KYC: How Asian financial institutions (FIs) are complying with stringent regulations

Just recently, 22 banks in India were fined Rs 50cr for Know Your Customer violations. In Singapore, a maximum fine of S$500,000, up from S$100,000, was set for entities found guilty of a terrorism financing offence. With back-to-back fines and sanctions issued by regulators, Asian banks are taking notice and are quite active in implementing a robust Know Your Customer (KYC) programs in order to avoid non-compliance sanctions. Firms operating in the Asian region must demonstrate a solid compliance framework and ensure that Anti Money Laundering (AML) regulatory requirements are adhered to at both the local and regional level.

However, this noble intention is fraught with significant challenges. While Asian governments and regulators have set standards (to varying degrees) set by intergovernmental Financial Action Task Force (FATF) to strengthen their anti-money laundering (AML) regimes, compliance with these standards across Asia widely differs from country to country and generally remains low. In its Asia Focus newsletter, the Federal Reserve Bank of San Francisco, Country Analysis Unit[1], cited the unique factors that contribute to the demand for money laundering activities in Asia. In its observation, it cited several reasons that make detection of such activities and enforcement of applicable regulations more difficult. To wit:

Structural Issues

Asia has a number of developing economies characterised by relatively low institutional capacities, political and economic instability, and high levels of corruption. These forces create both demand and opportunity for money laundering. An effective domestic AML/CFT regime requires the existence of certain structures, such as a robust regulatory framework, the rule of law, government effectiveness, a culture of compliance, and an effective judicial system.

Some Asian economies do not have these structural elements, or have significant weaknesses or shortcomings that impair the implementation of an effective AML framework. Government policies on taxes, currency controls and trade restrictions can also encourage individuals to circumvent formal financial channels and drive the demand for money laundering.

Prevalence of Cash Transactions

Many economies in the region are still based on cash transactions. However, this acts as a significant impediment to the implementation of AML oversight and reporting schemes because money laundering reporting requirements make the implicit assumption that most legal economic activity is credit-based. AML standards require that cash transactions above

[1]Asia Focus newsletter, the Federal Reserve Bank of San Francisco, Country Analysis Unit, November 2012

a specific threshold be reported and scrutinised. Because of their very nature, cash transactions generally do not leave electronic records, making them difficult to track and report.

Presence of Alternate Remittance Systems
Another reason that money laundering remains prevalent in the region is the presence of alternative remittance systems (ARSs). Ethnic banking systems in the Asia/Pacific region began centuries ago, serving as a means for trade across long distances. Today, they parallel the conventional banking sector and still provide essential banking services for many in the region.

However, the very nature of these systems also makes them highly vulnerable to exploitation by perpetrators of money laundering and terrorist financing. ARSs leave no paper trail, making it hard for authorities to distinguish between money laundering and legitimate transactions.

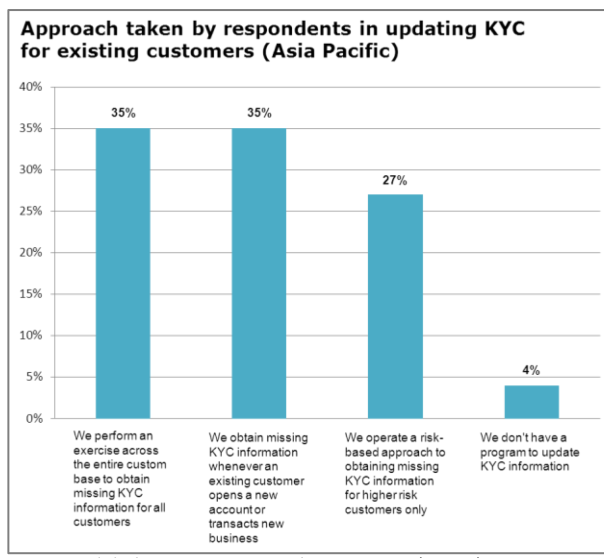
High Level of Criminal Activity
Certain criminal activities in Asia generate illicit proceeds that create a demand for money laundering. Major centers of narcotics manufacturing–Central Asia, the Golden Triangle and the Golden Crescent—are located in Asia, and revenue from the drug trade is moved out of the area and laundered, or redistributed to other areas of production to cover operating costs.

