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Financial Transparency and Inclusion Survey White Paper

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It’s what you know that counts

The battle against “dirty money”[1] continues. Money laundering, terrorist financing and tax evasion remain firmly on the regulator’s radar, and Know Your Customer (KYC) requirements remain at the heart of efforts to combat these crimes.

Despite concerns over de-risking and the impact on financial inclusion[2], there is little sign of the regulatory pressure diminishing. Regular enforcement action and penalties act as a reminder of the continuing importance of understanding customers and the transactions financial institutions facilitate. With regulatory developments such as the European Union’s Fourth Anti-Money Laundering (AML) Directive, expectations continue to rise.

There is sustained pressure on financial institutions, and increased regulatory scrutiny has resulted in increased costs, risks of compliance failures and a range of other unintended consequences.

As the United Kingdom’s Financial Conduct Authority’s Head of Financial Crime has stated: “There is a perception that anti-money laundering checks like this are a barrier to business, innovation and, ultimately, competition.”[3]

Innovation, though, may also provide the key to improving the KYC process to make it more efficient and more effective. Increasingly, utilities—central repositories to collect and share customer due diligence documents and data with participating financial institutions—are proposed as an answer to the KYC challenge.

Already, a number of services have launched for correspondent banks and big investment banks, prime brokers, hedge funds and other major capital markets players, as well as some large corporates. However, a broader, global customer due diligence focused on not just compliance, but increasing financial transparency and inclusion across the financial services client base has yet to be seen.

To establish whether such a service could play a role in tomorrow’s KYC processes, LexisNexis® Risk Solutions commissioned a global survey of 300 financial services senior managers with AML Compliance responsibilities to examine the challenges they face and the solutions that may help.

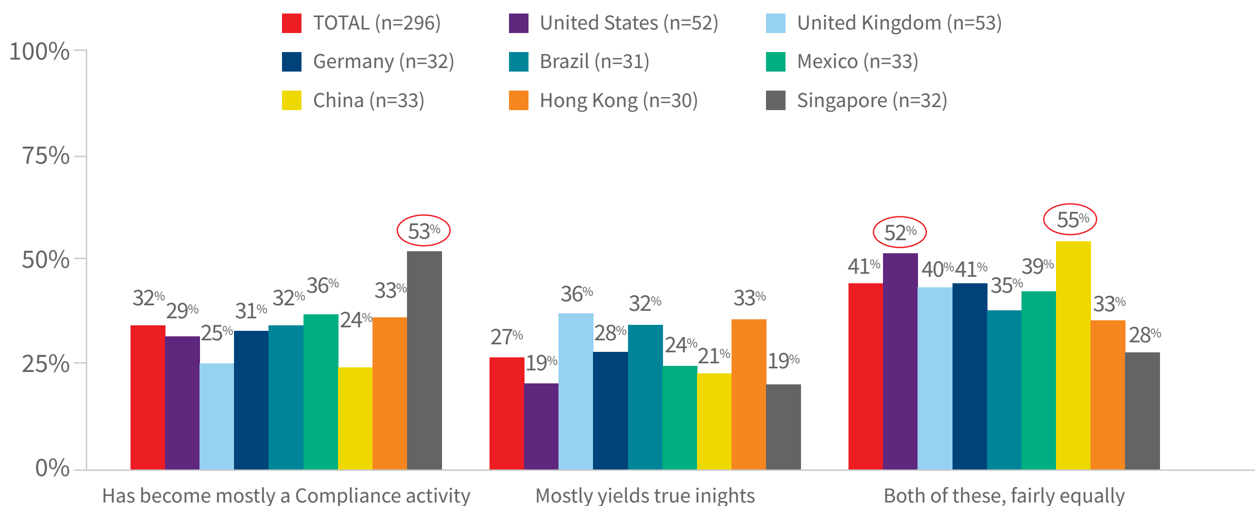
A shared concern

The results of the survey suggest banks share regulators’ and policy makers’ priorities for financial transparency and inclusion.

Respondents (87 percent) agreed that financial inclusion is a prerequisite for financial transparency. But how well do the existing processes of financial institutions achieve these ends? More than half in Singapore (53 percent), the United States (52 percent) and China (55 percent) say their onboarding processes are mostly (Singapore) or as much (United States and China) a compliance exercise as one that yields true insights about the customer. In fact, only in the United Kingdom, did more respondents feel onboarding was about gaining insight than thought it was focused on ticking boxes (36 percent).

These findings suggest significant doubt about the efficacy of KYC processes to fight financial crime.

Figure 1. True insights or ticking the box: perceptions of the onboarding process



A costly exercise

Conducting KYC does not come cheap; banks and others have long complained of the "heavy load"[4] regulations are putting on the industry.

