Evolving AML and KYC Standards

Now an Integral Part of Financial Institutions

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Increasingly complex and co-dependent regulations and tax policies are changing the process of on-boarding and monitoring clients and counterparties.

Seven years after the global financial crisis regulatory change and compliance pressure continues to intensify the APAC region. A significant burden is being created by increasingly complex and wide reaching anti-money laundering ("AML"), know-your-client ("KYC") programs. Their manifold challenges demand a steady organisational commitment and increase in resources, systems and staff. And this is further complicated by each financial institution's unique data, system and process deficiencies.

Besides ongoing compliance demands, recent developments like the volatility in China's stock markets have prompted authorities to require greater corporate governance from listed Chinese companies. Some of these measures will relate to transparency of ownership and trading issues that are part of AML and KYC functions.

So AML and KYC are expanding beyond being the necessary part of programmes to prevent tax avoidance by clients. What constitutes best practice and the resources needed to achieve multiple objectives are evolving to meet current and future market and regulatory conditions.

Anti-money laundering and tax evasion

Over aggressive tax avoidance techniques usually overlap with attempts at money laundering. Chrisol Correia, Director, AML International of LexisNexis says, "Tax laws are complicated to prosecute whereas money laundering violations are sometimes easier to indict and charge." He describes that money laundering used to be associated with serious crimes, but today they can be part of tax evasion or any other serious economic crime. Furthermore, AML obligations are not confined to banks: a very broad range of company types and professions are now required to comply with AML laws and regulations.

"AML investigations are also firmly tied with tax evasion cases. For example, authorities are looking for why parties possess undisclosed domiciles in order to establish tax legitimacy. There is more scrutiny of this kind of risk throughout a client's financial life cycle."

Money laundering and its predicate offence tax evasion are posing more risks for financial institutions and regulators are demanding more from compliance teams. For example, in March 2015 the Hong Kong Monetary Authority issued guidance concerning AML controls on tax evasion, an indictable offense in Hong Kong.

Their guidance recommends that financial institutions apply AML control systems, such as triggers for red flag indicators, to help monitor for tax evasion. Singapore has also passed legislation to heavily penalise banks that assist tax evaders.

Correia believes, "AML and KYC compliance are increasingly converging as risk management disciplines rather than operating separately to detect and combat fraud and tax evasion. This is accomplished through data management, information systems, management support, training and most importantly, organisational commitment."

The new reality of FATCA and China's growing role

FATCA is now fully operational and its reach and implications for financial market participants are being realised as it evolves through application and experience. Its reach not only covers the US activities of non-US financial institutions, but also other non-US entities that may be customers of these banks. This implies any entity in the financial supply chain that that comes into contact with US currency, assets or that is fully or partially owned by a US taxpayer.

Participation in FATCA now represents over 147,000 foreign financial institutions ('FFIs') and 110 intergovernmental agreements ('IGAs'). In Hong Kong, 2,874 Hong Kong based financial institutions have registered under FATCA.

Although China might have initially been lukewarm to FATCA in the early stages of its formation it is now engaged in multi-lateral cooperation with the US authorities and other jurisdictions to combat offshore tax evasion. According to Correia, China and the US have an agreement in principle in terms of FATCA, which includes "reciprocal rights" requiring the US to supply tax information to China.

At the same time, multi-lateral tax information exchange initiatives, such as those led by the G20 and OECD members, are gaining more momentum. A new Common Reporting Standard for this cross-border exchange of tax information is intended to become operational in 2017. Its purpose is to inform and exchange information in order to improve tax collection and policy development.

Correia comments, "It is unlikely that these agreements will not support new punitive measures. However, it is reasonable to expect that cross-border collaboration on tax investigations will increase. I expect that China will play a leading role in coordinating this cooperation."

China has numerous reasons for assuming a greater role in cross border agreements. Its domestic anti-corruption campaign is affecting many aspects of business. At the same time, Chinese companies are increasingly conducting business directly overseas. They know they need to establish the internal means to ensure that transactions are legitimate and monitored. Furthermore, the sharp decline and heightened volatility in Chinese markets during July and the government's ongoing intervention will require extensive disclosure and other governance improvements at the level of listed companies that depend on KYC and AML processes.

Correia said, "The Shanghai-Hong Kong Connect Stock Exchange scheme accelerated this trend. Chinese companies are widely engaged in establishing compliance systems and staff training. Chinese systems are often self-built by in-house developers. So their main challenge is trying link up. So they are currently spending and investing heavily on data and technology."

While China recently postponed implementation of restrictive laws on foreign technology sales in China, Correia said, "I doubt that China's laws restricting and controlling the sales of foreign technology are directed at AML/KYC related technology and applications."

He described that LexisNexis is seeking advice and working with Chinese authorities so that the company will be compliant with future changes. "Our clients understand the need for specialised software."

A Fully Integrated Process

Regulators currently expect senior management to take responsibility for money laundering risk management, which includes understanding the risks that may arise from tax evasion and ensuring the risks are managed effectively by establishing a strong AML compliance culture.

This involves senior management setting the tone from the top ranks. Developing a clear risk appetite while embedding a culture of ethical behaviour at both the institution and individual staff levels must be a company priority. Any failure to effectively manage and mitigate money laundering risks is not acceptable.

Tighter KYC and AML checks are being administered for a range of compliance risks at the beginning of the client onboarding and management process rather than later stages. "This is actually more efficient as major issues can be flagged early on and save processing costs. As the client's relationship develops, improved analytics and correlation studies allow institutions to gain understanding of their complete risk profile."

Today, there is broad acceptance by clients and institutions on the need to achieve more transparency about the ownership of companies. "Improvements are being made to provide more open company registry information. Institutions are now required to know, for example, the ultimate, beneficiaries and shareholders of companies who seek to do business with them."

And more importantly, he observes, "As these requirements broaden, more company registration information is becoming available to banks for the purposes of AML investigations, thereby providing more data that can be used to manage these risks more effectively."

"AML and KYC compliance are increasingly converging as risk management disciplines."

"Ineffective compliance can actually lead to reduced business opportunities."

- Chrisol Correia, LexisNexis Risk Solutions

Asia, Singapore, Australia and Hong Kong are long-established, full participants in the international financial system. Their AML teams are effective and pro-active. Correia characterises these jurisdictions as the "gold" standard in the Asia Pacific region. "In particular, Singapore and Hong Kong are well poised to achieve significant growth via offshore RMB trading. We therefore see financial institutions in these jurisdictions taking additional practical measures to raise standards for technology, systems and internal processes and this spreads through entire bank groups."

However, an inherent internal conflict exists when developing business. The relationship manager seeks to win client business. But, the compliance manager is supposed to monitor everyone's business. "However, both the front and back offices have realised that a properly and efficiently integrated client development and compliance operation can improve business results. Once you understand all of a client's risks - their tolerance and appetite - you can actually sell more appropriate products to them."

"Ineffective compliance can actually lead to reduced business. If you are a transaction bank that doesn't understand the background and credibility of your correspondent bank then clearing banks will be reluctant to conduct business with you."

Correia points out that that smaller companies and individuals can still participate in the financial system through mobile payments and stored value cards. "They provide people with access, but not through traditional banks. We believe these methods will expand. KYC systems can construct a risk profile to help people who cannot normally access mainstream financial services. It helps banks to score their risk level and improve access."

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