ORACLE
Financial Services

Financial Crime and Compliance Management

Dynamic Customer Due Diligence: The Need for Perpetual KYC

Globally there has been an exponential increase in money laundering and terrorist financing activities, and COVID-19 has only abetted this surge multifold. Emergence of app-based cross-border digital lenders, peer-to-peer lending, e-invoicing services and a host of other new financial products and services that require minimal customer identification procedure (CIP) are further fueling this threat. This means that financial institutions (FIs) will need to make their customer due diligence (CDD) practices more robust and consistent to counter these new challenges and threats.

This whitepaper explores one of the recent developments in the due diligence process, called the 'Dynamic Customer Due Diligence' or 'Perpetual Know Your Customer (pKYC)'. This document provides an overview, drivers and challenges of this new approach of performing customer due diligence.

Gowrishankar Gopal
Kavitha Jayachandra
Saurabh Gangopadhyay
Apr 22

ORACLE

DISCLAIMER

The following is not intended to outline our general product direction. It is intended for information purposes only, and may not be incorporated into any contract. It is not a commitment to deliver any material, code, or functionality and should not be relied upon in making purchasing decisions. The development, release, and timing of any features or functionality described for Oracle's products remain at the sole discretion of Oracle.

Table of Contents

1. INTRODUCTION

Money laundering, terrorist financing, bribery and other financial crimes are wreaking havoc both economically and socially. According to Bloomberg, global money laundering transactions are valued in the range of $1 to $2 trillion per year. In 2020, fines related to Anti Money Laundering (AML), Know Your Customer (KYC), data privacy and Markets in Financial Instruments Directive (MiFID) violations amounted to an unprecedented US$10.3 billion, and the sanctions fines totaled US$23.5 million, according to the US department of Treasury, OFAC enforcement Information report. AML breaches were the most common violation, with the US having the greatest number of banks on whom fines were levied.

Given the magnitude of the problem, global regulatory bodies have been ardent to tighten regulations for AML Compliance. The tsunami of heightened global regulation has made KYC compliance more demanding, complex, and expensive than ever before. Coupled with this is the challenge of global FIs to follow different requirements across countries/regions. While AML requirements at US and EU have been more consistent, those in the Asia Pacific are particularly challenging given the multitude of regulators and their rapidly changing policies based on global insights and findings. In addition to the fluidity in regulatory mandates, COVID induced changes in onboarding, multitude of customer touchpoints, increased digitization of transactions through POS terminals and mobile wallets amongst others are adding to the existing challenges.

2. EVOLUTION OF MONEY LAUNDERING

Historically, it all started a few thousand years ago in the Far East, where the first money laundering incidents were recorded. To reduce their tax burden, traders would go to great lengths to hide their wealth from rulers to avoid it being confiscated from them. The term 'money laundering' is said to have originated from Italian mafias in the United States during the 1920s where criminals (such as Al Capone) were purchasing laundromats to comb in their illegitimate business proceeds with legal profits. They were literally "laundering" illegal money. Following Al Capone's imprisonment, criminals were forced to become more "organized" as they realized the need to have a business "front" to disguise illegal proceeds. The foundation of modern AML laws was laid post World War – II.

To counter the insurgence of organized financial crimes, the Bank Secrecy Act of 1970 (BSA) laid the first groundwork for AML regulations by requiring FIs in the US to report transactions totaling $10,000 or more, to FinCEN (Financial Crimes Enforcement Network). AML regulations gained further traction when the Financial Action Task Force (FATF) was set up in Paris in July 1989 to examine and develop anti-money laundering measures, establish global standards to prevent money laundering, and get the member countries to implement them. Following 9/11, the USA PATRIOT Act 2001 further reinforced the AML regulations by placing several obligations on FIs to detect and prevent money laundering. Besides these, institutions must comply with various other regulations such as Frank-Dodd Act, FinCEN's rule on Beneficial Ownership, Foreign Account Tax Compliance Act (FATCA), Markets in Financial Instruments Directive (MiFID) and BASEL regulations and various local and regional anti-corruption and bribery regulations.

3. WHAT IS KNOW YOUR CUSTOMER (KYC) AND WHY WE DO IT

The main purpose of AML regulations is to prevent money laundering, and one of the primary mechanisms to ensure this is to put in place a robust KYC framework. It means that the business entity should be able to identify the legitimacy of the customer — one who is not tarnished by political or criminal connections, or has a history that would be too risky to deal with. After all, lending money to or servicing a person or a business entity who presents a high risk of default or who may be involved in illegal activities can be financially and reputationally damaging for any financial institution.