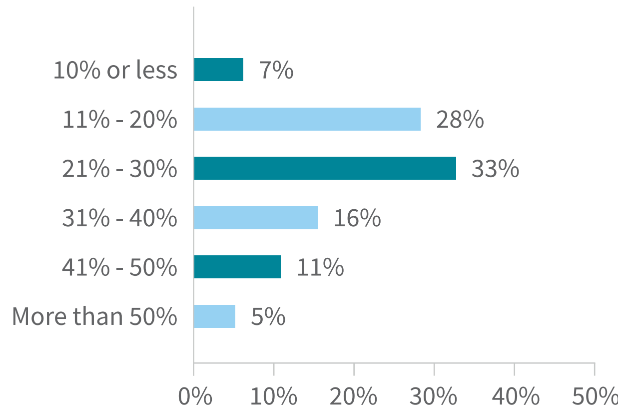
Our survey finds costs vary widely depending on the region, sector and size of the business, but only a minority (41 percent) in the survey said they spend under $1 million a year on AML compliance; 15 percent spend $5 million or more.

Customer Due Diligence (CDD) represents a significant portion of this: About a third of those in China (36 percent), the United Kingdom (34 percent) and Mexico (30 percent) allocate more than 30 percent of AML Compliance budget to CDD, we found; a fifth to a quarter in the United States (26 percent), Hong Kong (24 percent), Germany (22 percent) and Singapore (19 percent) do the same. In Brazil it's 61 percent.

Overall, most institutions allocate between 11 percent and 30 percent of their AML Compliance budgets to CDD, but about a third (32 percent) allocate more.

Previous studies give little hope this will improve. A survey last year found that, by 2018, a quarter of financial institutions with assets between $101 billion and $500 billion expected their spend on AML activity to increase more than 50 percent.[5]

Figure 2. AML budget allocated to CDC



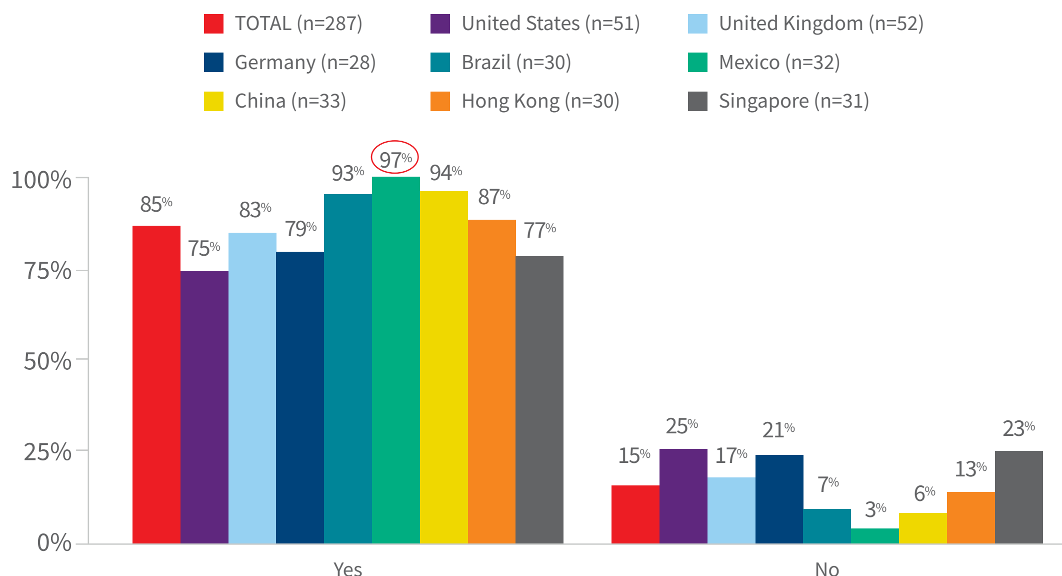
Customer service

Financial institutions' concerns are not just focused on costs; service also suffers.

The onboarding process is widely acknowledged to be critical to determining the lifetime value from customers. Both opportunities and risks are heightened in the early stages of customer relationships, resulting in elevated cross-selling and attrition rates. Research shows that almost all banks have reported lost deals and revenues as a result of onboarding deficiencies, with KYC being the primary challenge.[6]

Our survey confirms that the vast majority of banks recognise the importance of onboarding. Overall, 85 percent view their onboarding process as a competitive advantage, rising to over 90 percent in the developing markets of Mexico (97 percent), China (94 percent) and Brazil (93 percent).

