

EVALUATING CASH DEPENDENCY ON MONEY LAUNDERING VULNERABILITIES IN DEALERS OF PRECIOUS METALS AND STONES IN INDIA

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ABSTRACT: Money laundering poses a significant threat to the integrity of financial systems, particularly in cash-intensive industries such as trading in precious metals and stones (PMS). This study explores how the use of cash by small-scale jewellers in India increases their vulnerability to money laundering activities. Applying a mixed qualitative research approach, the study employs both exploratory and phenomenological methods to analyze industry behaviour, determine regulatory loopholes, and evaluate compliance-related challenges. Data were collected using semi-structured interviews with jewellers within Kerala, Rajasthan, Karnataka, and Tamil Nadu. They were then analyzed using thematic coding, sentiment analysis, and topic modelling (LDA) with the help of Python. The findings show that trust-based transactions, invoice manipulation through making charges, and regulatory arbitrage enable money laundering activities by informal networks. Despite existing *de jure* rules, a *de facto* enforcement gap allows illicit practices to continue. The research emphasizes how sincere jewellers hesitate to report malpractices because of industry criticism and competitive losses. To overcome such weaknesses, the researchers suggest enacting a floor price for a minimum making charge, enhancing compliance with AML through electronic documentation (CBDCs), and increasing regulatory coverage with tailored risk management models for small-scale jewellers. These results add to the general knowledge of financial crime in cash-intensive enterprises and provide policy interventions to formalize the industry.

KEYWORDS: Unrecorded Transactions, Money Laundering, Small Jewellers

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1. INTRODUCTION

Money Laundering is the root of all financial crime. It involves disguising financial assets earned from illegal activities through legitimate methods (Fincen, n.d.). According to [25], precious metals and minerals, primarily gold and diamonds, occupy a strange place in money laundering—they function both as a source of illegal funds to be laundered (through smuggling or illegal trade) and as an actual vehicle for laundering (through acquisition with proceeds of crime).

According to (FATF, 2006), trade-based money laundering techniques are used to launder money. One such prominent technique is purchasing gold in the form of widgets, ornaments, or antique items from one dealer and selling the same to another dealer. This technique integrates the funds from illegal sources into the formal economy and allows launderers to offset gains from the sale of jewellery with the tax paid. Such methods allow the funds to be recorded as legitimate and allow the Beneficiary Owner to receive complete entitlement.

However, the Financial Action Task Force has stated that these transactions put small jewellers at risk of money laundering and operational inefficiencies since vast amounts of money move without any indication of ownership (FATF, 2024). Various governments have implemented policies to reduce such practices. For instance, under section 269ST of the Income Tax Act, 1961 in India, any jewellery purchase exceeding a limit of Rs. 200000 must be supported by Customer Due Diligence by capturing PAN and Aadhar details. However, implementing such policies has become cumbersome for small jewellers. Apart from the regulatory drawbacks, (FATF, 2024) notes doubts about whether measures such as the cash threshold prohibition sufficiently mitigate the ML/TF risks in the sector. Preventive measures, like operational risk management, are not implemented thoroughly.

These issues have been heavily weighted, considering the size and materiality of the dealers in the Precious Metals and Stones sector (DPMS) and their importance in India. With India moving towards a 'Developed Country' from a Developing Country through the Viksit Bharat Plan 2024, a thorn remains in the form of a highly unorganized gems and jewellery industry, which contributes about 7% of India's GDP. High cash dependency and casual operations expose this industry to small-scale money laundering risks. This study highlights the causes of such cash dependency and jewellers' dubious methods of making a living. It will also explore policy recommendations to formalize the industry and mitigate money laundering risks.

2. LITERATURE REVIEW AND RESEARCH GAPS

Although significant advancements in Anti-Money Laundering (AML) compliance have helped curb financial crime, cash-intensive businesses remain at high risk due to the lack of comprehensive internal control procedures and the ease with which cash transactions can evade regulatory scrutiny. This vulnerability is significantly pronounced in businesses like jewellery and gold, where expensive, hand-carry portable goods like gold, diamonds, and jewels are most commonly used in placement and layering money laundering phases (Teichmann, 2017).

