Research on Know Your Customer (KYC)

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I. Introduction

Know Your Customer (KYC) is the due diligence and bank regulation that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business with them. In the USA, KYC is typically a policy implemented to conform to a customer identification program mandated under the Bank Secrecy Act and USA PATRIOT Act. Know your customer policies are becoming increasingly important globally to prevent identity theft fraud, money laundering and terrorist financing. Beyond name matching, a key aspect of KYC controls is to monitor transactions of a customer against their recorded profile, history on the customer's account(s) and with peers.

II. KYC has different connotations and the definition above is from an AML/CFT perspective

Know Your Customer processes are also employed by regular companies of all sizes, for the purpose of ensuring their proposed agents', consultants' or distributors' anti-bribery compliance. Banks, insurers and export credit agencies are increasingly demanding that customers provide detailed anti-corruption due diligence information, to verify their probity and integrity. Some specialist consultancies help multinational companies and SMEs conduct Know Your Customer processes when entering new markets. The consultative paper 'Consolidated know-your-customer (KYC) risk management' is a supplement to the Basel Committee's 'Customer due diligence for banks' issued in October 2001. It examines the critical elements for effective management of KYC policies and procedures in banks' foreign branches and subsidiaries.

The adoption of effective know-your-customer (KYC) standards is an essential part of banks' risk management practices. As discussed in the Customer due diligence for banks (CDD) paper, banks with inadequate KYC standards may be subject to significant risks, especially legal and reputational risk. Sound KYC policies and procedures not only contribute to a bank's overall safety and soundness, they also protect the integrity of the banking system by reducing the likelihood of banks becoming vehicles for money laundering, terrorist financing and other unlawful activities.

The CDD paper outlines four essential elements necessary for a sound KYC programme. These elements are

1. Customer acceptance policy
2. Customer identification
3. On-going monitoring of higher risk accounts

Jurisdictions should facilitate consolidated KYC risk management by providing an appropriate legal A global risk management programme for KYC should incorporate consistent identification and monitoring of customer accounts globally across business lines and geographical locations, as well as oversight at the parent level, in order to capture instances and patterns of unusual transactions that might otherwise go undetected. Such comprehensive treatment of customer information can significantly contribute to a bank's overall reputational, concentration, operational and legal risk management through the detection of potentially harmful activities

III. KYC (Know Your Customer) Information for Customers Intending to Open Bank Account

The Reserve Bank of India (RBI) has advised banks to follow a 'KYC guidelines', wherein certain personal information of the account-opening prospect or the customer is obtained. The objective of doing so is to enable the Bank to have positive identification of its customers. This is also in the interest of customers to safeguard their hard earned money. The KYC guidelines of RBI mandate banks to collect three proofs from their customers. They are

1. Photograph
2. Proof of identity
3. Proof of address

IV. Know Your Customer – What You Must Know

What is KYC?

Know Your Customer - KYC enables banks to know/ understand their customers and their financial dealings to be able to serve them better

Who is a customer of the Bank?

For the purpose of KYC Policy, a „Customer" is defined as:

1) A person or entity that maintains an account and/or has a business relationship with the Bank;
2) One on whose behalf the account is maintained (i.e. the beneficial owner);

V. Enhanced Due Diligence

EDD has not been internationally defined. As a result financial institutions are at risk of being held to differing standards dependent upon their jurisdiction and regulatory environment. An article published by Peter Warrack in the July

2006 edition of ACAMS Today (Association of Certified Anti-Money Laundering Specialists) suggests the following:

"A rigorous and robust process of investigation over and above (KYC) procedures, that seeks with reasonable assurance to verify and validate the customer's identity; understand and test the customer's profile, business and account activity; identify relevant adverse information and risk assess the potential for money laundering and / or terrorist financing to support actionable decisions to mitigate against financial, regulatory and reputational risk and ensure regulatory compliance."

VI. CHARACTERISTICS OF EDD

1. Rigorous and robust

Generally this means consistent, thorough and accurate. The process must be documented and available for inspection by regulators. The process must be SMART (Specific, Measurable, Achievable, Relevant and Time bound), scalable and proportionate to the risk and resources. A Ball workflow system ensuring that the KYC process and procedures are Defined, Repeatable and Measurable is recommended.

2. Reasonable assurance

What is reasonable depends upon factors including jurisdiction, risk and resources. For sanction matches it depends upon information provided by regulators. In all cases the suggested standard is to the civil standard of proof i.e. on the balance of probability.

