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cutting through complexity

FORENSIC

India Anti-Money Laundering Survey 2012

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Contents

Foreword

I am happy to learn that KPMG in India is launching its Anti Money Laundering (AML) Survey 2012. After the legislative framework for AML was laid down by the Prevention of Money Laundering Act, 2002, substantial progress has been made in increasing awareness and strengthening the anti-money laundering/counter financing of terrorism (AML/CFT) regime.

The Financial Action Task Force (FATF), which sets standards in the area of AML/CFT, is undertaking a fresh exercise to review and revise the existing recommendations to make them more relevant to the changing times. These changes may pose fresh challenges in terms of implementation and compliance.

The survey being brought out by KPMG is an important initiative in capturing inputs from the reporting universe. The survey also highlights important trends and patterns that would assist the regulators and policy makers in better understanding of the issues and challenges faced by the reporting entities.

While complimenting KPMG on taking this initiative, I am confident that the publication will also help in wider dissemination of the relevant issues and in improving compliance to further our quest for protecting the integrity of the financial sector.

Shri P. K. Tiwari
Director
Financial Intelligence Unit – India

Executive Summary

Increased focus on money laundering risk by the Senior Management

The estimated amount of money laundered globally in one year is 2-5 percent of the global GDP, or USD 800 billion - USD 2 trillion[1]. Increasingly, the financial services industry is looking at anti money laundering compliance as a key concern area, with it figuring as an important point of discussion for board of directors and senior management on a frequent basis. Organizations are using AML compliance as a parameter to measure senior management performance, which in turn is ensuring accountability across organizational processes and products. Increasing internal focus by the organizations on AML coupled with the external factors such as high profile corruption cases, terrorism, heavy fines paid by global financial institutions and FATF membership is gradually leading to tighter AML compliance.

76%
Discuss the AML profile on at least a monthly or quarterly basis

41%
Integrate AML in the business strategy of new products/ services

35%
Publicize the AML compliance programme internally

FATF: Membership comes with increased responsibilities

The commitment of financial institutions to the Financial Action Task Force (FATF) standards is crucial for the fight against money laundering and terrorist financing. India's membership and commitment to FATF standards will eventually lead us to attain an equal footing with other developed countries on compliance with AML regulations. The financial services industry has recognized the changes due to FATF membership and our respondents believe that scrutiny is intensifying primarily on customer identification procedures (KYC) and transaction monitoring and reporting. Increasingly, financial institutions are evaluating the inherent AML risks in their products and services/ delivery channels/ transactions and taking steps to mitigate those risks.

84%
Regulatory scrutiny has become more stringent post FATF membership

90%
Regulatory scrutiny is high in the area of Know Your Customer policy and processes

81%
Agree that scrutiny will remain high in the area of Transaction Monitoring / Reporting

1 United Nations Office on Drugs and Crime (http://www.unodc.org/unodc/en/money-laundering/globalization.html

Laying the foundation: Money laundering risk assessment

Regulators have advised financial institutions to regularly assess money laundering risks in their products/services/transactions/delivery channels as well as evaluate if their current policies and procedures mitigate those risks. While an increasing number of respondents conduct periodic risk assessments to evaluate their money laundering risks, a significant number undertake this based on a change in product/ procedure or regulatory change, which is a matter of concern. Also, with a significant number stating that their institutions' AML policies and procedures are based on local regulations and benchmarked against global best practices – this percentage needs to increase given the global requirements and standards that come as a part of being a member of the FATF.

65%
Conduct an AML risk assessment on at least a half yearly or yearly basis

32%
Conduct an AML risk assessment on the basis of an event

51%
AML policies and procedures are based on local regulations and benchmarked against global best practices

Drilling down to unearth the core

Largely, financial institutions have put in place basic policies and procedures to identify and prevent money laundering and terrorist financing. A risk based approach towards AML, proper customer identification procedures including identification of beneficial ownership and politically exposed persons, ongoing client due diligence and sanctions monitoring etc. are some of the key areas that are being monitored closely. However, while monitoring and identifying of these procedures is important, establishing an efficient client data updation process is also equally vital.

86%
Institution follows a risk based approach in relation to account opening

84%
Beneficial owner identified at the time of opening an account

83%
Have procedures for monitoring sanctions lists before account opening

81%
Customer documents are collected and verified before opening an account

77%
Have specific procedures in place for identifying politically exposed persons

Testing and monitoring the effectiveness of your controls

As important as it is to set up policies and procedures to monitor the risk of money laundering, it is equally important to establish a formal programme that tests and monitors the effectiveness of that system. A majority of our respondents do have such a procedure in place with the onus largely falling on the Compliance and Internal Audit functions.