In India, the jewellery and gold industry is plagued by unrecorded transactions, under-invoicing, and non-issuance of bills, which facilitates money laundering on a large scale. Before the Goods and Services Tax (GST) in 2017, the industry was characterized by high informality, with small jewellers operating in cash-intensive settings and often evading tax payments (NIPFP, 2016). Under-invoicing, i.e., invoicing value of transactions being less than the sale price, was prevalent, leading to substantial tax losses to the tune of ₹8,000-10,000 crore annually (FICCI, 2016). Non-issuance of bills also added to the problem, with 60-65% of transactions in the unorganized sector done without documentation, particularly in rural India (Income Tax Department Raids, 2016).

The 2017 introduction of GST was a milestone regulatory reform, bringing increased compliance and transparency to the jewellery and gold industry. GST replaced the erstwhile patchwork of taxes,

including excise duty and VAT, with a single 3% tax on gold and gold jewelry and 5% on making charges (World Gold Council, 2017). The simplified tax regime and the introduction of Input Tax Credit (ITC) and mandatory digital invoicing restricted the scope for under-invoicing and non-issue of bills. Post-GST, the market share of the organized sector rose to 35-40%, as many unorganized players were forced to formalize their billing operations and register under the purview of the law (KPMG, 2020). However, the inherent nature of the industry in dealing with cash-intensive transactions and the continued presence of informal practices have led to the circumvention of GST laws.

Another gap highlighted is the failure to consider psychological and cultural barriers to compliance by small jewellers. Anti-money laundering processes are found to be expensive and time-consuming, particularly by small businesses with limited resources. There is, however, no study on psychological and cultural factors driving such perception, e.g., low legal sanction awareness, fear of electronic technology, and belief that AML compliance is for large, formal businesses (FATF, 2020).

Another important research gap is the need for systematic research on risk management practices in small jewellers. Current risk management models are mainly framed for large firms and are not appropriate for the specific needs of small firms operating in high-risk industries like jewellery (Sharma, 2019). Studies can be performed on formulating customized risk management models for the needs of small jewellers based on financial constraints, operational context, and regulatory context.

Although the Prevention of Money Laundering Act (PMLA) provides a regulatory environment for AML compliance, its enforcement varies significantly across geographies and small and large enterprises, exposing jewellers to non-compliance (Narayan, 2018). Little research exists that evaluates the effectiveness of current regulatory environments in combating money laundering in the jewellery sector, especially among small enterprises in informal economies. Evaluating policy recommendations to bridge gaps in regulatory oversight and determining how public-private partnerships would drive compliance and awareness would be critical in strengthening AML practices at the micro-enterprise level.

The Financial Action Task Force identified an enormous deficit in applying the anti-money laundering framework in India's Gems and Jewellery sector. Of the 175000 Indian jewellers, only 9500 have registered with the Gems and Jewellery Promotion Council. The industry has normalized using cash to purchase inventory and issuing complex bills to circumvent regulations, allowing unbranded and unlisted jewellers to exploit loopholes to increase profitability. There is little to no check with limited internal control procedures, making this industry prone to small-scale money laundering operations. This is a significant issue for the Government looking to curb the entry of unaccounted funds into the formal economy, and it presents significant regulatory challenges and hurdles. Further, there is a lack of study on the same due to ignorance towards this sector owing to the perceived legality of cash usage for transactions. Also, studies conducted in India are negligible due to the limited data availability and sensitization of the topic. However, efforts have been made to bring such practices under scrutiny and provide an ethical working environment for honest jewellers.

3. RESEARCH METHODOLOGY

Given the limited literature on specific vulnerabilities jewellers face in India, this study adopts a mixed qualitative methodology. The researchers have employed an exploratory approach and phenomenological approach to the study. The research gaps highlight that the specific issue regarding the jewellery sector is sensitive, as it may lead to potential harm to those who speak out against such issues. This issue makes the topic understudied. So, an exploratory approach is crucial to uncover hidden variables and emerging trends and generate hypotheses for future study.

