International Journal of Law
ISSN: 2455-2194
Impact Factor: RJIF 5.12
www.lawjournals.org
Volume 4; Issue 2; March 2018; Page No. 123-127

KYC norms in India: Issues and challenges

Deepa Kaushik
Research Scholar, Faculty of Law, Maharshi Dayanand University, Rohtak, Haryana, India

Abstract
In today's world, KYC guidelines are laid down to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. RBI also simplified various KYC norms to minimized frauds and risks end protect banks reputation. RBI has also accepted e-KYC through aadhaar to reduce document risk and frauds and reduce cost. Banking Regulation Act was amended and gave powers to RBI to impose a penalty for single violation. Banks are often criticized for using know-your-customer (KYC) norms as an excuse to complicate the process of opening accounts. Many have registered complaints on Grahak Seva, the government's customer-grievances portal, alleging banks repeatedly seek KYC documents, even after these are provided.

Keywords: KYC norms, customer, banks, RBI

Introduction
The 2008 financial crisis left a legacy that caused a major shift in the financial world. Although for the best, a highly complex compliance framework now presents its own set of challenges to the industry, from rising costs to the difficulty of implementation. One such policy is 'Know Your Customer', commonly referred to as KYC. The logic behind the recent upgrade in KYC is reasonable; by demanding detailed information about counter parties, banks are less likely to engage in money laundering and terrorist financing unknowingly, while also being hampered from doing so knowingly.
In recent years, Governments worldwide have grown increasingly stringent on their regulatory efforts, followed by reinforcements, in clamping down money laundering. Financial institutions which were found to have lax compliance controls in the area of anti-money laundering (AML) weren't spared, and have been fined up to billions of dollars. In view that the regulations serve as a check-and-balance measure to ensure financial institutions are well-armed to counter such crimes; failure of compliance thus suggests a weak line of defence.
To safeguard our financial systems, regulatory pressures surrounding compliance with AML is set to further increase. Meanwhile, financial institutions will need to measure up in addressing rising regulatory demands, starting with meeting the "Know Your Customer" (KYC) compliance requirements to combat money laundering.
KYC is a bank regulation which enforces financial institutions and regulated companies to perform all that they need to identify, document and validate the authenticity of the customer prior to any engagement. Comprehensive KYC policies serve as a risk mitigator and surveillance control to safeguard financial institutions, their systems and platforms, from being taken advantage of by money launderers.

Objectives of KYC norms
1. To prevent banks from being used, by unscrupulous or criminal elements for their criminal activities including money laundering.
2. To minimize frauds and risks and protect banks reputation.
3. To avoid opening of accounts with fictitious name and address.
4. To weed out bad customers and protect good ones.
5. KYC procedures also enable banks to know / understand their customers and their financial dealing better which in turn help them manage their risks prudently

What KYC means?
It means Know Your Customer

Know? What should you know?
- Making reasonable efforts to determine the true identity and beneficial ownership of accounts;
- Sources of funds
- Nature of customers' business
- What constitutes reasonable account activity?
- Who your customer's customer are?

Your? Who should know?
- Branch manager,
- Audit officer,
- Monitoring officials,
- PO

Definition of Customer
- A person or entity that maintain account and / or has a business relationship with the book, One on whose behalf the account is maintained (i.e. beneficial owner)
- Beneficiaries of transaction conducted by professional intermediaries, solicitors, etc. as permitted under the Law,

- Any person or entity connected with the financial transaction which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction

It will thus be seen that for the purpose of KYC the customer is not just the person directly dealing with the Bank, but also includes those persons who may be connected with the transactions in any other capacity. These could be the persons who own the entity for which the transaction is being conducted, or they could be the beneficiaries of the transactions which are routed through the accounts of intermediaries.

Research Methodology

The present study is based on secondary method of data collection. Different aspects related to KYC norms are studied. A detailed study of RBI guidelines is made. Data was collected from different Websites of RBI and other Websites.

