Fintelekt

The Future of Financial Crime Compliance Screening in South Asia

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This Fintelekt Quick Insights Report on 'The Future of Financial Crime Compliance Screening in South Asia' highlights the financial crime compliance screening challenges that banks are currently facing and suggests specific improvement areas that demand focus from banks and regulators alike, going forward.

January 2019

Financial Crime Compliance Screening in South Asia

Increasing complexity in the international sanctions environment and de-risking by large global banks due to strong compliance measures introduced by more mature jurisdictions has rendered mere technical compliance to regulation by local banks largely inadequate.

The need of the hour, therefore, is for banks and other financial services organizations to move towards more holistic and robust screening measures that incorporate global best practices by addressing the gaps in their current compliance screening and sanctions programmes.

Across South Asia, country-specific regulatory guidelines direct banks to screen against the publicly available lists issued by the United Nations. Local names are added to this list by the Enforcement Directorate or Home Affairs Ministries of the respective countries.

With these minimal regulatory requirements, most banks in the region can say that they are technically compliant as they screen their customers against the mandated lists, but is this really enough to safeguard them from risk?

Screening Guidelines by Regulators in South Asia

- The Reserve Bank of India (RBI) specifies that reporting entities must put in place a suitable system to ensure that the identity of the customer does not match with any person or entity, whose name appears in the sanctions lists circulated by the RBI, which include the publicly available Al Qaida and United Nations Security Council Resolution (UNSCR) lists.
- Following the placement of Sri Lanka under the ICRG process, the FIU Sri Lanka issued detailed guidelines on screening of customers, beneficial owners and other connected parties to customers against the UNSCR lists. The circulars issued in 2018 mandate screening of customers at the on-boarding stage as well as screening the entire customer database as and when updates are issued by the FIU Sri Lanka.
- The Bangladesh Financial Intelligence Unit (BFIU) expects reporting organisations in the country to screen customers against the UNSCR list and to put in place an automated mechanism for such screening.
- Guidelines in Nepal also recommend screening customers against the UNSCR list.

Sources:

Latest circulars issued by the Central Bank / Financial Intelligence Units in India, Bangladesh, Sri Lanka and Nepal

Correspondent Banking Relationships

The major driver for compliance screening within banks in South Asia is not regulatory pressure but the fear of loss of correspondent banking partners.

Research by Accuity on "Derisking and the Demise of Correspondent Banking Relationships" shows that de-risking has affected some countries in South Asia more than others. Sri Lanka, for instance, saw a 35 per cent fall in the number of correspondent banking relationships from 2013 to 2016.

Following the USD 81 million cyber heist case in 2016, many banks in Bangladesh have faced greater scrutiny by correspondent banking partners.

In India, large private sector banks have relatively higher compliance and risk management standards as compared to smaller banks across the region. But yet, discussions with industry professionals suggest that large Indian banks feel equally threatened by the potential loss of correspondent banking relationships, especially as the termination of even a single relationship leads to other partners questioning the bank's AML compliance standards.

Since the introduction of the revised and more in-depth questionnaire on correspondent banking by the Wolfsberg Group in 2018, banks in the region are being subjected to a rising degree of due diligence by global banks.

The threat of de-risking is leading to pressure on South Asia banks to strengthen their AML programmes and apply relevant technology and tools to screening and sanctions monitoring.

Budgets for AML Compliance

Discussions with AML compliance officers at several banks have indicated challenges around AML compliance that relate to the overall culture in the South Asia region. Relatively low levels of involvement from senior executive managers and the board of directors has resulted from relatively low awareness levels on the importance of AML compliance, and the consequences of non-compliance. Consequently, compliance officers struggle to get budgets for investment into technology and resources for AML compliance.

The larger private sector banks and some large public sector banks in India may be regarded as an exception and have been generally seen to be more proactive in terms of investing in AML governance, technology and training.

The Use of Screening Lists

While all banks are referring to the publicly available United Nations lists for screening, many of them are using a manual process for updating and maintaining these lists, which is often-times randomly performed by the compliance staff. In a survey conducted in 2018 by Accuity in Nepal, 76 per cent of respondents indicated their biggest challenge in the screening process to be insufficient screening due to lack of automation.