A mix of 10 semi-structured interviews with jewellery shop owners and managers over 1.5 months was conducted to get in-depth insights and perspectives. The convenience sampling technique was used to decide the sample size due to the lack of willing speakers and the comfort of confidentiality in such discussions. This method also eased the data collection process for young researchers with no funding. The sample consisted of jewellers from all parts of India, particularly Kerala, Rajasthan, Karnataka, and Tamil Nadu. The phenomenological approach allowed the researchers to understand psychological and cultural barriers, a significant research gap that the previous literature failed to capture. The approach brought forward individual experiences on cash dependency and vulnerabilities and perceptions of risk management, which other research methods would have overshadowed. Data collection was halted as soon as homogeneity in content prevailed, highlighting a trend.

The interview results underwent qualitative content analysis. The recordings were transcribed and further refined into clear responses and statements. Thematic coding was applied using Python to identify recurring patterns and insights. The Latent Dirichlet Allocation (LDA) technique of Topic Modelling, performed through Python, was used to uncover the central topics and their distribution across a set of statements. Sentiment Analysis was employed through Text Blob in Python to analyze polarity and subjectivity scores and determine the general sentiment of responses. They also performed a Recording Analysis by listening to the audio multiple times to capture key answers and results and conduct an in-depth exploration.

The jewellers were contacted through friends and personal contacts. The interviews were carried out over the telephone to maintain confidentiality. The participants wished to remain anonymous to avoid self-incrimination. They consented to be recorded and transcribed but were promised their name would not be mentioned in any work.

4. CONCEPTUAL FRAMEWORK

The conceptual map in Fig. 1 outlines the factors contributing to the vulnerability of small jewellers in India to money laundering activities, as well as the key variables and relationships that need to be addressed to mitigate such risks.

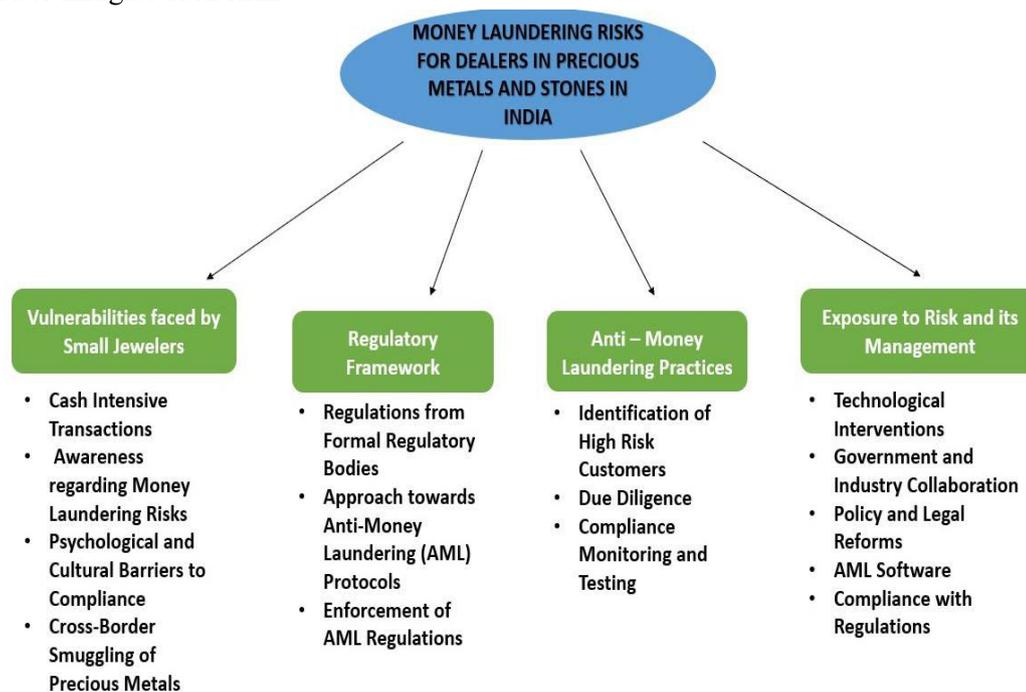


Figure 1: Conceptual map representing the various theories, variables, and constructs. Prepared by the author