Typically, FIs will request KYC documentation related to — identification, financial statements, certificate of incorporation, taxation, ownership, and management structure amongst others, at the time of onboarding a new customer. However, it has become quite common to ask for additional details or have follow up requests. Often these requests are triggered annually or after every two or five years, with high-risk customers getting more frequent requests.

4. PERPETUAL KYC AND DRIVERS OF PERPETUAL KYC

With increasing money laundering crimes, banks have realized the importance of maintaining accurate and up to date KYC and transactions related information of their customers that allows them to proactively manage risks at an early stage and across the customer lifecycle, by monitoring them continuously. This brings renewed focus on the concept of Perpetual Know Your Customer. Perpetual KYC is a framework to dynamically maintain and update a customer's profile and risk assessment based on internal assessment and various external triggers constantly.

Adopting Perpetual KYC means shifting to a radically new way of doing KYC where periodic reviews must give way to a dynamic process where technology is the key enabler. Handling and contextualizing a large volume of data matters the most, for maintaining an accurate and up-to-date view of the customer profile in order to mitigate regulatory risk at all times.

Regulatory Drivers

Regulators are increasingly laying down guidelines to widen the customer due diligence process, including additional sources like adverse media/negative news. For example, firms must perform adverse media searches as part of enhanced customer due diligence as per Financial Action Task Force (FATF) recommendations. However, these searches are error-prone and are more subjected to bias if done manually compared to the automated process of retrieving data from multiple media sources and curing them using defined rules and guidelines.

Reputational Risk

Although regulators prescribe periodic assessment as per the risk profile of customers, if a customer is subjected to AML fine/sanctions during the interim period between reviews, all the firms involved with the customer/transaction will be exposed to reputational risk in the industry. In such cases, having a system that monitors customer profile changes regularly and triggers customer due diligence when thresholds are breached would be more helpful in detecting early warning signals.

Technological Enhancements

The emergence of Artificial Intelligence (AI) and Machine Learning (ML) technologies coupled with cloud-based deployment and processing have opened new avenues and business cases in the AML compliance domain. Small and medium enterprises can leverage these technologies by adopting the Software as a Service (SaaS) approach. The technologies required for perpetual customer due diligence like Natural Language Processing (NLP), Optical Character Recognition (OCR), web scraping, high computational and storage capabilities, have become easy to adopt and implement, enabling quicker transitioning to the new approach for customer due diligence.

Cost Optimization

Although there are cost implications during the initial phase of the perpetual KYC solutions implementation, the benefits will outweigh the costs in the long run. The benefits include resource optimization, lower manual intervention, reduced rework, consistency of the process, and effective compliance.

Better Customer Experience

In the perpetual KYC process, only customers whose profile changes breach the thresholds (e.g., customers having more than 25% controlling stake), are contacted for new documentation and information. This significantly reduces friction at customer touchpoints. Also, the collection of additional information helps to build a 360-degree view of the customer which can be used to customize products and services for the customers. All this results in better customer experience and risk management.

5. A ROBUST PERPETUAL KYC FRAMEWORK

Typically, Know Your Customer (KYC) processes are largely workflow based, with sourcing and validating customer's documents, updating customer information, refurbishing missing data, screening customer information and assigning risk ratings. However, with perpetual KYC, the focus is more on how to manage the trigger parameters so that they are triggered on time, processed and actioned based on the insights gleaned.

So to outline the framework, as a first step, while acquiring a customer, identification documents are scrutinized to ensure that the customer/entity is not part of any sanctions list. In the second step, customer due diligence measures are actioned—such as collecting all available data on the customer from trusted sources, determining the purpose and intended nature of business relationship and key beneficiaries, and continuous periodic monitoring of relationships to ensure that activities are consistent with the customer's risk profile. In the third step, institutions schedule KYC rereviews based on the customer's risk profile. The highest risk customers are often screened annually or sometimes more frequently (depending upon risk profile and jurisdiction), medium risk customers every three years, and the lowest risk customers usually every five years. Enhanced customer due diligence measures such as more intense monitoring and deeper investigative research as mandated in perpetual KYC is carried out if the firm perceives that the customer's behaviour is at a higher risk than expected or a trigger event has been generated. High-risk customers are those with political exposure (PEP), or anyone whose country of origin is on the "High-Risk Third Countries" list, as outlined in Article 18 of the Fourth EU Money Laundering Directive (4AMLD). 5AMLD, which came into effect in Jan 2020, further enhanced these requirements.

