Moving to a Perpetual KYC Model – the Benefits and the Challenges.

Financial services firms have been looking for many years to improve efficiency in the AML/KYC onboarding process, looking towards a data led approach and automation to reduce costs. In many firms this has been a slow process with many other programs taking priority in terms of development resource.

However, the COVID pandemic has highlighted that processes which involve large manual work forces, often in offshore countries, are particularly vulnerable, resulting in institutions being unable to accept new customers due to lack of resources. This has placed a renewed focus on automation and in turn also turned attention to perpetual KYC as a method for maintaining client files, without the need for a full manual periodic review. This paper looks at the benefits of this type of approach and the challenges that organisations face to adopt it.

DRIVING FACTORS OF PERPETUAL KYC

Automation of the onboarding process, along with perpetual KYC to keep track of changes, has been around for some time, yet so far has not managed to become fully embedded or the norm.

There are numerous challenges a large institution faces when attempting to overhaul its processes, but the benefits are huge - faster onboarding, reducing the exposure to risk, and resilience.

Perhaps we should just remind ourselves why organisations are striving to move down this path.

FATF recommendation 10 (d) – "Customer Due Diligence":

> "Conducting ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the institution's knowledge of the customer, their business and risk profile, including, where necessary, the source of funds."[1]

And within the "Interpretative Note To Recommendation 10" Section 23:

> "Financial institutions should be required to ensure that documents, data or information collected under the CDD process is kept up-to-date and relevant by undertaking reviews of existing records, particularly for higher-risk categories of customers."[1]

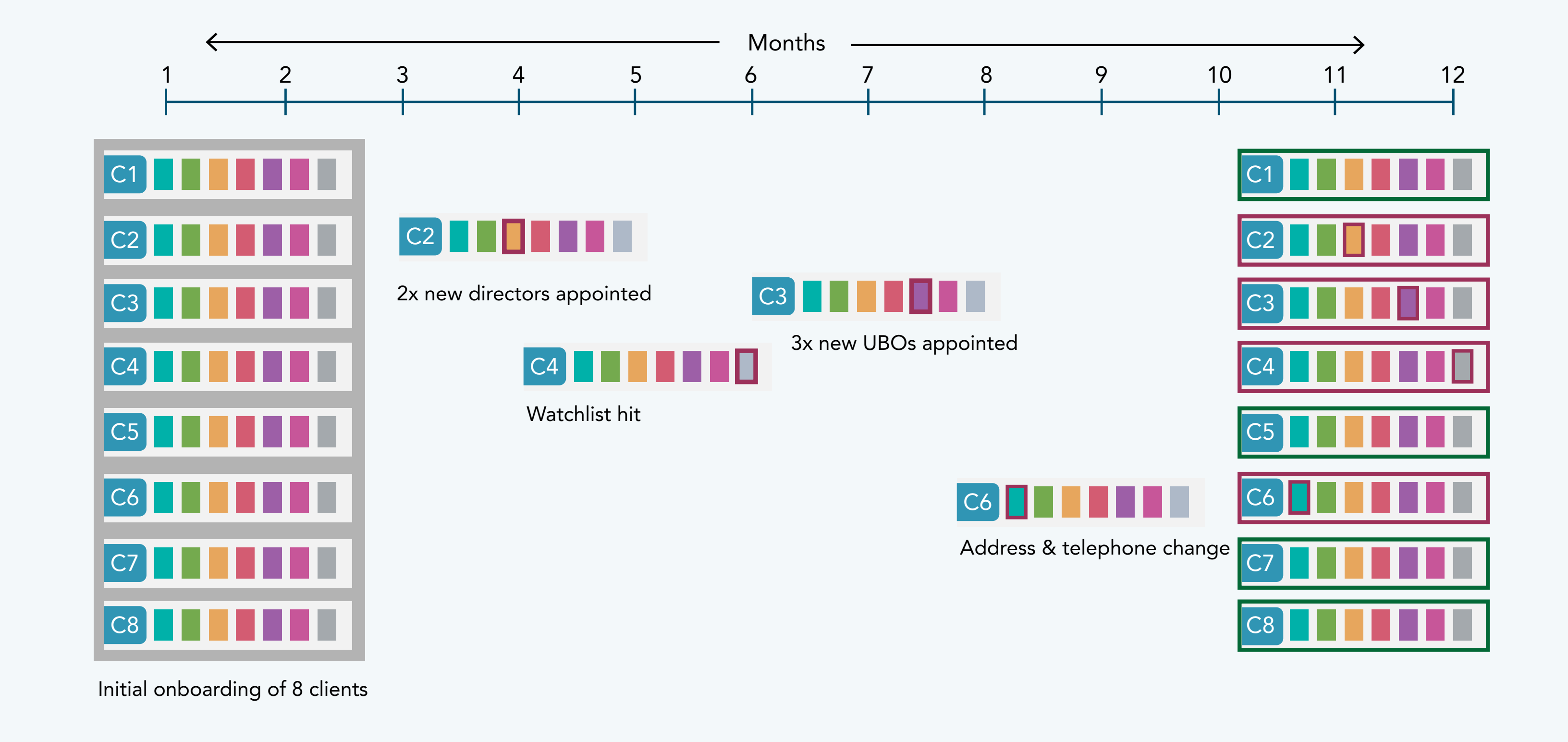
With a UK focus, Regulation 28, part 11 in the UK Money Laundering Regulations 2017:

> "(11) The relevant person must conduct ongoing monitoring of a business relationship, including—
>
> > (a) scrutiny of transactions undertaken throughout the course of the relationship (including, where necessary, the source of funds) to ensure that the transactions are consistent with the relevant person's knowledge of the customer, the customer's business and risk profile;
> >
> > (b) undertaking reviews of existing records and keeping the documents or information obtained for the purpose of applying customer due diligence measures up-to-date."

The vast majority of financial institutions aim to satisfy these requirements with periodic reviews of the client files. The frequency of these reviews is determined by the initial view of risk at the onboarding stage, usually the higher risk clients on a 12 month refresh cycle, with some firms choosing to review lower risk clients as infrequently as 3 to 5 years.

This is generally regarded as a laborious process, one which consumes a great deal of manual resource, and the added difficulty of obtaining updated information from clients, means some cases can take weeks or even months to finalise.

First let us look at some of the issues with this approach.



In this diagram we look at a scenario where 8 clients (C1 to C8) are onboarded in the first month of the timeline.

Each coloured bar within the larger box for each client just represents the different parts of the on-boarding process, i.e. verifying the entity, ascertaining who the directors are, finding the ultimate beneficial owners, the screening process etc.

Moving along the timeline, in month 3 client 2 has had 2 new directors appointed.

In month 4, client 4 has had a "hit" against a Watchlist via a screening process.

By month 6, client 3 has had a number of ownership changes, resulting in 3 new ultimate beneficial owners being identified.