71%
Have a formal procedure to test and monitor the effectiveness of anti-money laundering systems and controls

80%
Compliance function plays an important role in the testing and monitoring procedures

76%
Internal Audit plays an important role in the testing and monitoring procedures

Investment to be made in the area of AML

Not only is the risk of money laundering being taken more seriously, a majority of our respondents also feel that the overall investment in AML, including direct and indirect cost, will increase in the next two to three years. A majority of the respondents feel that this investment will, in all likelihood, be in the area of a 10 to 50 percent hike largely in areas such as implementing / upgrading their transaction monitoring system followed by implementing global policies and remediating/ refresh exercise.

44%
Investment will increase by 10 to 20 percent

29%
Investment will increase by 21 to 50 percent

AML Environment

The Financial Intelligence Unit - India (FIU-India) is the nodal agency in India for managing the AML ecosystem and has significantly helped in coordinating and strengthening efforts of national and international intelligence, investigation and enforcement agencies in pursuing the global efforts against money laundering and related crimes; while the Prevention of Money Laundering Act (PMLA) 2002, forms the core framework for combating money laundering in the country.

In June 2010, after a stringent evaluation, India was admitted as the 34th country member to the Financial Action Task Force (FATF). This membership has helped domestic enforcement agencies to exchange information and Indian financial institutions gain entry into markets of other member countries by portraying that Indian financial institutions are more comparative in terms of risk management standards.

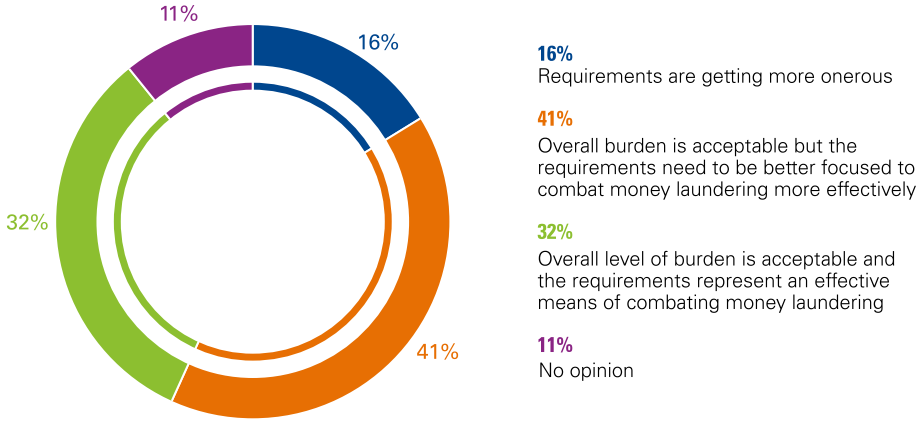
The FATF mutual evaluation report also highlighted certain improvement areas in the AML regime within India and hence it comes as no surprise that the regulatory guidelines have been strengthened by bringing in changes to the Prevention of Money Laundering Act (PMLA) and Rules in 2009.

FATF is an inter-governmental policy making body whose purpose is development and promotion of policies to combat money laundering and terrorist financing threats. FATF has established a series of forty recommendations and nine special recommendations that set out the basic framework for anti money laundering efforts and are intended for universal application.

Environment post FATF membership

On discussing the state of AML compliance post the FATF membership of India, while a majority of the respondents felt that the AML requirements were acceptable, a significant number also indicated that these requirements needed to be better focused primarily with respect to areas like customer due diligence, identification of beneficial owners and ongoing due diligence approach. Some of the respondents also feel that the burden is getting onerous. *(refer to Figure 1)*