Figure 3. Is the onboarding process seen as a competitive advantage (by country)



Those questioned also recognised that their customers might not agree. Asked how they would be likely to describe the onboarding process, problems were widely acknowledged.

"They think that the process and the procedures are too complicated, and they want to do it quickly and simply," said one respondent from China; "[It's] different for each product, which can be frustrating," wrote a United Kingdom respondent; "It's a slow process that requires many documents," said another in Mexico.

For customers, the process is frustrating, with requirements to provide the same information repeated with each new financial institution they deal with (and sometimes with each new product or service bought). It can also, according to one commentator, be insulting. "Sometimes customers feel offended by the number of different verifications needed," says a United States respondent.

For the institutions, taking short cuts during the KYC process is even more costly than losing business, with regulators showing little tolerance for attempts to minimise customers' inconvenience by diluting due diligence—even if no financial crime results from the relationship with the customer.[7] Improvements in the onboarding process will have to come from more efficient KYC processes, rather than reducing the checks required.

Sticking points

There is a need to address a number of areas around KYC that prove especially challenging.

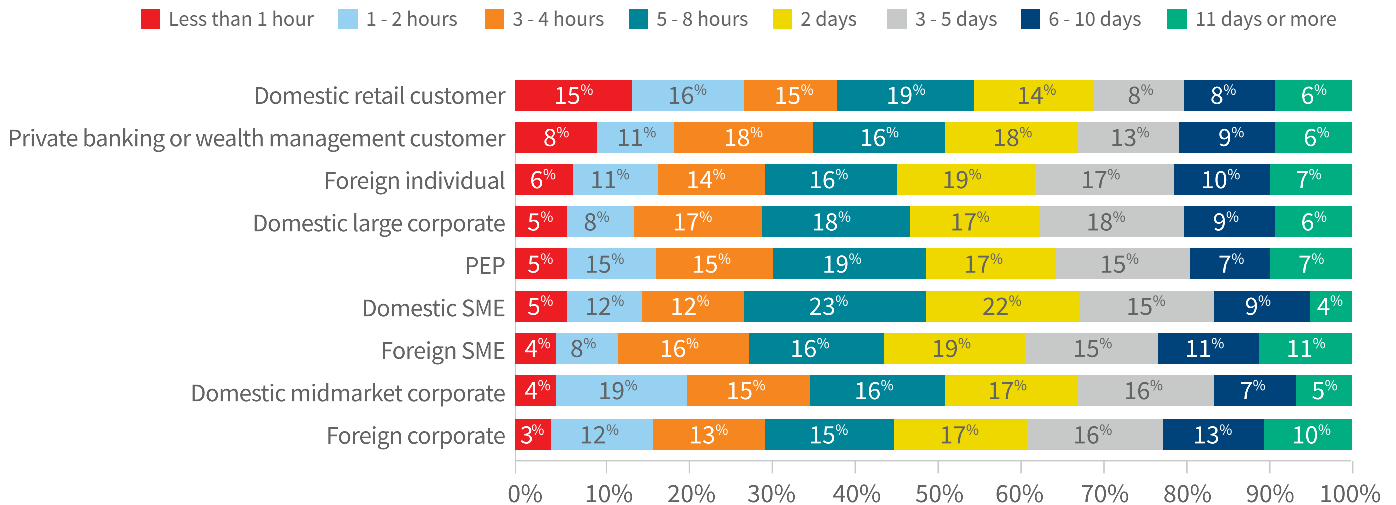
For a start, some types of customer prove more difficult than others.

Individual customers are usually fairly straightforward with a majority saying CDD for domestic retail customers can be completed in less than a working day. The same is true for SME and midmarket corporate customers, as well as even a majority of politically exposed persons screening checks.

For overseas customers, however, things are different. CDD on foreign individuals takes a similar time as it does for a domestic large corporate, and more than one in five say due diligence for overseas corporate customers and SMEs takes six days or more.

The problems here likely arise mostly for customers in countries where there are not well-developed credit markets, with the credit bureaus and other players that promote transparency. Limited third party tools exist today to validate identification documents and other data in many of these jurisdictions.

Figure 4. Time required for customer due diligence, by customer type



The cause for these delays is usually difficulty verifying information: the key challenge financial institutions say they face when onboarding both individual and small business customers. The time required to collect information for individuals, difficulty obtaining good quality information in different jurisdictions for SMEs, and a lack of transparency around beneficial owners for both were also cited as key difficulties.

While the cost of collecting information was still a top concern for over 40 percent of businesses, it trails other worries. The desire for quality, transparency and simplicity remain at least as important (if not more so) than budgets when it comes to drivers for reform of KYC processes.