Core elements of KYC

- Customer Acceptance Policy
- Customer Identification Procedure- Customer Profile
- Risk classification of accounts- risk based approach
- Risk Management
- Ongoing monitoring of account activity
- Reporting of cash and suspicious transactions

All the above are nothing but due diligence measures that are generally taken by any bank/financial institution in order to make sure that no fraud takes place with respect to the transactions being operated in the bank. Proper scrutinization of documents that are provided by the customer will stand as a support to meet the objective of the KYC Norms.

Procedures again vary from a normal customer that one gets to know, non face-to-face customers (i.e. customers who access through Internet banking/Mobile banking), additional documents maybe called upon for a better understanding of such customer.

KYC Policy in India

Way back to the second half of 2002, it is then RBI directed all the banks to implement the KYC guidelines for all the new accounts that will be further getting into operation. As all of us know that KYC is an identification process to establish true identity and beneficial ownership of accounts, source of funds, the nature of customer's business, reasonableness of operations in the account in relation to the customer's business, etc. It's having a legal backing and Reserve Bank of India guidelines are in place under Section 35A of the Banking Regulation Act, 1949 and Rule 9(14) of Prevention of Money laundering (Maintenance of Records) Rules, 2005. Any bank contravenes with the said guidelines or any non-compliance would attract penalties under the Banking Regulation Act, 1949.

These guidelines are issued under Section 35A of the Banking Regulation Act, 1949 and Rule 7 of Prevention of Money-Laundering (Maintenance of Records of the Nature and Value of Transactions, the Procedure and Manner of Maintaining and Time for Furnishing Information and Verification and Maintenance of Records of the Identity of the Clients of the Banking Companies, Financial Institutions and Intermediaries) Rules, 2005. Any contravention thereof or non-compliance shall attract penalties under Banking Regulation Act [1].

What is required of financial institutions to meet KYC requirements?

While the regulatory requirements and expectations for KYC vary by jurisdictions, here are some general guidelines that apply across the board:

- Perform and complete customer due diligence before entering into a business engagement (this includes obtaining and screening personal/organisations' details, e.g. unique identification numbers, business details, and more).
- The precursor to this is having a robust customer identification programme to validate the authenticity/ accuracy of clients' information, and to identify discrepancies.
- Run sanity checks - clients' information need to be cross-checked against the watch lists indicated by regulators, which contain details of unscrupulous individuals and organizations that are restricted from conducting business transactions.
- In the event where the customer is a politically exposed person (PEP), additional due diligence is required.
- After the due diligence process is completed, ongoing tracking and monitoring of customers' transactions is required to constantly keep a lookout for suspicious activities.
- Once the business relationship has been established with a client, periodic risk-based monitoring of the client is recommended to ensure that his/her details are always current.

Compliance with KYC norms

That being said, compliance is no easy task - it requires a dedicated team of specialist data experts and a complete transformation of internal processes within institutions.

KYC is not optional. Unless complied with, it poses the risk of huge fines. In the year 2013 all the three banks have been fined by the Reserve Bank of India with 5 crores, 1 crore and 4.5 crores respectively in violating certain KYC Norms.

As such, KYC is now an integral part of a bank's risk based approach, which is vital for monitoring clients and counterparties. KYC enables institutions to understand risk more effectively, which is a crucial tool in a globalised network.

Through the correct implementation of KYC, financial parties are made aware of pertinent issues relating to a customer, such as their reputation, whether they have a fraudulent history or if they are currently facing money-laundering penalties. There is

[1] Master Circular – Know Your Customer (KYC) norms / Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002 dated July 1, 2008 available at https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?Id=4354&Mode=0 accessed on 13 Mar.2018

also the ever-important risk profile of the country in which the institution is seeking to do business, if sanctions come into play and whether there are any Politically Exposed Persons (PEP) involved

Difficulties in implementation of KYC Norms

Implementation is thus a costly enterprise, largely due to the complexity of decision trees and the necessary integration of technology platforms. Sourcing accurate and up to date data is a considerable challenge for institutions, which is made more difficult by the lack of standardization across the industry. Furthermore, ongoing monitoring of counterparties and tracking any changes in relevant information requires integrated computer systems and a specialized team, not to mention the countless man-hours required for such an enterprise.