3. Relevant adverse information

Information obtained from any source, including the Internet, free and subscription databases and the media, which is directly or indirectly indicative of involvement in money laundering, terrorist financing or predicate offenses.

Examples include fraud and other dishonesty, drug trafficking, smuggling or other proscribed offences, references to money laundering, or conducting business, residing in or frequenting countries deemed by the Financial Action Task Force and/or (institution) as being countries under sanction or countries with which (institution) does not do business; to official sanctions or watch lists; and to investigations, convictions or disciplinary findings by authorized regulatory bodies.

VII. OVER AND ABOVE KYC PROCEDURES

EDD files rely upon initial client screening. This definition requires revalidation of the customer's identity – knowing the client's identity, not who they say they are. EDD processes should use a tiered approach dependent upon the risk.

Crucial to the integrity of any EDD process is the reliability of information and information sources, the type and quality of information sources used, properly trained analysts who know where to look for information, how to look and how to corroborate, interpret and decide the results. Open source intelligence companies such as World Compliance and C6, aggregate this information and compile it daily into a comprehensive database. Estate Engineer (Civil) Sunil Ch. Das, Agartala Searching on Google, for example, means different things to different people. Experience has shown poor returns from staff that believed they were experienced, but in practice were not and consequently failed to find relevant information.

KYC Process Capability Maturity Model

A draft KYC Capability Maturity Model was published and shared with a range of international KYC practitioners in 2009 and 2010. An updated and peer-reviewed version will be published in the ACAMS ACAMS Today magazine in early 2011.

The KYC Maturity Model is based on the typical 5 levels of the standard Capability Maturity Model. These levels are typically described as Initial, Repeatable, Defined, Managed and Optimized and have very strict meanings. The KYC maturity has however been somewhat simplified, renamed and re-built as follows: Chaotic, Reactive, Proactive, Service Managed and Value Managed. Practical process improvement learning's have also been taken from common manufacturing and IT productivity methodologies such as Lean, Agile, 6-Sigma, ITIL and Balanced Scorecard.

VIII. CONTINUOUS DUE DILIGENCE

CDD refers to the monitoring of clients and their activities to see if the client does not change markedly over time. In effect this combats the possibility that an individual (or more often an organization) that has passed KYC is still who they say they are and doing what they said they would do when they underwent KYC checks. For example a corporate account set up honestly and openly by one person who passes KYC checks could be passed years later to another person that would not, without CDD the services provider would not know that the new owner is present. KYC (CDD) policy would normally demand KYC checks on the new owner regardless of the account history.

KYC is a client identification program that verifies and maintains records of the identity and address of investors.

1. KYC norms were introduced in 2002 by the Reserve Bank of India. It directed all banks and financial institutions to put in place a policy framework to know their customers before opening any account. The purpose was to prevent money laundering, terrorist financing, theft and so on.
2. Today other regulators too have made KYC mandatory. The Securities and Exchange Board of India (Sebi) has mandated it for mutual funds and broking accounts, the Insurance Regulatory Development Authority (IRDA) while buying insurance and the Forwards Markets & Commission (FMC) for commodity trading. You need to submit it even for making post office deposits.

IN BRIEF

* KYC is mandated by most regulatory authorities

* Documents for proof of identity and address are needed.

* Certain investments may need PAN card details

* Duplication of documents in some cases is possible

* Investee firms may also incur compliance cost

3. Documents needed: The mandatory details required under KYC norms are proof of residence and identity.
4. A person's ration card, passport, utility bills or a letter from the employer or his housing society is accepted as residence proof. For proof of identity, passport, voter ID card, Permanent Account Number (PAN) card or driving license too could work. Nowadays, most institutions ask for the customer's PAN too.
5. Impact: Although the effort towards strengthening identification norms has helped in preventing money laundering and reducing fraud, it has had a negative impact in an unexpected quarter. The growth in investor numbers in various instruments is either stagnating or reducing. Apparently, the KYC norms are proving restrictive because of the hassles of documentation.
6. The KYC requirement sometimes leads to unnecessary and repetitive work, delaying operations. Customers complain about the paperwork involved. Ultimately, it means customers have to run from pillar to post for complying with the KYC norms. Investors complain of being asked to provide details repeatedly or face a freeze on their accounts
7. Impact for service providers: Companies and distributors say, KYC requirements have burdened them with substantial administrative obligations. The verification rules place a financial burden on banks, insurance companies and mutual funds due to the involved costs. Currently, every entity has to individually conduct this verification which results in duplication of effort for customers as well as the institutions.
8. There is a need to simplify KYC requirements. The authorities could opt for centralization of the KYC norms to make investing easy for those not well versed with paperwork. Mutual funds have done this at an industry level by giving the mandate to a single entity, CDSL Ventures. Uniformity in requirements for KYC prescribed by all authorities would help make the filing easier. One important document that will make life simpler is - 'Aadhar', the unique identification number to be provided to each citizen by Unique Identification Authority of India (UIDAI), a government initiative. But there is still some time before it will be implemented. By making KYC norms simpler, it will make investments simpler. It is especially required if investing is to become more inclusive.'
9. Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors, etc. as permitted under the law, and any person or entity connected with a financial transaction, which can pose significant reputation or other risks to the Bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