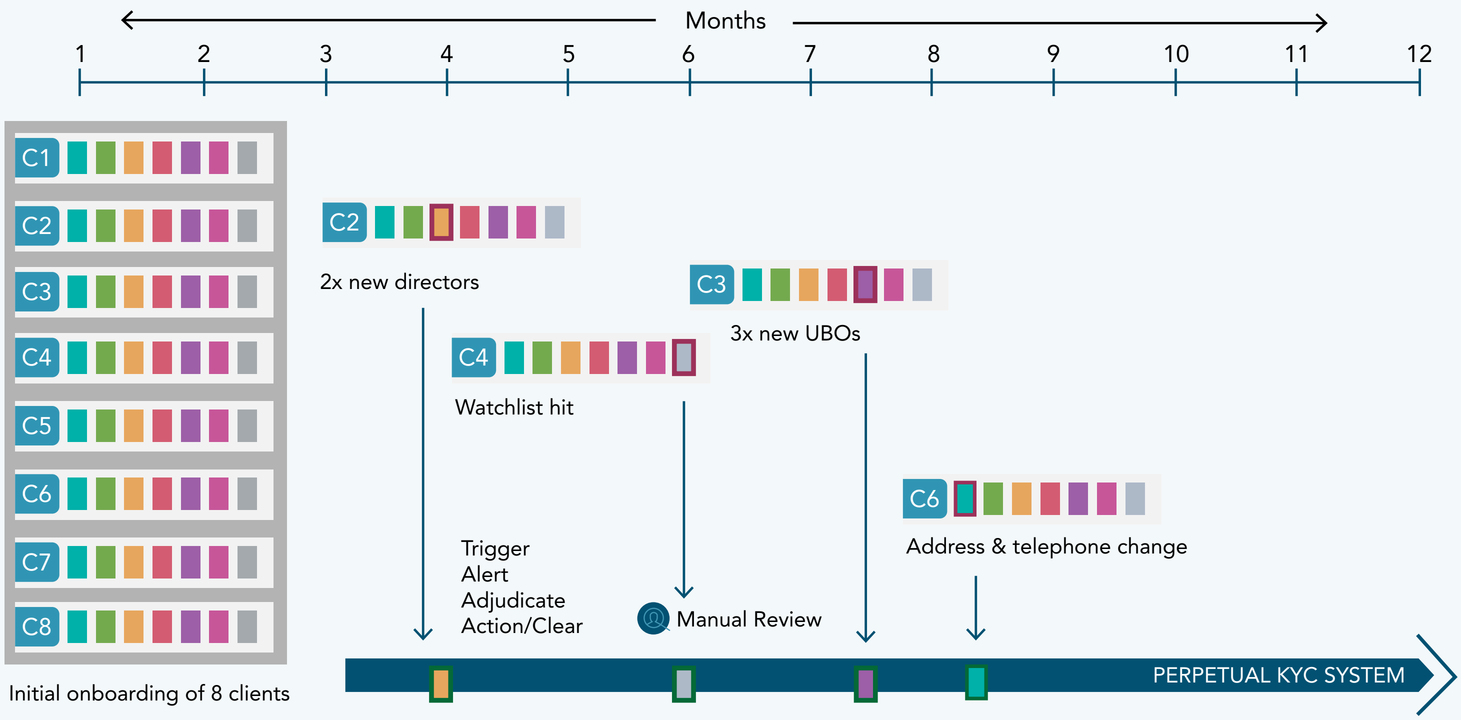
And finally, by month 8 client 6 has changed address and telephone number.

At the 12 month anniversary of onboarding, these clients are scheduled for a periodic review.

It would be hoped that this process would identify all the changes we just described, and that these would be documented and checked. However, in addition to these changes, each client would most likely have had a full refresh of all aspects of the information, for example, the beneficial ownership would have been checked as well.

In addition to the clients who did experience a change, this process would have been repeated for clients 1, 5, 7 and 8 - only to conclude that, in these instances, no changes have taken place.

With perpetual KYC the process is different, we start in the same manner with the 8 clients being onboarded, however, the system is designed to ingest change alerts, and will capture and create actions for the changes as and when they occur.



These alerts are pushed to a KYC platform or a system that will then conduct an evaluation for the change.

For example, with the first change, the appointment of 2 new directors, their details could automatically be sent to screening for Sanctions, PEPs, Adverse Media; if no matches are found for them, then this change could be applied, recorded and cleared with no impact to the risk rating without manual intervention.

Clearly the system will still require the ability to place certain changes in to a queue for manual evaluation - as with change 2, a Watchlist hit, a CDD analyst may be required to conduct further checks and false positive analysis if the system cannot clear it via a rule. This process though, would provide the analyst with the requisite information to deal with the check quickly and efficiently.

At this point it should be noted that many organisations will have a proportion of this in place, mainly for the screening aspects. It is generally accepted that screening of the entities and people will be refreshed/redone each night and highlighting any new information quickly. Many organisations have chosen to take this part and place it in a shared service centre, or centre of excellence. Whilst this may be efficient in concentrating the workforce, in this aspect, it can mean the fluidity of the client journey can become disjointed. Another consideration is that, although screening all names each night is a good approach, the wrong names could be screened, for example, if new directors or UBOs have been appointed.

BENEFITS OF A PKYC APPROACH.