While keeping abreast of the latest details is necessary for each and every customer, the regularity in which it is necessary to do so depend on the risk profile of the client and the country. Those that are deemed as high risk will require re-evaluation more frequently and additional data points. Therefore, by understanding the level of risk to begin with, the system can be far more manageable than many presume. Of course, it is inevitable that in such shifts in working models, there are numerous teething problems during the transitional period, as evidenced in this case by the rising incidence of fines for poor risk management and data inefficiencies, which thereby indicate that there are still a number of inefficiencies in compliance procedures.

As a result of the increasing cost and difficulty of KYC compliance, a number of institutions are turning to de-risking, whereby they no longer offer services to entire groups of customers that score highly in terms of money laundering risks. De-risking impacts correspondent relationships considerably, while also preventing mutually beneficial financial dealings. In addition, there is a growing incidence of unbanked banks, in which larger institutions withdraw their support of smaller, local counterparts that rely on such partnerships significantly. Both outcomes could be particularly detrimental for countries seeking investment and project financing for much needed infrastructure development, which often happens to be those with higher risk profiles.

Moreover, de-risking is actually counter-intuitive as it can enable the very crimes it seeks to prevent. It is recommended that front house offices engage effectively with regulators so as to better understand how compliance can be carried out without the negative consequences described above.

Key challenges for financial institutions.

Recently RBI simplified KYC norms, saying a single document will suffice as proof of identity and address. It added no separate KYC documentation would be needed while transferring accounts from one branch to another branch of the same bank. Those who don't have any "officially valid document" are allowed to open "small accounts" with banks.

But challenges remain. Bankers say if an account is used for conducting a large transaction, they sometimes seek additional documents, fearing misuse. This, however, happens on a case-to-case basis. "The entire KYC process becomes difficult to negotiate when a customer has multiple accounts with different banks. If the accounts are split with different holders, it becomes even more difficult to carry out proper background checks. Banks need stronger technology platforms to weed out these discrepancies [2].

The regulations governing KYC requires the synchronization of numerous processes as well as roles and responsibilities, which on the whole, can be a complex and extensive undertaking. There are still many challenges ahead, certainly in terms of compliance functions that continue to face difficulties due to limited resources and the volume of regulatory changes. The successful management of cross-border requirements will require significant investment into technology, data and the relevant expertise within compliance teams. To offset rising costs, it is crucial for banks to focus primarily on their own jurisdiction and build relationships with relevant regulators. This in turn will help institutions to manage compliance costs and stave off the temptation to de-risk [3]. New trends in KYC banking regulations have led to a number of challenges that institutions must now contend with. Among the common challenges financial institutions encounter in their efforts to establish/maintain an effective KYC programme include:

- Risk in misinterpreting regulators' guidelines - That may lead to compliance gaps.
- Lack of communication between business units/departments - This may lead to inconsistent and unconsolidated data, thus resulting in weak/unreliable customer Intel.
- Manual processes in the due diligence life cycle are vulnerable to human errors - That may have a far reaching effect if left unnoticed; this include assigning the wrong risk rating to clients, as judgment is subjected to the analysts'/decision makers' individual interpretation of the matter.
- Inadequate Database - Regulatory authorities have been penalizing banks to the tune of huge penalties. This has been done, when banks fail to adhere to regulatory norms. In addition to losing business to fulfilling KYC requirements, banks have had to pay hefty penalties. Bankers blame it on the system and "inadequate database".
- Lack of an All-Encompassing Technology **-** Currently, banks neither meet nor solve KYC requirements and problems. This is due to lack of an all-encompassing technology. The onus is on banks to meet KYC requirements but the problem is in the lack of a proper system.
- Onboarding and Overhead Costs **-** Banks face plenty of difficulties in successful onboarding, profiling and monitoring of customers. Onboarding, in itself, is a cost-intensive activity, while performing KYC checks leads to unwanted costs, effort and waste of time.