6. PERPETUAL KYC FOR AN EFFECTIVE AND IMPROVED CUSTOMER DUE DILIGENCE

Institutions are moving towards perpetual KYC solutions for performing customer due diligence wherein customers, irrespective of their risk profile, are screened on a real-time or near real-time basis, based on trigger events. These trigger events could be negative news on the individual/entity, change in legal status/domicile, etc. These trigger events initiate the customer due diligence process if the events breach specified thresholds (e.g., frequent negative news). This enables financial institutions to be more proactive in identifying and acting upon risk events early compared to periodic review, thus averting any negative impact on the financial institutions and their reputation. Due to this ongoing and dynamic monitoring of customer data vis-à-vis key triggering events, perpetual KYC is also referred as Dynamic Customer Due Diligence or Continuous Customer Due Diligence.

7. CHALLENGES IN IMPLEMENTING PERPETUAL KYC

Implementing perpetual KYC solutions for customer due diligence is easier said than done, despite considerable improvements in technology. Some of the key challenges are:

Disparate Systems and Sources

Most organizations do not have integrated systems that enable them to have a holistic view of the customer, and to monitor customer's risk profile internally. This in itself forms the biggest roadblock in implementing an organization-wide perpetual KYC solution. Consolidation of data across various sources like blogs, newspapers, social media, judicial data, and electoral registers presents challenges like diverse integration points, threshold limits and rules.

Non-Standardization of KYC Model/Regulations

The very nature of KYC/AML regulations globally requires that organizations do not follow a uniform KYC model. In an ever-changing regulatory landscape, with an absence of a standardized model, the processes and rules for collecting, maintaining, and updating client data differ vastly across banking organizations. Given that these models, by the very nature of it are not flexible enough to capture accurately the client's risk appetite and behavior, creating a meaningful risk profile becomes particularly difficult.

Limitations of Publicly Available Sources

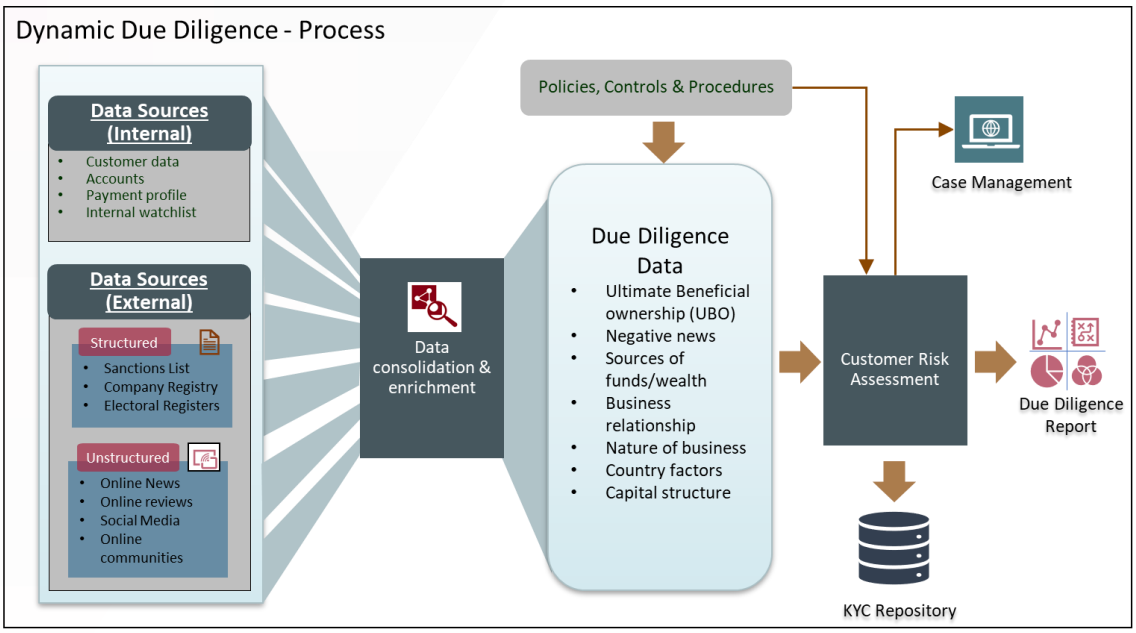
Customer data is often gathered from publicly available sources that may be inaccurate, incomplete, or unconfirmed. Also, because of multiple privacy regulations and concerns among the customers, banks find it increasingly challenging to verify the accuracy of the data gathered.

Incomplete Data Capture in Onboarding Process

Banks generally capture only the mandatory fields during the onboarding process, ignoring the value-added fields. This means that getting the accuracy for any adverse media match might get reduced, due to the limited data points available about the customer.

8. RECOMMENDED APPROACH FOR SUCCESSFUL IMPLEMENTATION OF PERPETUAL KYC

Given the challenges discussed in the above section for implementing a perpetual KYC, the below diagram provides an outline of the recommended approach for conducting dynamic due diligence



Data Sourcing

The customers once onboarded need to be monitored continuously against internal and external data changes which might impact the customer profile, e.g., electoral registers provide customers profile change from a low-risk customer to PEP (Politically Exposed Person).