The AML Process Maturity Survey in Bangladesh by Fintelekt showed that 17 per cent banks were still using manual tools for screening, while another 28 per cent were using in-house developed look up tools.

Lack of automation in the screening process results in repeated manual checks, absence of an audit trail, less than comprehensive coverage and inefficiencies in resource usage. Another survey by Accuity in Sri Lanka found that repeated manual checks were a challenge for 68 per cent respondents, which could lead to high operational cost and low efficiency to stay compliant. The use of technology in screening in the region is limited to transaction monitoring systems, many of which are developed in-house. Smaller institutions, in particular, are performing screening checks manually or using excel-based look-up tools.
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The benefits of using a watch-list filtering software apart from real-time updates and more comprehensive coverage are the availability of additional information on the entities featured in the public lists which help faster resolution of false positives; adverse media reports and tracking; and data on Politically Exposed Persons (PEP), which is another area that is subject to heightened due diligence by correspondent banks.

Trade Finance Screening

The awareness of threats emanating from trade-based money laundering (TBML) is high among South Asian banks. Fintelekt surveys conducted across the region show that TBML was ranked as among the top challenges for banks.

Despite the high awareness, trade compliance screening, especially around counterparties, dual-use goods, trade documents, port or vessel tracking is not being given adequate priority in most banks. Against the background of growing vulnerabilities from increasing trade and commerce in the region, investments in integrated systems for trade compliance screening are seen to be minimal.

So far, trade finance screening is primarily being conducted manually across the region. Some banks have configured red flag indicators into their transactions monitoring systems, but a bulk of the alerts for likely sanctions violations or suspicious activities are triggered manually by trade finance operational staff and by the relationship manager.

Fintelekt surveys across the region found that 75% per cent banks in India, 78% in Nepal, 97% in Bangladesh and 50% in Sri Lanka rated TBML as among the top 3 challenges faced by their banks.

Data Quality and Availability

Reliable customer data against which screening can be performed is the prerequisite for a robust screening programme. Customer records are stored manually in many financial institutions. This was especially noticed in the case of Nepal, where a Fintelekt survey found that 47 per cent banks were maintaining KYC/CDD records manually.

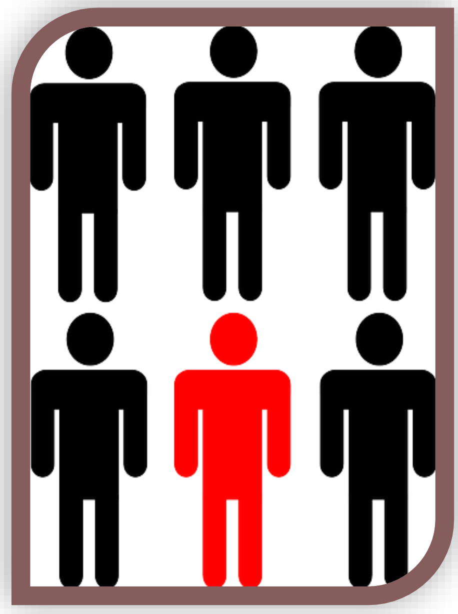
Another concern is that customer information collected at the time of on-boarding is minimal. Especially for legacy accounts, retroactively collecting information is an arduous task. Moreover, not all details captured from customers make its way into the core banking system and are therefore unavailable as a reference for screening purposes.

A Fintelekt survey in Nepal found that 47 per cent banks were maintaining KYC/CDD records manually.

The lack of quality in the data input often leads to a higher number of matches against watchlists, the resolution of which is resource intensive for the front-line staff or AML compliance analyst team.

Focus Areas for the Future

Banks and financial institutions are not immune to the global regulatory environment, which is becoming increasingly complex. Violation of sanctions imposed by the US for instance, could attract penalties for any organisation dealing with US dollar payments.



Banks involved with overseas trade and remittances are generally more vulnerable and need to be more proactive in complying with sanctions requirements by strengthening due diligence and screening processes.

Additionally, the rapid rate of economic growth and therefore financial services in South Asia and new developments such as mobile money services, agent banking, digital payments and cryptocurrencies are leading to new and emerging ML/TF risks, which underscore the need to strengthen the response from banks and financial institutions.

Going forward, significant investments in technology, processes and people will be inevitable for all banks and financial institutions in South Asia, should they wish to build a sustainable business.