The benefits of this type of approach generally break down in to 2 main areas:

- Right sizing the approach
- Risk mitigation

With perpetual KYC one of the main attractions is the efficiency aspect, the program is "right sized" based on the amount of change coming in. You can expand on clients that experience more change and have resources working on the cases that require the most attention, and conversely not waste effort by conducting a "re-papering" exercise, where the entire onboarding process is repeated, only to conclude there has been no material change. A common theme is that most clients, when opening an account, have an incentive to provide the requisite information - they want the account opened fast. However, once established, it can fall off the priority list to re-confirm information, and delays in obtaining information can drag out periodic reviews out longer than the onboarding timescales.

A case that highlights this is the fine the FCA gave to Commerzbank in June 2020 [3].

Within the final notice, the FCA fined Commerzbank £37,805,400 (the fine would have been £54,007,800 were it not for Commerzbank's co-operation and commitments to resolve the issues).

Section 2.2 of this notice reminds us of the overarching obligations:

> "2.2. To mitigate this risk, UK firms must take reasonable care to organise and control their affairs responsibly and effectively and to establish and maintain an effective risk-based anti-money laundering ("AML") control framework, and also must comply with the applicable Money Laundering Regulations."

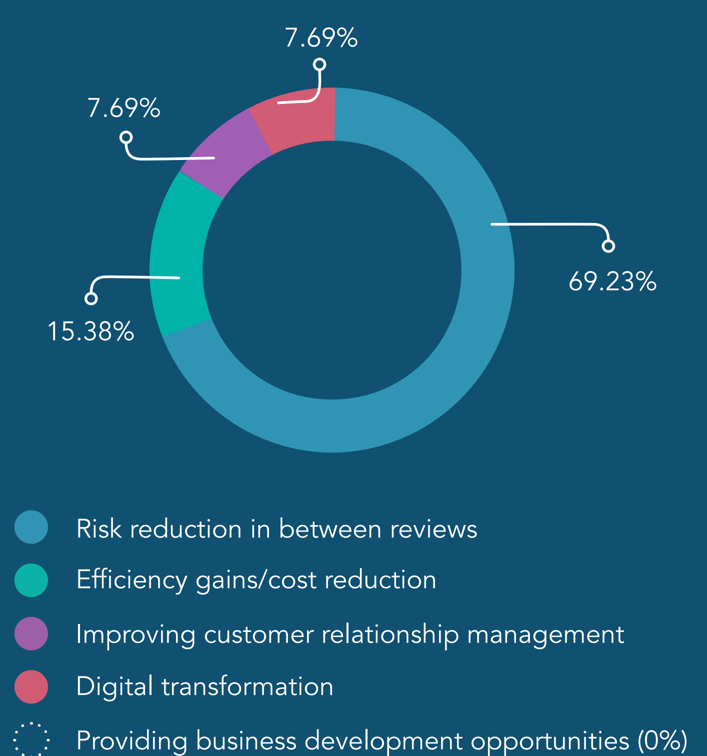
Section 2.5.5 highlights the problems discussed above:

> "2.5.5. A significant backlog of existing clients being subject to timely refreshed know-your-client ("KYC") checks developed during the Relevant Period, in part because Commerzbank London's first and second lines of defence tasked with carrying out key AML controls were, throughout the Relevant Period, understaffed. For example, in mid-2016, the Financial Crime Team in Compliance consisted of just 3 full-time employees, when in mid2018, following an acknowledgement by Commerzbank London of the need to dramatically increase staff in this area, this was increased to 42 full-time employees. In October 2016, 1,720 new clients were in a "huge backlog" awaiting to be onboarded and, by February 2017, 2,226 existing clients were overdue refreshed KYC checks. Whilst steps were taken to reduce the backlog during the Relevant Period, these measures were taken too late, and effected too slowly;"

Clearly, the initial staffing levels were too low, but even by increasing staff levels from 3 to 42, the firm struggled with clearing the backlog.

This emphasises has the 2-sided problem of resources to process the information and make risk based decision, alongside actually getting the information from the client.

What do you believe is the main driver to move to pKYC?



