today, there are thousands of RegTech companies worldwide, with the UK home to at least 234 firms and another 335 based overseas but operating in the UK [17]. This continued interest, driven by blind obsession or greedy investors, has propelled the RegTech market revenue from $8.7 billion in 2021 to a future estimate of $44.5 billion by 2030 [18].

Undoubtedly, the UK government's support for RegTech has continued to evolve. However, despite nearly a decade, the promised benefits for regulators, firms, and consumers have yet to materialize [11]. Meanwhile, the cycle of hefty fines and escalating compliance costs passed onto the public persists, alongside the pervasive negative impact on small businesses. This sustained backing of RegTechs fuels significant market growth and investor interest. As we navigate this paradox, one must question whether the current approach is genuinely effective or merely perpetuating a costly pattern of bailouts burdening taxpayers, with government financial services regulators still appearing completely unprepared in their response.

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