

# Challenges in performing customer due diligence



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## Introduction

Customer due diligence (CDD) includes gathering sufficient information about a customer to enable the institution to assess the nature and extent of risks including money laundering and terrorist financing risks, which the customer is associated with. Hence, CDD is a key pillar of any compliance framework.

Transparency, identification of Beneficial Owners (BOs), establishing Source of Fund (SOF) and Source of Wealth (SoW) and Politically Exposed Persons (PEPs) are some of the common problem areas FIs are facing. In addition FIs across the globe are under the lens of all the regulators as far as CDD approach is concerned.

Increased emphasis on action and stricter enforcement of regulations coupled with pace of regulatory change has made the regulators more focused and targeted on CDD practices adopted by financial institutions (FIs).

## Regulatory framework

Customer due diligence requirements prescribed by regulators worldwide have been increasing over the years and FIs have been facing mounting regulatory costs and tighter risk control. There has been greater enforcement action against banks/FIs undertaking business across geographies, including India. It will be imperative to understand some key regulatory expectations and the appropriate approach in meeting the regulatory requirements on CDD.

Financial Action Task Force (FATF) recommendations is one of the key requirements which emanates from FATF guidelines. Recommendation 1 focusses on the risk-based approach and recommendation 10 and 12 supplements the CDD requirement by prescribing CDD and PEP related guidance.

Financial Crime Enforcement Networks (FinCeNs) New Customer Due Diligence rules, effective May 2018, supplements the FATF recommendations and also showcases the increased focus of the regulators on CDD compliance framework. These new CDD rules were issued to clarify and strengthen customer due diligence requirements for certain financial institutions. A key highlight of this new rule is the requirement to identify and verify the beneficial owners (BO/UBOs). Looking at this issue from a global perspective, European Union (EU) appears to be far ahead in implementing rules for ensuring transparency in the ownership structure of legal entities. The issue of UBO identification was on the regulatory agenda as early as 2005, with the introduction of the third European Directive on AML. Subsequent introduction of fourth (2015) and fifth (2018) money laundering directives further increase transparency on legal entities' ownership requirements.

Basel Committee on Banking Supervision's guidance on Customer Due Diligence is another key benchmark for FIs across the globe which explains the importance of KYC standards for supervisors and banks along with the essential elements of KYC standards.

India also has similar regulatory guidance and directives set by its key regulator – Reserve Bank of India (RBI). If we go through the required regulatory guidelines of RBI, we can note that India is one of the most complex geographies and yet we have one of the most robust regulatory ecosystems in the world. Whether it is about information available on authorized signatories, directors or BOs in public domain in the form of MCA registry or setting up the requirement for ID&V for the KYC documents, the Indian regulations are more matured as compared to that of few key jurisdictions globally.

The real goal though for firms is not to simply implement new rules and respond to regulatory concern; it is to prevent and detect criminal money being laundered and terrorism being financed.

## Customer due diligence challenges and opportunities

As per the data released by one of the leading players of client lifecycle management solutions for financial institutions, a staggering USD26 billion in fines has been imposed for non-compliance with Anti-Money Laundering (AML), Know Your Customer (KYC) and sanctions regulations in the last decade. Some of the high profile cases and

the related enforcement actions clearly exemplify the challenges faced by FIs and the banks on CDD.

Although FIs in India have robust CDD policies and procedures which are well embedded in their compliance framework, yet the changing business landscape, customer expectations and the increased globalization of the regulatory framework is posing increased challenges for conducting CDD. Few of these challenges are covered in the subsequent paragraphs.

**Data quality** - Financial institutes (FIs) continue to struggle with the challenge of aggregating and managing vast amounts of KYC data. As the ever-changing regulations are driving FIs to collect broader, deeper KYC related data sets, to enhance risk identification and control structures, data quality difficulties has been pushed to the forefront today. This leads to ineffective decision-making as data integrity has a major impact when performing the necessary due diligence.

**Cultural issues in furnishing CDD information** – In India, cultural issues play a big role in performing CDD. However, clients generally remain hesitant to disclose personal or business related information. This makes performing the required due diligence all the more difficult.

**Policy and procedures** –Although the industry and FIs at large have evolved over the last two decades in-terms of having robust policy and procedures, however there are still instances where the policy and procedures are not articulating clearly on the requirement of various type of due diligences, i.e. when to conduct a simplified due diligence and when to conduct the enhanced due diligence. Same applies for the guidance on Source of Wealth (SoW) and Source of Funds (SoF) corroborations too. We must note that such instances are not only detrimental to the robustness of the overall compliance framework, but also breeds confusion among the front line staff to perform necessary due diligence.