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RISK MITIGATION

The second benefit of following a PKYC approach is mitigating risk by capturing information more timely and also receiving alerts you may not have previously captured.

At Dun & Bradstreet, we ran a proof of concept exercise for a US bank whereby they used our UBO monitoring service to deliver change alerts on ownership.

They started with a hybrid approach, whereby these triggers were fed into the periodic review process that was still manual in nature.

An insightful piece of feedback was that, after 6 months, they found that the updates broke down in to 3 equal sections.

During the POC, they conducted the periodic review at the point of one of our alerts.

The first third - they felt that the periodic review process had the same timeliness and outcome, meaning that either the client had just been reviewed, or was imminent for review, and they were aware of the ownership change we delivered.

The second third were clients that were not due for review for some time out, so they brought the review forward, contacted the client and obtained the information on the changes, effectively receiving the information earlier than it would have been in normal operations.

Then the final third – this was the most interesting It followed the same process, i.e. they brought the review forward, contacted the client, but did NOT get the information. Naturally this generated a number of queries and investigations, where the Relationship Manager fed back that the client disagreed and there were no changes. However, when we ran through the ownership chain, there were a number of changes that were several layers away from the client in the US and it simply wasn't known all the way through the group.

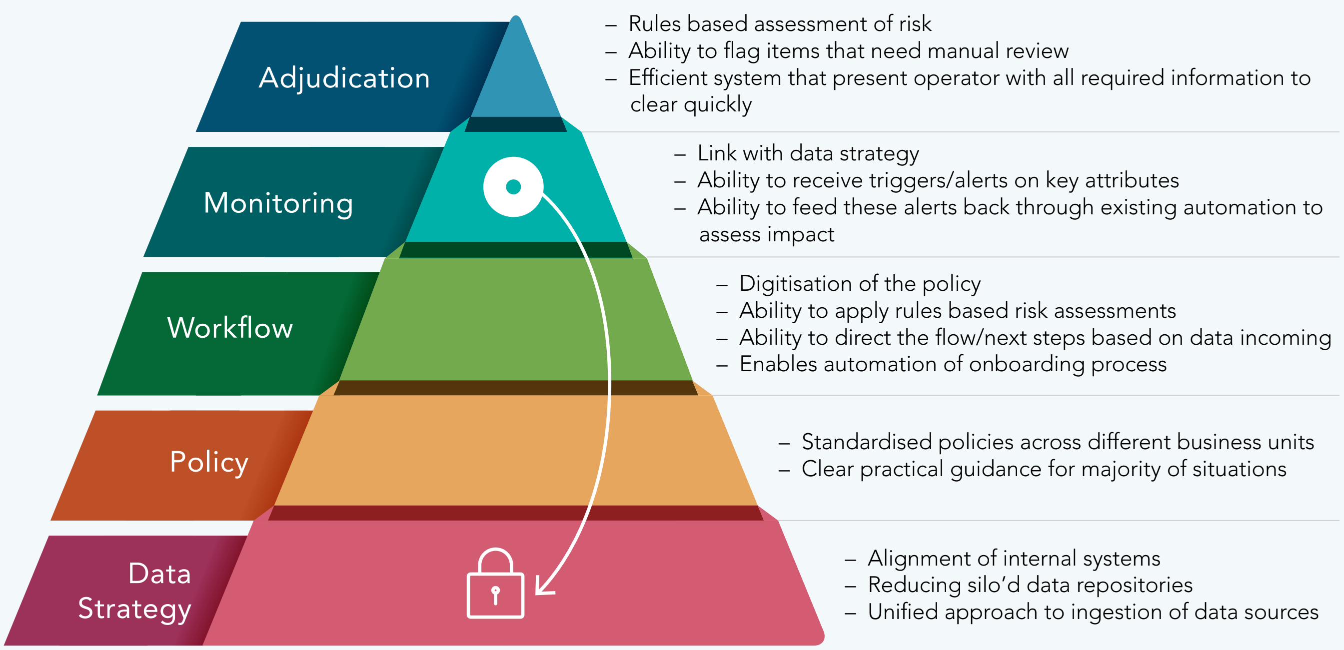
In one case, a new investor bought shares in a Hong Kong company that was seven layers away from the US.