De-risking and access to finance

These difficulties not only impact customer service and costs, but can undermine policy makers' other priorities if they lead to de-risking: the wholesale exclusion of challenging geographies or customer types to ensure cost-effective compliance with KYC requirements.

First, as others have noted, de-risking actually threatens to undermine AML and counter-terrorist financing objectives by pushing fund transfers towards informal, less regulated channels.[8] Second, it can have a significant impact on goals to increase financial inclusion, particularly in the developing world, where less than half of people have a bank account.[9] Conversely, as 83 percent of respondents in our survey agreed, bringing more people into the global financial system enables financial institutions to provide more financial transparency to regulators.

This is well recognised, and, as a result, regulators have repeatedly warned banks against de-risking.[10] In the United Kingdom, the FCA has stated that its AML assessments will include considering whether firms' de-risking strategies could lead to consumer protection or competition issues.[11] Attempts to de-risk have also been successfully challenged in the courts.[12]

Nevertheless, the problem persists

More broadly, the challenges around transparency and sourcing information has consequences not just for the millions of "unbanked" in the developing world, but those in the United States and elsewhere,[13] as well as those without credit histories[14] and both businesses and individuals that struggle to access the finance or other services they need. Even where information is available on such people, a full picture often isn't possible, with data siloed across different credit bureaus and financial institutions.

The result is individuals and businesses are turned away. Half of financial institutions in our survey turn away between 6 percent and 15 percent of potential individual customers (50 percent) and small business customers (48 percent) due to their current KYC or credit risk management processes. Results, though, differ markedly between institutions. In the United States, almost a quarter (23 percent) turn away 5 percent or fewer of individual prospects, while one in ten (11 percent) turn away more than 25 percent. In Brazil, 42 percent of organisations turn away more than one in five small businesses, while only 6 percent of those in Singapore do the same.

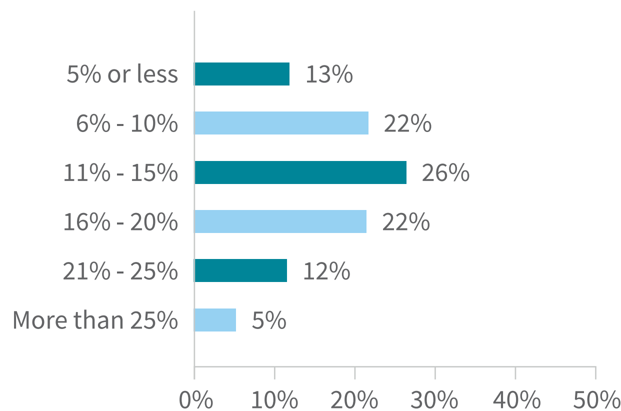
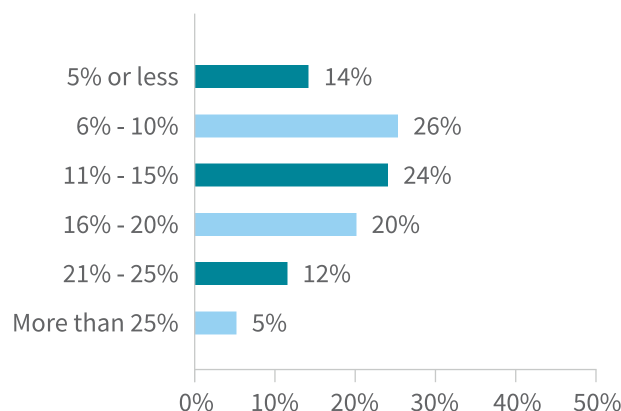


Figure 5. Small businesses (above) and individuals (below) turned away



In all cases, the survey suggests that a huge pool of individuals and businesses are turned away every year. That's despite a desire on the part of financial institutions to address this, with more than three quarters (77 percent) saying that providing financial services to the unbanked and under-banked was very important to their business.

Centrally sharing information held by financial institutions could help to address this, increasing transparency and enabling financial services firms to be more confident in managing the compliance and credit risks of these clients. The survey suggests that even small improvements here could have a significant impact in widening access to financial services. For many other clients, it could mean better pricing.

A use for utilities

There is no silver bullet for these problems. The scale of money laundering, the difficulties detecting terrorist financing, and the lack of harmonisation in requirements around tax and transparency across the world see to that.

Nevertheless, the consensus around the benefits a global utility could bring is striking. Of the 300 respondents in our survey, only one said their institution would not benefit at all from participating in a global customer due diligence utility.