**De-risking initiatives**– Increased regulatory expectations and the changing business landscape has forced FIs to adopt the de-risking strategy to either terminate or restrict or deny services to a broad class of clients. This poses one of the biggest challenges in framing the CDD approach and also to grapple with the frequent changes in the internal policies and procedures. Though such de-risking related strategy is adopted at a macro level, i.e. at policy level, however, implementation of such de-risking related changes sometimes are fraught with gaps at micro-level, i.e. at front line. The issue is not the de-risking strategy, but the resultant confusion and the lag to understand and execute the CDD related framework among the front-line staff which is created due to frequent change in the policy and approach due to changes in the de-risking initiatives either by governments or regulators.

**Ambiguity and evolution of customer identity documents** – One of the key difficulties in performing customer due diligence is the ambiguity in obtaining customer identification documents. In the last five years, the regulatory space in India has become more complex with the entry of new players and the resultant change in the guidelines. We do not have to go back too far when the concept of Officially Valid Documents (OVD) was coined. This concept of OVD brought more clarity on the IDs to be collected and the required due diligence by the FIs. However, there are still challenges in the implementation and adherence of OVD guidelines and the related due diligence required. The instance of policy paralysis on the Aadhar initiative and the related impact on the approach of FIs for due diligence is a classic example to evidence that.

**Identification of Ultimate Beneficial Owners (UBOs)** – The identification of UBOs and Beneficial Owners (BOs) is not that simple as it sounds and there are lot of jurisdictions which are strengthening their regulatory framework for the identification of UBOs and BOs. As a result we have multiple policy requirements from various regulators setting multiple thresholds for the identification of UBOs and BOs. For FIs who operate at a global level, the difficulty lies in adhering to these multiple and sometime conflicting guidance on the identification of UBOs and BOs. There are also several instances where the guidance on the identification of UBO /BO is not elaborated much in the policy document and there is just a passing reference to cater to the regulatory requirement.

**Politically Exposed Persons (PEPs)** – Identification of PEPs remain a challenge in a jurisdiction like India. The political structure in India is so vast that at every level of society there is an element of PEP. Also there are instances where the respective individual is not actually a PEP whoever by the virtue of power exercised by him/her, there is a possibility of him/her being treated as PEP. However, the overall judgment of classifying an individual as PEP is left to the compliance staff who may not be able to conduct the required due diligence considering the complex political structure.

In the context of the above challenges, it must be noted that if the FIs/banks are able to sail through these challenges and come-up with a robust CDD compliance framework, it may bring opportunities not only to them as an institution but may also bring the benefits to the industry at large. Few of these opportunities are as follows –

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- Preventing the risk of reputational damage and the enforcement actions and fines by the regulators.
- Increased revenues and decreased cost of compliance.
- Profitability of products.

### **Conclusion**

Considering the above challenges, in India a tick in the box approach to perform CDD will not work. Complying efficiently is, therefore, a distinct yet critical challenge for CDD rule subjected entities; investment in the right set of tools, data, and staff training will rapidly become instrumental in building a competitive advantage over those firms that rely on manual processes and unskilled staff. It will require a considerable amount of industry-wide and government level efforts. The government on one hand needs to attune themselves to global best practices and at the same time the industry players have to come together and follow a corroborative approach to manage the challenges and difficulties in conducting due diligence. FIs have to now take a giant leap in-terms of making their compliance framework more robust and has to be explicit in-terms of necessary guidance to their staff to tackle the challenges and perform customer due diligence more effectively and appropriately. Some immediate steps that FIs/banks should take are as follows:

- Assessing the overall AML programme to address the requirements of the CDD Rule.
- Updating AML policies and procedures, particularly areas including suspicious activity reporting, information sharing.
- Enhancing customer risk rating methodologies and AML and sanctions risk assessments to incorporate risks associated with UBO information.
- Migrating existing CDD data into a searchable, readily accessible IT platform(s).
- Ensuring that IT systems provide the required fields to capture UBO information.
- Conveying the impact of the CDD Rule to senior management and the Board of Directors, identifying risks, costs, and plans to address identified gaps.

There is a whole gamut of RegTech and Fintech support system available today which few years back was not there. The innovations in the RegTech and Fintech space is really disruptive and banks and FIs need to embrace technology in a bigger way going forward to tackle the difficulties and challenges in performing customer due diligence. This paradigm and proactive approach by FIs and banks can surely assist in not only tackling the CDD related and other challenges but can also assist in setting-up an industry wide approach by having more robust standards and global best practices.

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