So regardless of the frequency of review, there are advantages to having data feed alerts – alerting that new risks have been introduced that would previously been missed.

FOUNDATIONAL COMPONENTS

In terms of achieving a Perpetual KYC program, the reality is much more challenging, there are numerous factors that can hinder an organisation from implementing a robust approach.

There are some foundational elements that need to be in place, this are illustrated in the figure below.



Working from the bottom - there needs to be a solid data strategy in place. Most institutions are likely to have a fair amount of legacy tech "baggage", so we need to acknowledge that this part is often the most challenging and overlooked. Most senior, or strategy focused people, have a desire to skip straight to the latest innovations in the market, but many of these reside at the top of the pyramid, and the full benefit or potential cannot be realised unless the groundwork has been done.

This data layer very much links to the Monitoring tier, second from the top; if the data layer is a jumble of disparate systems it is going to be difficult to pipe in the live feeds of information that generate the triggers. Data can be hosted in numerous disparate silos, which require a plan in terms of how to other consolidate into one golden source, or, a management strategy to keep them synchronized if they cannot be phased out.

Moving upwards to the next layer, there obviously needs to be a cohesive policy. Most organisations will have this well documented, but it is key, as essentially this is what feeds the next part of the pyramid - Workflow.

When looking for high levels of automation, the policy needs to be well defined and capable of being digitised into a workflow system or layer.

Workflow - this is usually a combination of flow and decision making rules. As a simple example, there will, more than likely, be agreed levels of risk associated with the type of product, how the client is being onboarded, i.e. face to face or remotely; these sorts of attributes will build up a view of the risk.

There will probably be checks to see whether or not the entity is listed on a stock exchange; this then introduces the flow or direction, which could be simplified due diligence, or conversely, some factors may cause the client to require enhanced due diligence.

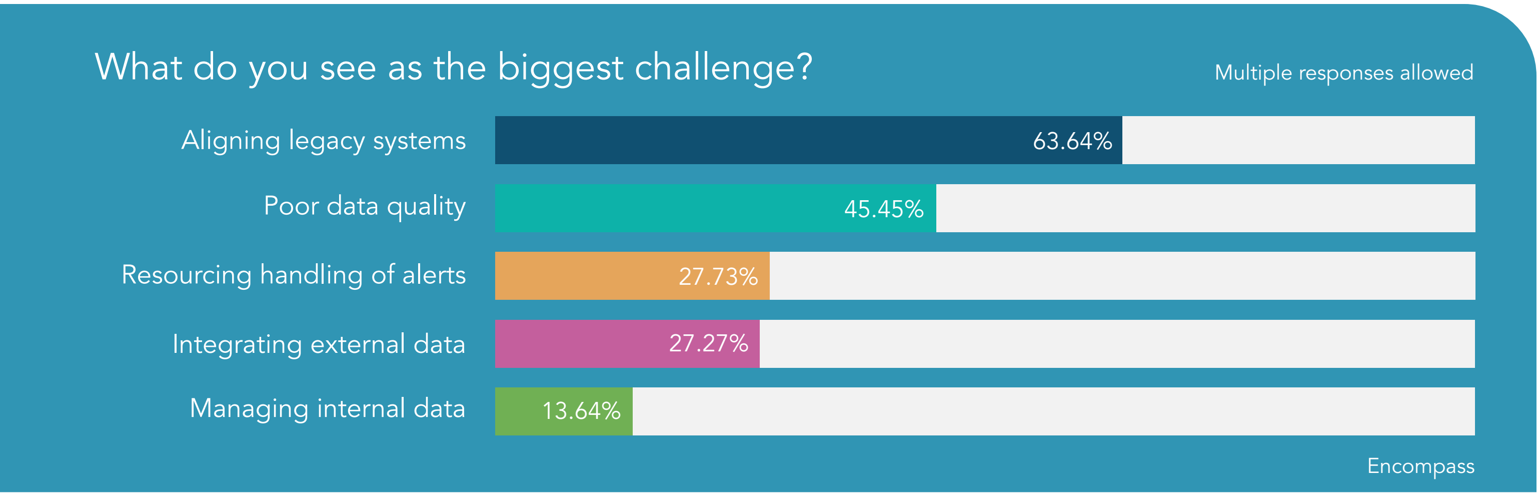
There are numerous FinTechs/RegTechs that are focusing on this area, and most will have their own idea of how to capture the flow and rules; or there may be an internally built system that is already handling this. This is an exciting space currently with many entrants bringing innovation and systems that can range from a straightforward, off the shelf solution for due diligence, right through to extremely complicated software that can cover rulesets for multiple jurisdictions, multiple client types, all with their own bespoke ruleset determining which data points need to be sourced and how to score or evaluate them.