Why does the bank ask you for proof of your identity and address?

The identification of a customer is a very critical process with a view to protect the customer interests by preventing from fraudsters who may use the name, address and forge signature to undertake benami / illegal business activities, encashment of stolen drafts, cheques, dividend warrants, etc. This also helps to safeguard banks from unwittingly used for the transfer of deposit of funds derived from criminal activity or for financing terrorism. Identification of customers will also help to control financial frauds, identify money laundering and suspicious activities, and for scrutiny / monitoring of large value cash transactions.

Are KYC requirements new?

No, KYC requirements have always been in place and Banks have been taking KYC documents in accordance with the guidelines issued by RBI from time to time. RBI has revisited the KYC guidelines in the context of recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering standards and on Combating Financing of Terrorism and enhanced the KYC standards in line with international benchmarks.

Is KYC mandatory?

Yes. It is a regulatory and legal requirement. Regulatory: In terms of the guidelines issued by the Reserve Bank of India (RBI) on November 29, 2004 on Know Your Customer [KYC] Standards – Anti Money Laundering [AML] Measures, all banks are required to put in place a comprehensive policy framework covering KYC Standards and AML Measures. Legal: The Prevention of Money Laundering Act, 2002 (PMLA) which came into force from July 1, 2005 (after "rules" under the Act were formulated and published in the Official Gazette) also requires Banks, Financial Institutions and Intermediaries to ensure that they follow certain minimum standards of KYC and AML as laid down in the Act and the "rules" framed there under

When does KYC apply?

KYC will be carried out at the following stages:

1. Opening a new account
2. Opening a subsequent account where documents as per current KYC standards not been submitted while opening the initial account
3. Opening a Locker Facility where these documents are not available with the bank for all the Locker facility holders
4. When the bank feels it necessary to obtain additional information from existing customers based on conduct of the account
5. When there are changes to signatories, mandate holders, beneficial owners etc. KYC will also be carried out in respect of non-account holders approaching the bank for high value one-off transactions.

Who is your contact point in the bank for KYC purposes?

Your contact point in the Bank will be the Relationship Manager / the official who opens your account and who is in touch with you for your transactions.

What is money laundering?

Money Laundering refers to conversion of money illegally obtained to make it appear as if it originated from a legitimate source. Money laundering is being employed by launderers worldwide to conceal criminal activity associated with it suahc as drugs / arms trafficking, terrorism and extortion. All crimes that produce a financial benefit give rise to money laundering.

What has this got to do with opening bank accounts?

The first step in the laundering process for criminals is to get their money into an account with a Bank, often using a false identity and address. The funds so deposited will be transferred to other accounts locally or abroad or used for buying goods or services. These transactions would appear to be like any legally earned money and becomes difficult to trace it back to its criminal past. Banks under law should not only prevent this, but should stop criminals who wish to use the banking channel to launder the ill-gotten money from illegal / criminal activities.

How could this affect you as a customer?

A key defense against money laundering is to prevent accounts being opened in false identities. Anyone wishing to open an account will therefore be asked for proof of their identity and address. These documents have to be essentially obtained irrespective of the type of account to be opened and the purpose for which the account is opened for. The fact that these documents are asked for opening of account does not mean that you are suspected of money laundering. Criminals try to appear to be normal law-abiding customers, for example they may try to open a number of accounts using small amounts of money. Hence it is necessary to identify all prospective account holders or customers. Anybody including a criminal could falsely use your identity, if these identity documents are not obtained.

What proof of identity will you need?

