

## **Know Your Risks: Not knowing KYC / AML Compliance level in your bank<sup>1</sup>**

*“The board of directors of a bank deal with high level policy and strategic level matters. KYC / AML are essentially operational issues, and it is entirely for the executive management to comply with the requirements and report. What value can the board add?”* That is often a typical conversational thread from some directors on board of the banks. If your thought process runs parallel, a few random snippets may drive home the context that KYC-AML is also for board of directors.

- During current year i.e FY 2022-23 (till date), monetary penalties levied by RBI on PSBs for KYC/AML non-compliance constituted 27.40% of total penalties levied. That for private and foreign banks constituted 13.28% and 7.24% respectively. There have been cases, where banks have been levied penalty by FIU-IND in addition to that levied by RBI. Incidence of such penalties negatively affect the bank as well as individual directors in various regulatory / supervisory assessment and do entail consequences.
- For ensuring overall compliance with KYC-AML-CFT matter and for reporting statement of financial transactions, a bank is required to nominate a ‘designated director’ each; few other compliances specify such identified director.
- The extant regulations also task the board in formulation of KYC-AML policy of the bank as well as review of periodic customer risk assessment exercise. The correspondent banking relationship is another area where board is directly involved too. The outcome of supervisory assessment of performance of board factors in any gap comes to fore.
- In the current financial year, India is due for Mutual Evaluation by FATF, an important event which all jurisdictions make their best efforts to pass with flying colors, other than in shades of grey. India became a member of the Asia Pacific Group (APG) in 1998 and a member of the FATF in 2010. The scope of mutual evaluations essentially involves two aspects: (i) technical compliance, for assessment of whether the necessary legal framework and other associated measures are in force and whether the supporting institutional framework is in

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<sup>1</sup> Keynote address by Shri Jayant Kumar Dash, Executive Director, RBI for CAFRAL Program on KYC and AML for directors of banks on March 15, 2023.

place; and (ii) effectiveness, to determine if the systems are working towards achieving the defined set of outcomes. The outcome of the second part would be largely dependent on the ground level feedbacks from regulated entities. There is a flurry of activities in preparation of the same and the banks – more particularly their boards, cannot afford to show any slip in this matter of utmost national importance.

In short, board members have a clear affirmative duty for establishing and exercising appropriate control over an effective form of internal compliance framework involving all KYC-AML matters. It is important that the directors on boards of banks are actively aware of the issues around KYC-AML-CFT in all its perspectives, both micro and macro. While the sessions during the day are lined up for various technical and applied aspects of KYC / AML regime relevant to the participants, let me touch upon a few dimensions that may be of interest to members of a bank's boards.

### **Boards and KYC-AML frameworks**

2. In many of the cases, where enforcement action of various degrees was taken for non-compliance with relevant regulations, one of the noticeable aspects was the perceived distancing from responsibility at board level rather than actually understanding their KYC-AML risks and adequacy of the risk mitigants put in place. The multi-hued charts and presentations of its compliance review often fog the ability of some of the board members to discern if the AML compliance framework was operating at a desirable level or if the emerging concerns were identified that required immediate attention and redress. Typically, the board oversight of KYC-AML compliance manifests in five pillars consisting of (i) Written policies, procedures and internal controls; (ii) Designated Director / principal Officer under PMLA rules; (iii) Internal / independent testing of KYC-AML framework; (iv) a risk based customer due diligence framework tailored to bank's business and customer profile; and (v) employee training programs. In order to set a deliberate tone throughout the bank, the board must demonstrate its commitment to KYC-AML compliance. An interpretive attention to goings-on reported in media and newspapers would provide reasonable grist to the mill in understanding the emerging and newer risks in use of banking channel for the purpose of financial crimes.

## **Regulatory expectations**

3. It is not difficult to perceive that RBI has lately been ascribing increasing importance to governance, internal controls, risk management *per se* supported by better board engagements. Similar expectations around controlling financial crimes through or in banking, including KYC-AML matters, are an obvious extension. A clear understanding of the changing regulatory regime around KYC-AML as well as best practices, not limited to India alone, would help the directors frame the right questions in the board room while approving the Policy or taking note of the periodic reviews. One must be aware that this is one of the symbiotic areas where every change in regulation and every incident taking place within or outside the bank warrants close look at policy or operational refresh. Hence, constant strengthening is rather a norm in KYC-AML matters although it should not translate linearly into customer inconvenience. An effective board oversight on a compliance framework requires a significant degree of transparency about the brass tacks of that framework, and its resourcing standards as well as and the overall environment including attitude of senior management to implementing the framework as well as dealing with non-compliance.