As mentioned earlier, it is likely that screening clients for Sanctions, PEPs adverse media etc will already be covered. However, many organisations have chosen to consolidate this function into one central area or service centre. This approach was often chosen for a number of factors. The large number of analysts required to perform the false positive remediation manually has been a significant cost, and hence prompted a desire to locate this in offshore centres, where a centre of up to a thousand positions could be created. It also was an easy part of the process that was consistent. We have seen organisations whereby different channels may have remained with disparate onboarding policies, for example, Retail Banking, Commercial Banking, Private Wealth etc. Although each may have chosen to apply different rules and source different data, the screening element remained fairly consistent and lent itself to be taken to a central function.

Over the last decade there has been a huge drive to have a more cohesive policy framework, that has brought these disparate approaches more in line with each other.

With the recent rise of challenger banks, which do not have the same legacy infrastructure, and which are free to choose whatever architecture they wish, we have seen a pressure on traditional banks to speed up the client journey, and not having full control of the screening part has now become somewhat of a barrier.

We have seen a trend over the last 1-2 years of large financial institutions taking a different approach to this; rather than looking at re-engineering the existing process, either piece by piece or "big bang", they have adopted an agile tech lab structure and are essentially building an entirely new process alongside the current one. This enables them to be free of the legacy barriers and to maintain controls over all aspects of the onboarding journey, with tight integration of the data flowing through all the relevant workflow steps. This champion/challenger approach allows for a small amount of new to bank clients to be passed through the newer route to test and learn. Any mistakes can be ironed out with little impact to the



BAU process, and as the challenger performs faster and more reliably, more of the cases are moved over until all new clients are on the new infrastructure.

To recap, a solid data led approach to sourcing the required data attributes, a clear policy that covers all situations and a workflow layer that has the ability to apply the rules automatically, and aims to conduct as much straight through processing as possible is essential.

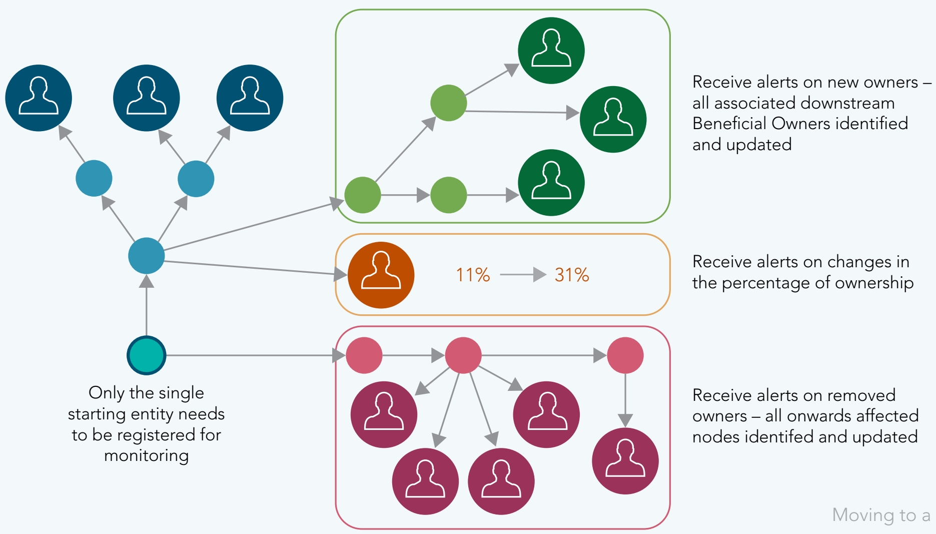
If these 3 layers of pyramid are well structured then actually moving to PKYC to maintain the client data should be more straightforward. The monitoring element then becomes a feed back loop back to the bottom of the pyramid, i.e. a change is received and it is fed through the existing automated process.