---

[2] http://www.business-standard.com/article/finance/know-your-customer-a-challenge-for-banks-and-their-customers-114122300666_1.html accessed on 10 Feb.2018

[3] https://www.worldfinance.com/banking/kyc-regulations-challenge-the-banks accessed on 18 Mar.2018

Leveraging on technology to improve the effectiveness of KYC

The accuracy of the clients' profile and data is highly crucial towards achieving the objective of KYC. This is where technology comes in - to enhance data precision and also to improve the turnaround time needed. Among the popular digital solutions that financial institutions use are:

- Real time screening technology - to assist in the cross-checking of clients' details against regulators' watch lists.
- Data analytics – to provide an analysis and a consolidated view of the data across various business functions.
- Workflow management systems (WMS) - to automate manual processes.

In addition to meeting regulators' compliance demands, there's also a growing need for financial institutions to leverage on new Fin Tech solutions to further optimize their KYC programme and better differentiate themselves from the competition; especially in the areas of expediting clients' on boarding process, minimizing cost and the duplication of effort, and most importantly, bolstering security and safeguarding their reputation as well as the integrity of their systems from being involved in money laundering activities/financial crimes.

KYC is the backbone of anti money laundering compliance

By their very nature, money launderers will go to great lengths to cover their tracks. In the process, they use the normal activities of legitimate businesses like banks, credit unions, money service businesses, and other financial services organizations to help them "clean" ill-gotten gains. One of the strongest tools financial institutions have in combating the covert use of their services for illegal ends is to Know Your Customer (KYC).

As money launderers have become more sophisticated, and more adept at using both bank and non-bank service providers (like cash couriers and trading services), regulators have placed more emphasis on Know Your Customer, and even Know Your Customer's Customer. Although it is true that certain types of transactions (such as high currency amounts), locations (foreign vs. domestic), or businesses (international bank vs. local credit union) may have inherently different levels of risk, the truth is that any type of transaction may be fraudulent because it is being used with criminal intent. Financial institutions have to pay close attention to the customer's characteristics in the risk assessment process.

Every anti money laundering compliance program has to include a Customer Identification Program (CIP) based on Customer Due Diligence (CDD) investigations. Because financial entities can vary so much from each other in terms of typical types of transactions, customers, locations, scale, and business lines, the Know Your Customer efforts can vary as well. In general, CDD will include verifying the identity of customers and understanding the monetary thresholds for required reporting and record retention, as well as the specific rules governing specific types of transactions

Due diligence in verifying your customers' identities is a requirement of anti money laundering compliance. When integrated into an enterprise risk management plan, Know Your Customer can be a critical part of a financial institution's success, as well.

Violation of KYC Norms

RBI is likely to adopt a zero tolerance policy on KYC and anti money laundering norms. The move follows a series of violation of norms by banks, which were identified by the RBI in the recent past.

The regulator also feels that the quantum of penalties for such violations is small. It is currently looking at a proposal to increase this. Another proposal is to put operational curbs such as not allowing a bank to disburse loans for three months or not allowing them to take part in treasury operations for a limited period. Branch expansion is another area where restrictions could be imposed.

At present, a small violation of KYC / AML is over locked by the central government during inspection. Now, they are saying even if a bank is 99% compliance, one percent non-compliance attracts penalties. Banks could also see the monetary penalty rising sharply from the present Rs. 5 lacs per violation.

The Banking Regulation Act was amended and gave powers to RBI to impose a penalty of Rs. 1 crore for a single violation.