The best identification documents are those, which are issued by a Government authority, which should have a photograph, address and signature. For an individual document like copy of the Passport, Election Identity Card, Permanent Account Number (PAN) card, etc. would be sufficient for the purpose of establishing the identity of a customer. This has to be submitted along with a document to establish the address of the customer. You may approach the nearest branch of the Bank for the list of acceptable documents to be submitted for proof of identity and address. Similarly, for other entities like firms, companies, trusts, etc., documents like Partnership Deed, Trust Deed, Memorandum & Articles of Association, Certificate of Incorporation, Registration and Service Tax, License under Shops and Establishment Act, etc. would be applicable and the branch / sales staff / call center would be able to help you in providing the details of the list of approved documents.

What will happen if you do not provide the required KYC information / documents to the Bank?

The Bank will be entitled to refuse to open the account (if you are a prospective customer) or discontinue its relationship with you citing non-providing of KYC information / documents (if you are an existing customer). If you however, require reasonable time to furnish certain non-critical documents you can approach the branch / sales staff. If you are a small depositor, would you still have to go through the stringent KYC requirements? While the internal procedures of the Bank and the guidelines of RBI require that satisfactory proof of your identity and address, RBI has simplified the KYC procedure with the objective of greater financial inclusion, i.e. making available the basic banking facilities to those persons who intend to keep balances not exceeding Rupees Fifty Thousand (Rs. 50,000/-) in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed Rupees One Lakh (Rs.1,00,000/-) in a year. Help us to Help You Please help us to prevent crime, tax evasion and the laundering of the proceeds of such crime or evasion by being patient when staff asks you to provide documents to prove your identity. You can also help prevent crime against yourself and others by maintaining the confidentiality of your account details and identity documents. Indian Regulations on Prevention of Money Laundering – A customer must know Under the Prevention of Money Laundering Act (PMLA) 2002, and the Rules thereof, the banks are required to report:

a) All cash transactions (deposits and withdrawals) of the value of more than Rupees Ten Lakhs or equivalent thereof in foreign currency;

b) All series of cash transactions integrally connected to each other, which have been valued below Rupees Ten Lakhs or its equivalent in foreign currency where such series of transactions have taken place within a month and the aggregate value of such transactions exceeds Rupees Ten Lakhs.

c) All cash transactions were forged or counterfeit currency notes or Bank notes have been used as genuine and where any forgery of a valuable security has taken place;

d) All suspicious transactions whether or not made in cash and by way of as mentioned in the Rules.

IX. UNDER REGULATORY INSTRUCTIONS ISSUED BY THE RESERVE BANK OF INDIA IN CONSULTATION WITH THE GOVERNMENT OF INDIA AND INDIAN BANK'S ASSOCIATION

a) Demand drafts, mail transfers and travelers cheques for Rs. 50,000/- and above can be issued by banks only by debit to the customer's account or against cheque or other instrument tendered by the purchaser and not against cash payment;

b) Demand drafts, mail transfers and travelers cheques for Rs. 50,000/- and above can be paid by banks only by credit to the customer's account or through other banking channels and not in cash.

Many of the new 'Know Your Customer' initiatives and regulations have not been viewed in a positive light by the financial services community. These regulations, along with many others, are viewed simply as a necessary evil and compliance as an increased operating cost. Even the language of regulation is negative. We talk in terms of obligations, duties, and requirements. The word most frequently paired with 'regulatory' is 'burden', and the antithesis of 'regulation' in any discussion of the issue is 'freedom', as though the two terms are mutually exclusive. Clearly, while identifying and profiling customers and reporting suspicious transactions may become an accepted part of banking best practice. These initiatives have not been greeted with great enthusiasm. But this could be a serious miscalculation of the changing landscape in financial services. The fundamental role of a financial services company must be to make a profit by serving its customers. And more profit can be made and more customers retained if the customers are well served. This having been stated, what could be better than getting to know more about your customers?

Knowing your customer should not be seen as a function to be relegated to Compliance, but a fundamental building block for a profitable operation. Good intelligence is essential to planning business strategy. Financial Institutions should reconsider any initial negative reaction to these new regulations and should avoid allowing valuable information to gather dust in the compliance department. Many banks have already paid millions of dollars to understand and implement complex CRM programs and processes. Meeting regulatory compliance should be a byproduct of knowing your client with successful and profitable customer relationships being the ultimate goal.