5. DATA ANALYSIS AND INTERPRETATION

- The common topics from LDA revolved around 'gold' and 'customer,' indicating the importance of customer interactions in this sector. The central theme across all interviews was that the industry worked on 'Trust.' Trust must exist between the buyer and the seller when carrying out any dubious transaction. The presence of trust-based transactions often allows the sellers and buyers to override regulations. This phenomenon explains the presence of large-scale undocumented transactions. The trust factor was believed to exist in terms of non-reporting to authorities in consideration of higher commissions.
- One jeweler with a strong presence in Kerala highlighted two primary sources of gold in India for retailers. The major source of gold comes from generational wealth. These customers come from influential backgrounds with high levels of inheritance in the form of gold. They also include the affluent class who aim to make a quick buck by selling generational gold. Customers of such gold often demand fake bills to avoid paying taxes. Jewellers issue such bills for a 2-3% commission in such cases. Although illegal, such transactions do not affect a small jeweller's overall business as they believe total compliance would lead to reduced profit margins and scrutiny. Also, these transactions prevent them from falling under any tax bracket as they cleverly navigate taxation laws and avoid tax. The dubious nature of the industry has normalized the issuance of such transactions.
- Another source of gold comes from Gulf countries. This gold is highly susceptible to money laundering as the number of illegal gold entering the country is high. The jeweller from Kerala also described a street at Calicut Port with 200-250 small-scale jewellers selling about 8000 kilos of Gulf gold in cash. This trend aligns with the observations of the FATF on India's money laundering control mechanism, highlighting a significant shortfall in mitigating risk from imports.
- A small-scale corporate jeweller from Rajasthan said that the Prevention of Money Laundering Act applied to large corporations and registered entities like theirs. They must take the PAN and Aadhar details of individuals purchasing gold for more than Rs. 2,00,000 in cash. Since they own a trademark, regular external audits are conducted on them regarding compliance. However, he pointed out that in many instances, store managers generally inputted their employees' PAN and Aadhar details or a fake ID instead of the customer's ID to create a legal paper trail and record of compliance with the PML Act, 2002. This was done for customers who were close relatives or friends, and the seller had trust in them. These practices were highly reflected in small family-run businesses, where the employees were responsible for the family rather than themselves, as in the case of a large company. They did not fear indulging in risky moves as the family bore the risk and reward.
- In one instance, the jeweller highlighted that most suspicious transactions occur when the making charges are manipulated. These charges are the costs paid to artisans for creating exquisite jewellery. These charges are not fixed in the industry and differ from product to product. Manufacturers often tweak these charges to get extra cash when making customized jewellery. Also, large corporations use Making Charges as a marketing tool. Two typical schemes run in the market. In the first scheme, the store charges Making Charges below market rates to attract more sales. In the second scheme, the corporation sets up a parameter, a machine that measures the actual purity of gold against the claims made to the customer. It is often revealed that the customer has been tricked by small jewellers on purity and hallmarking. As an alternative, the company offers to redesign the product but charges high Making Charges. The customer believes he was tricked by the small jeweller from whom the ornament was purchased earlier in cash and agrees to pay extra to get the ornaments hallmarking and verified. Although legal, these instances

cause small jewellers to depend on cash transactions to maintain profit margins. They are left at the mercy of large corporations and manufacturers, who control such charges in the industry.