While drug trafficking is most likely the main source of money laundering business in Asia, the Asian Development Bank has identified gambling, bribery, tax evasion, and human trafficking as additional demand sources.

Social, Cultural and Legal Norms
In addition to the prevalent use of cash, other social, cultural and legal factors and business traditions in Asia can pose obstacles to enforcing international AML rules. Rigid confidentiality rules and privacy laws in a number of jurisdictions prevent access by regulators and other authorities to information on suspicious transactions. In addition, the continued acceptance of nominee ownership (where an entity holds assets for the actual owner) in some economies prevents the proper identification of beneficial ownership, reduces transparency, and customer" requirements.

Know Your Customer (KYC)

The challenges cited above make KYC all the more important. In the Asian region (and in other regions, for that matter), the need to refresh KYC on an ongoing basis takes a whole new level of significance. In the latest Anti Money Laundering Survey[2] conducted by KPMG, it was revealed that in the Asia Pacific region, 35% of financial institutions "perform an exercise (updating of KYC information for existing customers) across the entire custom base to obtain missing KYC information for all customers" while the rest perform a less strict approach.



Source: Global Anti-Money Laundering Survey (KPMG)

According to the same KPMG study, "two-thirds of Asia Pacific respondents use variable factors when assessing customer risk at the account opening stage. An ability to utilise data gathered for the purposes of CDD (Customer Due Diligence) is critical."

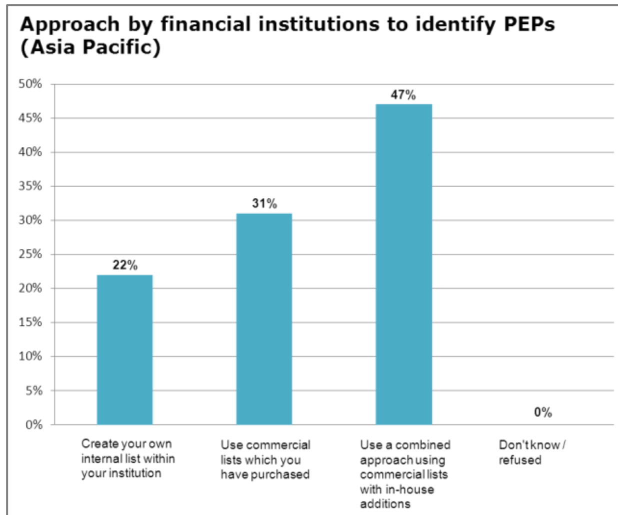
It further added that over the years, there has been a significant increase in the use of wide

[2]Global Anti-Money Laundering Survey 2011 by KPMG (kpmg.com)

range of factors to assess the risk of a potential customer, in the context of the account opening process. Since 2007, “the proportion of institutions using the country in which the customer lives, the type of product for which the customer is applying, and whether the customer is a PEP (Politically Exposed Persons), has increased by approximately 10 percent.

However, the number of financial institutions using variable factors, such as the anticipated volume and / or value of customer transactions, has only increased by two percent (compared to present conditions).

“Across all regions, a customer’s risk rating is primarily reviewed either periodically (74 percent of respondents) or when a client change occurs (73 percent),” the report notes.



Source: Global Anti-Money Laundering Survey (KPMG)

Politically Exposed Persons (PEP)

In identifying PEPs, countries in the Asia Pacific region tend to use a hybrid approach, amalgamating commercial lists with in-house additions. One explanation for this approach is the release by regulators of their own lists of undesirable organisations. Because of this, it would make a lot of sense for financial institutions to incorporate their corporate regulators’ lists into the commercially available PEP lists.

The Need for Data Quality

Key to the success of any screening and monitoring process is data quality. Moreover, this is critical to the wider AML decision-making process. The financial institution’s ability to obtain ‘quality’ data will be determined by a business’ data governance infrastructure. Putting proper measures in place to ensure that it is complete, consistent, accurate, up-to-date is now the biggest challenge Asian banks must face heading into the future.