Developing People

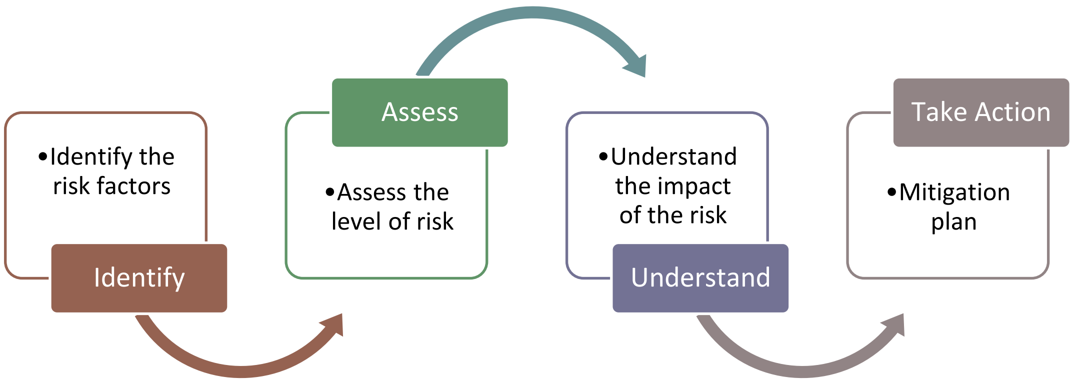
The first line that performs KYC/due diligence and often times the first level of customer screening is the customer-facing staff, which may have limited knowledge about AML/CFT risks affecting the business.

Providing ongoing training to these employees on the importance of compliance, latest typologies and the relevant regulatory guidelines will ensure that they are able to spot abnormalities more effectively.

Addressing Risks Holistically

Screening against public lists may no longer be sufficient going forward. Banks will have to move to a holistic assessment using a risk-based approach that addresses all the relevant parameters such as the geography of operation, type of product and customer profile and develops a suitable mitigation plan.

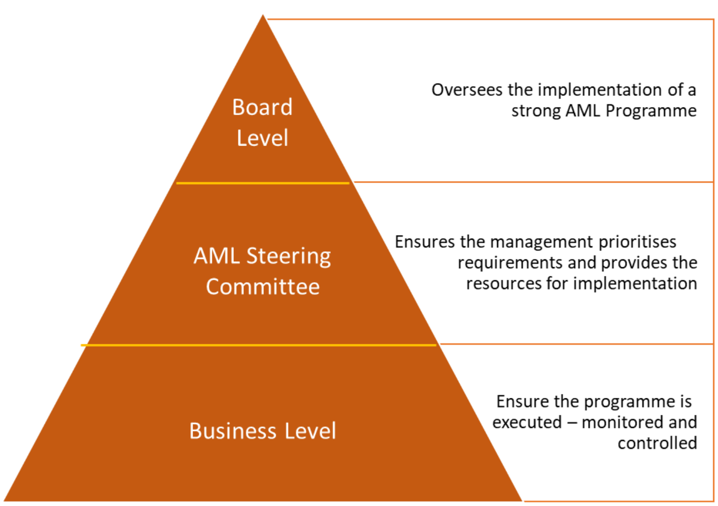
Risk Based Approach to KYC



Culture of Compliance

A tick-mark approach to compliance will not be adequate going forward. Especially in smaller banks across the sub-continent, compliance officers have routinely expressed the need for stronger involvement in AML compliance from the senior executive management and the Board of Directors. Setting the right tone from the top will lead to greater awareness and more priority to AML/CFT compliance throughout the organisation. Providing continuous AML and sanctions training and regular briefings to Board members on new compliance standards emerging around the world will help in sensitising them to the responsibility of compliance.

The seriousness and focus shown by the Board and senior management is the most critical requirement for success of AML Programmes



Investing in Automation

Going forward, investing in AML monitoring and compliance screening systems will be inevitable for banks across the region. Discussions with compliance officers at banks suggest that they are aware of this priority and spending across the region may likely increase in the near future.

Automating KYC processes and substantiating them with the relevant data and information inputs will be a critical component of efficient AML compliance in future. Banks that have already invested in technology will need to ensure that their current systems are adequate and sufficiently fine-tuned to the changing requirements of the global regulatory environment.