4. Globally, there have been unreported instances where regulators have required that individual board members quit or have been debarred from holding board positions for certain period of time due to their failure to effectively oversee their organisation's compliance framework. Boards should, therefore, be alive to the fact that regulators are often prepared to take board members to task under extant statutes, where compliance frameworks have been found wanting due to deficient board oversight.

## **Source of misreckoning AML risks**

5. For the purpose of competent oversight and forming a realistic view about the effectiveness of an AML compliance framework, board members must first gain confidence in their own understanding about the factors that add up to an effective regime. A perception that some of the boards lack demonstrable knowledge about the KYC-AML requirements, when pitted against the bank's broader compliance framework, needs to be repelled. Limited understanding by some board members of what the relevant 'risk appetite' of the business is i.e. how much business with high-risk AML traits the bank is prepared to take on, given the compliance costs and risks

involved and how this is incorporated into the overall compliance and risk management framework. Two perspectives in the context may be useful:

(a) One perspective for the above situation at time arise from a perceived lack of board ownership over KYC-AML compliance reviews / reports. Hence, the AML compliance function ends up deciding what information the board needs to receive with a convenience bias. There must be better alignment of information the directors need for an effective oversight and what AML compliance function thinks about need for any information being placed before the board.

(b) Remaining alert for ingenious efforts in omitting, downplaying, or re-characterizing deficiencies, breaches etc. is often helpful during board reviews. The degree of sensitivity over potential regulatory scrutiny, e.g during an onsite supervisory process, of such board reviews often spurs tendency to avoid mentioning bad news rather than in providing the board with the full picture. This often lends a false sense of assurance to board members and, in particular, non-executive directors.

### **Information is empowerment of the board for effective oversight**

6. Few board members would wish to be left in the shades when it comes to KYC-AML risks and the bank's strategy to mitigate them. It would be a fatal flaw if board members are lulled into a false sense of comfort because they are not receiving the right information. The oft-repeated remedy for this lies in "the tone at the top". The effectiveness of past dialogues with the teams responsible for KYC-AML compliance function in submitting a complete and transparent information around the framework deficiencies should modulate the tone.

(a) An essential pre-requisite for a meaningful dialogue and appropriate tone is contemporary KYC-AML knowledge of the directors which should be basically self-driven and supported by the bank. There are KYC-AML training programs which are specifically designed for board members and senior management of banks, which should be a good starting point. The next step might be a practical briefing by the KYC-AML compliance function as being implemented to the bank which should help the member identify the specific obligations attributable to the board. A more granular awareness about the AML compliance framework adopted across the various

business lines and their accountability to it would be logical next. Finally, it is for individual directors to evaluate the memoranda / reviews that are being placed before the board from the perspectives of its overarching objectives. In case that does not afford enough assistance to identify new or evolving risks; or for that matter ensure sustained compliance with matters handled in the past, additional or different information requirements must be thought of.

(b) The punctuality of information flow assumes significance too. I am sure, recent amendments to PML Act / Rules a week or so ago would have drawn your attention. The corresponding amendments to RBI directions would be a natural sequel to follow. As a self-test, it will be instructive to reflect on how many boards / WTDs have been promptly briefed about or pondered over its potential implications on business and incremental compliance requirements from this or asked such questions.

### **Minding the gaps in compliance reporting**

7. The above discussion lends relevance to the tenet that one should have the knack to be more aware of information not reported than that are reported to the board. A firmer grip on the applied and functional aspects of KYC-AML requirements would be very helpful in noticing the missing pieces and frame the right queries. Without a strong foundation, boards may be at risk of being pervaded with presentations that fail to clearly outline the underlying AML risks for the bank, either from regulatory or operational perspectives. Some typical examples of gaps in information for boards could be around:

- Key requirements / implications of any new KYC-AML regulation with timelines / resources etc. that is made applicable here as well as in other jurisdictions of bank's operation.
- The process and extent of embedding the results of ongoing or periodical KYC-AML risk assessment of the bank into its KYC- AML framework not in a time-lapse mode.
- The distribution of customers' risk profile in the bank and its movements vis-à-vis the risk appetite in this regard.
- Areas of KYC-AML related activities with high customer inconvenience without commensurate risk identification potential.

- Proportion of alerts generation to total transactions monitored and its conversion rates to established suspicious transaction for reporting purpose.
- Effectiveness is the KYC/re-KYC remediation project to close the outstanding or emerging compliance issues.
- Effectiveness of the assurance about AML Compliance Framework.