The institutions that understand that compliance with Know Your Customer regulations can be an investment rather than a cost will reap the rewards of this new landscape. The increase in regulation over the past two decades has been a delicate game of cat and mouse between legislators and the financial services industry. And moves to strengthen regulation in different parts of the world have invariably followed hard on the heels of scandal – BCCI, Barlow Clowes, Marcos, and Abacha to name but a few. Many politicians pay lip service to the sanctity of the individual's right to financial privacy, but only up to point. The reality is in the massive amounts of new legislation moving through national and international bodies. Massive inroads have already been made into the privacy edifice by successive raids against drug trafficking, money laundering, corruption, tax evasion, and, as no one will need reminding, terrorism. Anonymity, whether individual or corporate, is no longer to be tolerated and sources of funds must now be known. And there is no bucking this trend.
Pressures are being brought to bear from many different directions and at many different levels – national governments, international bodies, multinational authorities, non-governmental organizations, self-regulatory groupings, and private sector or professional associations. If there was any hope that this issue would go away, the events of September 11th have dismissed that notion. The G7 leading industrialized nations set the ball rolling with the creation of the Financial A action Task Force Against Money Laundering. And the ranks have been swelled variously by parallel or supporting contributions from the Organization for Economic Cooperation and Development, the International Monetary Fund, the United Nations, the Financial Stability Forum, and the Basel Committee on Banking Supervision.

The latter's approach to 'Know Your Customer' (KYC) standards is from a wider prudential perspective than money laundering alone. It originates from its concerns for market integrity and the direct and indirect losses that may be incurred by banks that do not have or have not properly implemented appropriate due diligence procedures. That there are increasing pressures on private banks in particular to verify the identity of their clients is no news to many of the largest banks in that group. Forces for change from without the industry have been equaled, and quite possibly exceeded, by forces for change from within.

The majority of respondents see it as important to achieve operational performance and to manage the hazards within the business but only a few are also beginning to view risk management as a proactive tool in the development of the business strategy and strategic opportunities. Private banks, say the Basel Committee, are particularly exposed to reputational risk, and should therefore apply enhanced due diligence to such operations. Development of strong brand is becoming increasingly important.

Image and reputation are ranked second as a key differentiator by chief executive officers in the PWC survey. They are also perceived as the second ranked criterion for clients selecting a private bank or wealth manager, and as the top ranked measure of success. At a minimum, leaders must consider the effect that internal processes and procedures can have on the reputation and brand of their organization. Institutions that do not have a facility to meet these new regulations are unnecessarily exposing themselves to other significant risks that include civil fines and significant penalties. External audit exemptions could result in a decreased share value for many highly profitable private banks. Investors must be confident that leadership has this issue under control. To look at the new KYC regulations as simply a compliance issue is the wrong approach. This is a glass half full, not half empty.

Knowing your customer is what the modern financial services industry is all about. The process allows you to manage your risk, but if properly implemented it should also provide the data to help steer your strategy, improve customer service, and increase profitability. Financial institutions must shake off the 'regulatory burden' mindset and seek to capitalize instead on this 'regulatory bonus'. Performing effective due diligence is not simply a compliance issue, but a golden opportunity to better understand your customers and their needs. Capturing and utilizing the right information can transform an otherwise burdensome compliance process into a cornerstone of business development and customer relationship best practices.

X. CONCLUSION

1) Banks doing KYC monitoring for anti-money laundering (AML) and checks relating to combating the financing of terrorism (CFT) increasingly use specialized transaction monitoring software, particularly names analysis software and trend monitoring software.
2) Know Your Customer processes are also employed by regular companies of all sizes, for the purpose of ensuring their proposed agents', consultants' or distributors' anti-bribery compliance. Banks, insurers and export credit agencies are increasingly demanding that customers provide detailed anti-corruption due diligence information, to verify their probity and integrity. Some specialist consultancies help multinational companies and SMEs conduct Know Your Customer processes when entering new market.
3) The adoption of effective know-your-customer (KYC) standards is an essential part of banks' risk management practices. As discussed in the Customer due diligence

for banks (CDD) paper, banks with inadequate KYC standards may be subject to significant risks, especially legal and reputational risk. Sound KYC policies and procedures not only contribute to a bank's overall safety and soundness, they also protect the integrity of the banking system by reducing the likelihood of banks becoming vehicles for money laundering, terrorist financing and other unlawful activities.

4) "A rigorous and robust process of investigation over and above (KYC) procedures, that seeks with reasonable assurance to verify and validate the customer's identity; understand and test the customer's profile, business and account activity; identify relevant adverse information and risk assess the potential for money laundering and / or terrorist financing to support actionable decisions to mitigate against financial, regulatory and reputational risk and ensure regulatory compliance."
5) There is no escaping the paperwork while investing in financial products. Be it, opening a new bank account, demat account or buying insurance, filling the Know Your Client (KYC) documents is a mandatory procedure today.

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