This is despite the obvious challenges of moving to a utility model: transforming processes, adjusting their workforces, tackling data protection regulatory hurdles and overcoming a traditional reluctance to share customer data. Of those we questioned, 79 percent agreed they would be willing to collaborate with their peers to streamline onboarding, KYC activity and watchlist processing. An almost identical proportion (78 percent) said specifically that they would be willing to share data to see such improvements.

The same proportion (78 percent) also said the benefits would outweigh the costs if they could be part of a shared service to "efficiently obtain, manage and utilize due diligence collected from common customers to achieve lower compliance costs and improved risk management for both the institutions and their customers."

The most obvious advantage of using such a service, are a reduction in compliance costs and increased protection for their businesses' reputation (cited by 44 percent). Four out of ten also said it would boost the efficiency of their compliance departments.

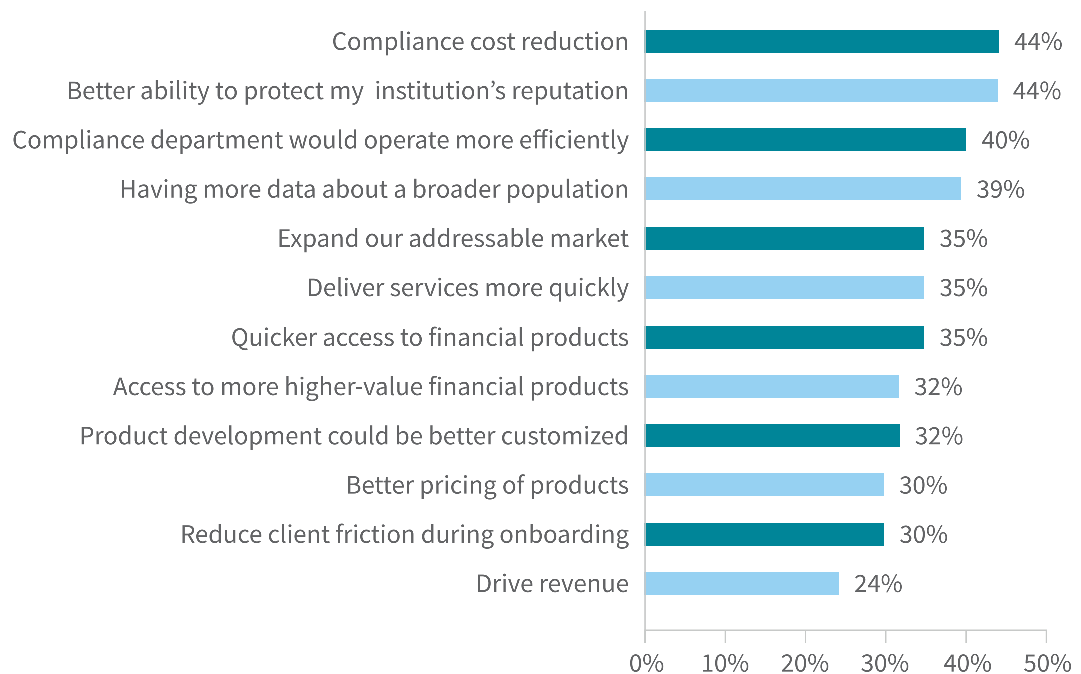
A utility, respondents recognise, could make the process cheaper, while simultaneously making it more robust. Centralising information held across the industry, as well as providing economies of scale to invest in sourcing data through other sources, can improve the depth and quality of KYC inputs available.

Those questioned saw a wide range of potential benefits. It could, for instance, address financial inclusion by increasing the data available for a broader population of consumers to enable better decisions (39 percent); improve services by enabling institutions to deliver them, along with access to financial products, more quickly (35

percent); reduce friction during onboarding (30 percent); and improve profitability through increased innovation (32 percent) and better product pricing (30 percent).

Almost a quarter (24 percent) said a customer due diligence utility would drive revenue.

Figure 6. Potential benefits of a global customer due diligence utility (Ranked)



The road ahead

There would undoubtedly be challenges in achieving such a model. Data protection regulations, regulatory acceptance and fears over transferring control are among the frequently mentioned barriers to financial institutions' adoption of utilities.[15] Ultimately, liability for lapses remains with the financial services providers themselves.

Nor will such a utility come at once. It will be a journey—from an initial goal to achieve cost reductions through economies of scale; to increased standardisation of processes, procedures and information requirements so real efficiencies can be realised; and ultimately to a service sharing customer information across the industry.

It is this final step that will be most difficult to achieve, because it is not just the financial services industry that must be convinced of the case for utilities. The millions of individuals and businesses whose information they require must also be convinced. Any effort to build a utility with the scale to be successful will therefore have to begin by putting their concerns at its heart.

Sources:

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