The RBI has penalized ICICI bank and BOB for violating norms governing KYC and AML. The fine was Rs. 50 lacs for ICICI bank and Rs. 25 lacs for BOB. Four banks – SBI, ICICI bank, BOB, & AXIS bank were scrutinized in January by the RBI for discrepancies and frauds by bank officials. The scrutiny was on the basis of a complaint by a reputed statutory organization. This round of penalties for violation of KYC norms comes after a gap of 1 year [4].

The RBI has slapped a penalty of Rs. 1.5 crore each on three public sector banks – Bank of Maharashtra, Dena Bank and Oriential Banks of Commerce for violating rules of KYC / AML. RBI also asked eight other public sector banks – Bank of India, Punjab National Bank, and State Bank of Bikaner and Jaipur, Union Bank of India, Central Bank of India, UCO Bank, Vijaya Bank and Punjab and Sindh Bank to ensure strict compliance with KYC norms.

The RBI has asked banks to exercise full KYC procedure at least every two year for high risk individuals and entities, from earlier directive of not less than once in two years.

For low risk individuals and entities, KYC data updating has been relaxed to at least every 10 years from the requirement of not less than once in five years earlier. For medium risk individuals and entities it has been relaxed to at least every eight years, from not less than once in two years.

Freezing of Accounts on Non-Compliance

Any non-compliance thereof can lead to freezing of such account. However it is mandatory that a 3 month notice shall be served to the concerned customer detailing the subject-matter. A partial freezing is made on such account in which a 3months notice is served. If still the account tend to be in non-compliance after 6 months, all the debits and credits would be

[4] http://www.financialexpress.com/industry/banking-finance/rbi-slaps-rs-50-lakh-penalty-on-icici-bank-rs-25-lakh-on-bank-of-baroda/20332/ accessed on 2 Apr. 2018

disallowed i.e. the account cannot be operated further. In such a situation it is at the bank's discretion to close such accounts. However reasons for such closure are to me mentioned clearly.
When the bank believes the account to be lacking a true identity, i.e. in case of a suspicious account the bank should file a Suspicious Transaction Report (STR) with the Financial Intelligence unit-India under the Department of Revenue, Ministry of Finance, and Government of India.

Conclusion

KYC norms became more stringent in nature after demonetization process. Among other things, demonetization has fortified the tax administrators' tools and has also led to endless interventions to produce greater compliance through direct as well as indirect means. Under 'Operation Clean Money' of the Central Board of Direct Taxes (CBDT), more people have been forced into the tax net. Notably, advanced tax administration practices have been invoked which among other things include the Aadhaar-PAN linkage initiative. As per Parliamentary information, this linkage initiative has unearthened more than 11.44 lakh permanent account numbers (PANs) as cases of multiple PANs [5].
Finally, banks in recent times have embraced IT and systems to an extent that were not the case before and therefore, proper KYC norms complement and supplement the IT systems that the banks have and ensure compliance with the rules. In conclusion, it is clear more than ever that banks have to clean up their act and the regulators cannot overlook the transgressions anymore. This is the reason why well-maintained KYC norms help all stakeholders.

References

1. http://www.iba.org.in accessed on 16 Mar.2018
2. http://www.rbi.org.in accessed on 13 Mar.2018
3. http://www.business-standard.com accessed on 10 Feb.2018
4. http://www.firstpost.com accessed on 12 Mar.2018
5. http://www.post.jagran.com accessed on 28 Feb.2018
6. http://www.greaterkashmir.com accessed on 12 Feb.2018
7. http://www.taxmann.com accessed on 15 Mar.2018
8. http://www.financialexpress.com accessed on 2 Apr.2018
9. http://www.ijsrp.org accessed on 22 Mar.2018
10. http://www.thehindu.com accessed on 12 Mar.2018
11. http://www.indianexpress.com accessed on 1 Apr.2018
12. https://www.worldfinance.com accessed on 18 Mar. 2018

[5] http://www.greaterkashmir.com/news/opinion/kyc-norms-inevitable/262721.html accessed on 12 Feb.2018