Leveraging Latest Tools such as AI/ML

Legacy IT systems and manual processes can't cope with the high customer volumes and unclear risks – least of all be effective in stopping financial crime. Newer tools such as machine learning (ML) and artificial intelligence (AI) are offering new avenues for organisations to reduce the number of false positives via predictive decisioning, and consequently reduce the workload of AML compliance teams.

The simple pattern-matching approaches of the recent past are highly susceptible to both false positives and false negatives. Advances in AI/ML and affordability of large-scale computing resources enable more sophisticated anomaly detection. Complex judgments based on multiple sets of compliance obligations and numerous data sources can be undertaken swiftly, reducing the burden of compliance by offering high automation and increased accuracy.

Several pilots across the globe have been launched to build use cases in this space and as this technology gains optimal maturity in the future, the AI/ML solutions would be able to provide even more comprehensive support to FIs – across their compliance management processes and lifecycle stages. Further, the use of APIs across the organisation is helping banks to create a unified compliance screening platform and move to real-time screening and sanctions monitoring. By leveraging some of these technological developments, banks can leapfrog to global benchmarks in compliance screening - Pushing this traditionally offline industry into the 21st century.

Traceability - From Black box to Glass box

Increasingly, regulators around the region are demanding more transparency and asking questions like:

- *What was the filter configuration?*
- *What version of the watchlist database was used?*
- *What business rules were applied and why?*
- *Who reviewed it and what decisions did they make?*

Needless to say, such processes cannot be manual and they need to be cost-effective.

Strengthening the Eco-System

Given that banks and financial institutions in the sub-continent need to move towards global best practices in compliance screening and continue to invest in people, processes and technology to retain correspondent banking relationships, the AML ecosystem could be further strengthened by addressing areas such as the following:

Dealing with Specific Vulnerabilities in the Financial System

While multinational and large local banks in South Asian countries have relatively more robust processes, Fintelekt research found that the vulnerabilities lie with small and medium public as well as private sector banks and financial institutions where awareness of the risks associated with inadequate screening is low. These institutions may require more handholding, training and education to ensure that they are brought up to speed with customer screening best practices.

More Prescriptive Guidelines from Regulators

The maturity of the regulatory environment and clarity in both the guidelines issued as well as punitive action in case of lapses, is critical to shaping the AML/CFT regime. More prescriptive guidance to reporting entities will ensure greater awareness of risks and thereby better processes. Periodic review of industry standards, more focus on screening during inspections and proactive discussions with reporting entities and industry associations may help keep track of lacunae within the system.

Public-Private Collaboration

A collaborative approach to screening may lead to improving effectiveness, harmonizing efforts and reducing cost. Industry stakeholders could come together and share information in a more structured manner such as through the creation of a utility or an industry-wide negative list.

Such initiatives may also provide greater confidence to correspondent banking partners on uniform KYC processes being followed by banks in a particular country.

An initiative has been started by the Monetary Authority of Singapore (MAS) which is working closely with local and foreign banks to explore a banking KYC shared-services utility that will streamline and centralize processes such as customer identification and verification, collecting and validating KYC documents, and screening against sanctions and blacklists.

Similarly, in India, the Central KYC Registry (C-KYC) was unveiled by the government in 2016 to serve as a centralized repository of KYC records of customers in the financial sector with uniform KYC norms and inter-usability of the KYC records across the sector.

Periodic review of industry standards, more focus on screening during inspections and proactive discussions with reporting entities and industry associations may help keep track of lacunae within the system.

Closing the gap between finance and trade to curb TBML is also needed especially as close coordination between government agencies and the banking sector is warranted. This is an area that will benefit from public-private collaboration, as even a small percentage of cases thwarted will reduce a substantial amount of money laundering in absolute money terms.

Harnessing RegTech

The advent of regulatory technology (RegTech) is demonstrating, albeit in the more mature countries, innovative use cases for improving efficiency and addressing specific challenges within KYC/due diligence and sanctions screening.

A financial technology (FinTech) ecosystem is already getting established in India (spurred by the introduction of biometric identification tool - Aadhar) and in a small measure in Bangladesh. Through a sandbox approach, regulators in South Asia can further fuel innovation and encourage uptake of RegTech by banks and financial institutions.

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