- Nevertheless, not all jewellers are unethical. Honest jewellers who believe in compliance with regulations do exist. They perceive the risk of undertaking dodgy operations as "too high" and "not worth the effort." An interview with a retailer based in Bangalore indicated the requirement for small and medium-sized firms to follow such regulations. Being a risk-averse dealer, this jeweller did not indulge in fake transactions and issued bills for the most minuscule sales. Karnataka has strict laws and requires the registration of every jeweller with GST. Mid-size jewellers have no incentive to carry out such transactions. However, the cluster of these jewellers maintains silence on such practices, fearing industry backlash, supply chain disruptions, and competitive disadvantage.
- The overall tone of the interviews, as concluded through sentiment polarity, indicates an overall positive sentiment with a moderate mix of facts and opinions. This shows that the nature of unaccounted transactions in the industry is large-scale. There exists a de facto de jure gap. A few large industry players have normalized the bypassing of regulations. Small family-owned jewellers do not understand the risk of being involved in such measures. Complex compliance systems and fear of loss of customers have induced them to take on operational losses and disruptions rather than implement anti-money laundering measures. The positive sentiment depicts a deep contrast between the seriousness of implementing regulations and casualness in operations.
- One of the jewellers pointed out that the jewellery industry is considered a luxury segment, thereby creating a notion amongst policymakers that government support is not required to run the industry. This leads to reduced support for small-scale jewellers in terms of funding opportunities and operational plans, which induces these jewellers to rely on unethical means to maintain profit margins. He suggested implementing funding opportunities for the jewellery sector to organize it. He also highlighted that most dubious transactions occur when manipulating the Making Charges. These charges are not fixed in the industry and differ from product to product. Manufacturers often tweak these charges to get extra cash when considering customized jewellery.
- The overall interpretation suggests that small-scale money laundering risks occur in the industry. The current regulations only apply to cash threshold provisions. However, there is no comprehensive preventive mechanism that mitigates money laundering risks. The presence of a large unorganized sector and the voluminous transactions in the industry prevent the authorities from correctly implementing regulations. Out of the 10 interviews the researchers conducted, seven jewellers were retailers who believed in compliance and unnecessary risk avoidance. This indicates that the majority of the jewellers are honest. However, the methods used by dishonest jewellers overshadow the presence of such honest jewellers. This shows a concentration of wealth in the hands of the few, which prevents other players in the market from being fully compliant.

6. RECOMMENDATIONS

- One of the jewellers pointed out that the jewellery industry is considered a 'luxury segment,' thereby creating a notion amongst policymakers that government support is not required to run the industry. This leads to reduced support for small-scale jewellers in terms of funding opportunities and operational plans, which induces these jewellers to rely on unethical means to maintain profit margins. He suggested implementing funding opportunities for the jewellery sector to organize it.

- A retailer who ran a family business highlighted that the majority of the retailers in the industry finance their business by bootstrapping and unsecured loans from moneylenders. The Government could look at supporting the industry by referring to it as a 'handicraft' good rather than a 'luxury' good. This would allow small jewellers and retailers to receive National Handicrafts Development Program funding. Innovative Funding opportunities should be provided, allowing small jewellers to revise their operations and move toward compliance and risk mitigation.
- Ensuring fair competition is the key to formalizing this industry. This can be carried out by introducing a Minimum Making Charge policy. This policy would employ the economic concept of price floor. A price floor is a minimum price introduced in the market to avoid undercutting market prices in a competitive market. The concept of price floor was extensively studied by (Dufwenberg et al., 2006). This paper states that in a market with increased competition, price floor leads to higher market prices and increased profitability for all the firms in the market. Firms do not merely look at profit maximization while deciding prices. They also look at the cost of deviation from such equilibrium. A price floor increases such costs, thereby reducing disequilibrium in the market. Based on this concept, a Minimum Making Charge will prevent the undercutting of prices by large corporations and ensure a level playing field by competing in skill, art, and service quality rather than price. This would prevent invoice manipulation, increase information in the market, and discourage cash dependency, facilitating money laundering.
- As part of broad measures, a centralized record-keeping system could be developed in partnership with the private sector, allowing for improved mechanisms in detecting ownership trails. This can be facilitated by the development of Central Bank Digital Currency (CBDC), which would enable the recording of all transactions on the blockchain and ensure data security. (Dupuis et al., 2021) States that CBDC would facilitate curbing money laundering by quickly flagging suspicious transactions and providing safe cross-border payments provided that the country uses an account-based CBDC instead of a token-based CBDC and maintains a Centralized Government Ledger.

Thus, for India to achieve the ambitious goal of being a 'developed nation,' the Government must focus on formalizing this highly unorganized sector. Efforts should be made to get more registered players in the market and devise Anti-money laundering strategies to curb future risks.

7. SCOPE FOR FURTHER RESEARCH

One of the significant limitations is the lack of data availability and the lack of transparency. Although data has been sourced from diverse sources and data collection was stopped after homogeneity was noticed, the entire data may not be generalized for the whole industry. Further research could focus on understanding the gold investment business and money laundering in the gold loan business. Studies on the diamond industry and semi-precious metals can also be carried out. Further, through a hypothesis study, quantitative studies and surveys can be carried out to compare compliance officers' awareness of money laundering in the jewellery industry.

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