### **Cost of Compliance**

13. I would rather be candid about the intuitive thoughts that would infiltrate the minds of an astute banker relating the true cost of KYC-AML compliance. There has been a lot of discussion on the topic. The influence of AML regulations in the advance economies, as well as local and regional concerns, have led to a significant broadening of compliance measures all across and is still moving. This drives a deepening of operational and technology requirements around AML compliance for banks and other financial institutions which translates to (i) direct costs for compliance operations and (ii) indirect costs in terms of its impact on productivity, customer acquisition and business growth with which the board is undoubtedly associated.

14. While I will not hazard any guess on the total size of KYC-AML compliance set ups in banks in India, I would underscore the point that this is an unavoidable cost of doing banking and it has to be embedded into operating cost as a part of business strategy. At the same time, the cost is also amenable to control, based on the type of technology and resources deployed and it would vary in terms of its proportionality based on the scale/operating model. India is one of the jurisdictions where technology infrastructure and other enabling environment that are supposed to help reduce the cost of compliance. However, I would also like to draw your attention to the results of global surveys where vast majority talk about their motivation or top driver for KYC-AML compliance though necessarily emanating from regulatory regimes, the second largest respondents ascribed it to their need to improve the business results. Global survey shows AML compliance functions deploy in the range of 1 -18% of its employees depending upon the size of the institutions. On a higher plane, no bank would like its name being associated with any financial crime much less money laundering. Cost cutting in KYC-AML function is not an option.

## Current Topics

15. If one subject that is of topmost importance to India around KYC-AML-CFT axis, it is the Mutual Evaluation by FATF towards end of this year. The international team would also be interacting independently with a few of the regulated entities. It is incumbent upon each RE to ensure comments-proof compliance with the regulatory regime so that there is no gap in 'effectiveness' of the related regulations.

16. An emerging challenge is the use of digital or tokenized assets by criminals, including cryptocurrencies. In several cases, the ED and the Narcotics Control Bureau have seized crypto assets. While this issue also requires attention in terms of legislative initiative and implementation, banks must be sure that they do not unwittingly get into undesirable situation of being a conduit of proceeds of crimes.

17. Emerging pattern of geo-political risks will always have a potential undertone of transmission through banking channel, possibly through newer vectors. Banks need to be very receptive to all possible leads and not to close slightest of suspicion without fair investigation.

18. It is almost customary to refer to AI-ML today in most discussions around technological capacity and capability. The 7<sup>th</sup> March notification by Govt. also alludes to this. Recently, there was an interesting view taken in a Dutch court over use of new technology. A new bank there had depended entirely on AI for its AML compliance which was objected to by the regulator. However, as per the judgment, the decision would have been different if it were proved that the bank did not exercise adequate continuous control over its business relationship with its customers.

19. An unmissable flip side of India's remarkable progress in digital payment ecosystem has been cyber / on-line frauds. The mule accounts used for such crimes are designed to remain below the transaction monitoring 'frequency'. While, it may not be very significant value-wise, given the large volumes, it is one of the most fraught aspects of a digital banking journey which should not be lost sight of in transaction monitoring.

20. Finally, there is a very critical trade-off between strict KYC-AML compliance and customer convenience. That has been recognized by Hon'ble Finance Minister in her last budget speech. We have observed, due to possible lack of awareness or just overzeal, bank customers are subjected to avoidable runs. This could also be possible due to missing past records. The public expectations on the crest of digital technology is quite high and banks should be alive to it. Government and other financial regulators would be happy to facilitate the journey, without compromising the rigors of any of required standards. You would also agree that the entire focus of KYC regime in terms of customer traction is unduly skewed in favor of CIP and re-CIP which needs to be optimized. This can be sought to be achieved on the triad of streamlining the main pain points involved in CIP, universalization of CIP and finally leveraging the Central KYC Registry mechanism by higher leveraging of the risk based approach. This has potential to minimize the gross tractions as well as the cost structures.

## **Conclusion**

21. Oversight of the board over bank's KYC-AML compliance program is crucial for its success. The board members must possess high-level knowledge of specific fundamental elements of such programs. The next few months and years may see a significant amount of regulatory change that will most certainly impact upon banks' KYC-AML compliance frameworks. The role of the board will prove to be an integral part of ensuring that these changes not only receive strong apex support, but that they are appropriate for the business and effective in achieving regulatory compliance and mitigation of financial crime risks. Enhancing the board members' knowledge of KYC-AML requirements will bolster their ability to ensure that the board receives the information needed to make informed decisions about the organisation's AML compliance framework. Taking greater ownership around the reporting it receives also sends a strong message to the organisation as a whole that the board truly takes its oversight role in this area seriously.

I wish, today's deliberations in the ensuing sessions contribute its share of sensitizing the board members on the importance of this most important piece of compliance matter.

Thank you.