- The internal data sources include customer data store, internal watchlist, account details, etc. Predominantly this data is in a structured format like a relational database, although unstructured data in the form of contractual agreement and identification documents are also present.
- External data sources include external watch lists like Office of Foreign Assets Control (OFAC), World-Check, and adverse media/negative news. This data is generally unstructured and needs the application of technology to infer helpful information from the data.

Data Consolidation and Enrichment

The data is collated across a variety of sources, cleansed, and enriched. Data cleansing is one of the most critical steps in this process since the data set will be massive and only a subset of useful data must be extracted ignoring superfluous, surplus, and duplicate data.

Utilizing Data for Customer Due Diligence

The above process provides input data required for the customer due diligence process like business relationships, beneficial owners of the entity, sources of funds, and capital structure. Firm-level policies and procedures define the risk factors to be considered for the customer due diligence process in line with regulatory requirements e.g., the percentage threshold for controlling interest, verified media sources, and threshold limits.

Customer Risk Assessment

The data collected is screened against defined events like frequent negative news, criminal court order against the entity/individual, and new business relationships to sanctioned countries. If the event changes the customer profile and exceeds the defined threshold (e.g., number of negative news), customer due diligence process is triggered. If the change is not a material change, the updated information is stored in the customer repository for reference and future use. Customer due diligence reports are generated, and alerts are sent to the case management system for further action.

9. CONCLUSION

Institutions must approach perpetual KYC solutions in a flexible, dynamic, and holistic manner to stay ahead of the ever-evolving regulatory landscape. Firms must ensure strong resiliency in operations and reduce customer malpractices by monitoring changes in customer's risk profiles in near real-time. Without disrupting customer experience, they will have to explore cloud-based AI/ML software solutions and other digital technologies to gather customer information and collaborate with their peers and third parties in procuring, storing, analyzing, and sharing data. Only by ensuring the above can they beat the bitter onslaught of nefarious practices unleashed upon them by the money launderers in this digital era.

10. REFERENCE

I. https://www.bcg.com/en-in/publications/2017/financial-institutions-growth-global-risk-2017-staying-course-banking
II. https://www.bloombergquint.com/markets/banks-moved-2-trillion-defying-money-laundering-orders-icij
https://home.treasury.gov/policy-issues/financial-sanctions/civil-penalties-and-enforcement-information/2020-enforcement-information
III. https://www.fincen.gov/history-anti-money-laundering-laws
IV. http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf
V. Directive (EU) 2015/849 of the European Parliament and of th... - EUR-Lex (europa.eu)
VI. http://www.fatf-gafi.org/media/fatf/content/images/Updated-2017-FATF-2013-Guidance.pdf
VII. https://www.fatf-gafi.org/media/fatf/documents/COVID-19-AML-CFT.pdf
VIII. https://www.ey.com/en_sg/banking-capital-markets/how-to-get-ready-for-dynamic-continuous-kyc
IX. https://amlintelligence.com/
X. https://www.ftc.gov/
XI. https://www.fatf-gafi.org/
XII. https://www.celent.com/insights/428842331
XIII. https://www.nasdaq.com/articles/8-ways-kyc-compliance-will-evolve-in-the-next-5-years-2020-11-03
XIV. https://www.acfcs.org/special-contributor-report-top-5-emerging-trends-for-aml-compliance-dawn-of-a-new-decade-2021/
XV. https://www.swift.com/news-events/news/efficient-customer-due-diligence-key-improving-corporate-customer-experience
XVI. https://sumsub.com/knowledgebase/adverse-media/
XVII. https://pideeco.be/articles/what-is-adverse-media-negative-news-aml/
XVIII. https://eur-lex.europa.eu/legal-content/EN/LSU/?uri=CELEX:32015L0849
https://ec.europa.eu/info/law/anti-money-laundering-amld-v-directive-eu-2018-843_en

ORACLE CORPORATION

Worldwide Headquarters
500 Oracle Parkway, Redwood Shores, CA 94065 USA

Worldwide Inquiries
TELE + 1.650.506.7000 + 1.800.ORACLE1
FAX + 1.650.506.7200
oracle.com

CONNECT WITH US

Call +1.800.ORACLE1 or visit oracle.com. Outside North America, find your local office at oracle.com/contact.

blogs.oracle.com/oracle facebook.com/oracle twitter.com/oracle

Integrated Cloud Applications & Platform Services

White Paper Title
January 2017
Author: [OPTIONAL]
Contributing Authors: [OPTIONAL]