Typical barriers stopping firms from this step have been centred around only being able to automate a proportion of the onboarding. Hence a view that if a certain aspect is manual, then stick to a periodic review.

A usual stumbling block is the identification of Ultimate Beneficial Owners (UBOs). This can be a tricky area to complete with some complex scenarios. With the changes made as part of the 4th and 5th EU Anti Money Laundering Directives, availability and accessibility of this information is now greatly improved. The data vendor landscape has evolved to give extremely good coverage in this area.

Equally it is now possible to monitor entire ownership chains based off a single starting entity. This means that even if a change occurs several layers away from your client, the change can be detected, reported and linked back to the client in question for review thus negating the need for manual building out of ownership structures, calculating percentage dilution by hand etc.

The functionality, below, is codified to represent the 3 main scenarios, i.e. a new UBO being appointed, a UBO that has been removed, or an existing UBO that has had a change, e.g. increasing their holding from 9% to 26%.



There will always be those cases that will fall out of such an approach, so a well trained CDD team will still have to exist, but the vast majority of new clients are capable of being completed automatically.

This is where the top of the pyramid resides, the adjudication and investigation layer. Many changes will still need that added scrutiny of a manual review, and there will be those cases where offshore jurisdictions are involved and obtaining information is extremely difficult.

The aim is to reduce as much as possible that is sent to this layer.

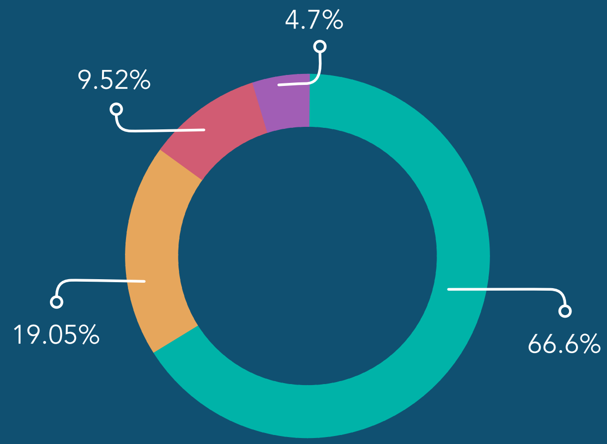
We can look to other areas to draw a parallel, for example with IT security and privacy. Many systems are developed in a fast paced agile environment, and then, towards the end of the project are reviewed by an IT security function. This usually results in a raft of recommendations and concerns that need to be addressed. But then best practice moved to security by design where this was a consideration applied all the way through the development cycle. This meant that situations whereby, to fix security vulnerabilities, the developers had to really undo, and maybe rebuild, certain aspects of a system, could be avoided. Security by design, rather than afterthought should avoid coding down these dead ends.

It is this view that needs to be introduced in to the KYC process, where updates and monitoring are included by design, rather than at the end.

Consider what data you take in whilst onboarding, and right at the start think about how this can be monitored automatically. Try to re-engineer parts that are overly manual or not using structured data. Or look to solutions such as RPA to overcome areas out of your control and collect information automatically where it was once manual.

If these are considered from inception, then the transition to a perpetual KYC approach will become much easier.

Do you believe you will move to a pKYC operating model at your firm?



- We would like to but haven't started yet
- We have already moved to a pKYC operating model
- We have started on the journey
- We don't think it's possible
- No desire to move (0%)

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For more information, please go to www.dnb.co.uk/pkyc or email marketinguk@dnb.com.

REFERENCES

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[3] Final Notice 2020: Commerzbank AG – FCA

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