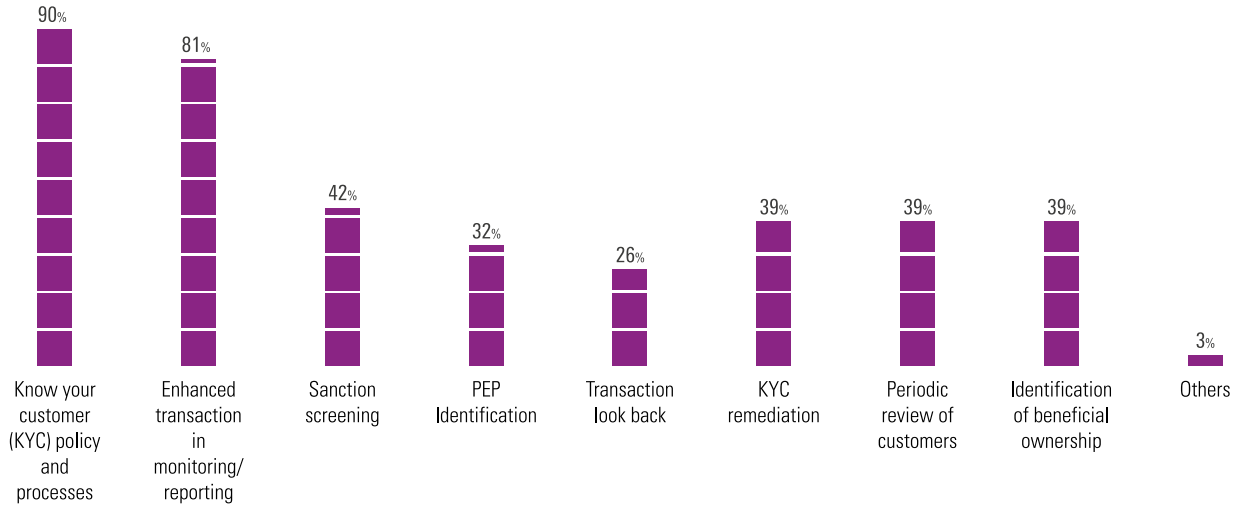
Figure 1: In relation to AML compliance in the country post FATF membership, which of the following statements fits your view?



Source: KPMG in India's AML survey 2012

Post obtaining the membership, an overwhelming 84 percent of the respondents believe, as a consequence, that the regulatory scrutiny will become more stringent. The key areas that specifically stand out *(refer to Figure 2)* are Know Your Customer (KYC) policy and processes and transaction monitoring.

Figure 2: Which of the following areas has the most regulatory scrutiny?



Source: KPMG in India's AML survey 2012

There have been multiple instances where enforcement agencies have taken action against financial institutions in the recent past. RBI has fined 48 Indian Banks in six months leading up to June 2011 for violating the KYC and AML norms[1]. These actions by the banking regulator may have triggered the respondents to believe that regulatory scrutiny has become stringent.

Globally, regulators have imposed financial penalties and initiated look back reviews for deficiencies in the areas of sanction screening and payment filtering[2]. Though currently the respondents to the survey have not considered these areas to be prime areas for regulatory scrutiny, however, in our opinion based on global trends, this shift will probably occur.

1 As per news reports - http://articles.economictimes.indiatimes.com/2011-07-1/news/29758455_1_small-banks-aml-apex-bank

2 www.bankersonline.com/security/bsapenaltylist.htm

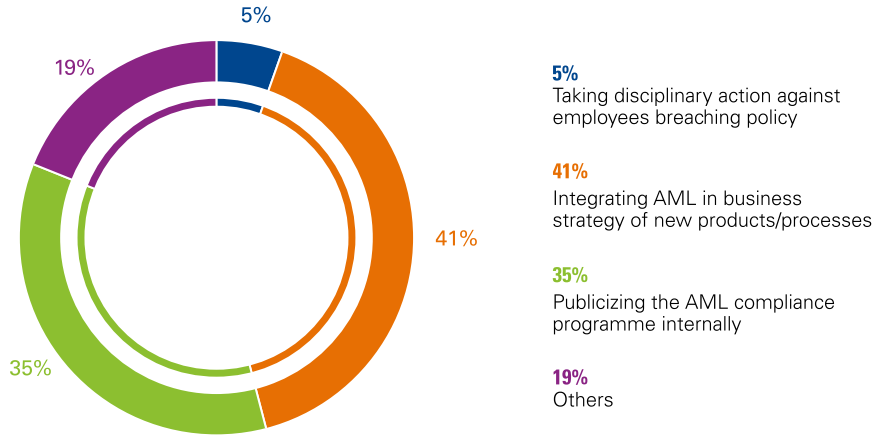
AML is a board level topic

Senior management play a key role in setting the right tone at the top and ensuring accountability throughout the hierarchy to maintain effective oversight at all levels within an organization. They are responsible for managing the risks faced by the organization and are accountable to shareholders and regulators alike.

Compared to our last survey, there has been a substantial increase in the level of involvement and importance that is now being given to AML issues. While in 2009 only 67 percent of the respondents indicated that their senior management including their board of directors took an active interest in AML related issues and discussions; in the current survey 86 percent of the respondents state the same.

Today, management is setting leadership examples by integrating AML compliance within the business strategy *(refer to Figure 3)*. It is important to note that respondents have begun to take disciplinary action against employees breaching policy. While it is a very small percentage, this shows the growing seriousness of the management towards AML compliance.

Figure 3: How has the management set an example for AML compliance in your organization?



Source: KPMG in India's AML survey 2012

This increasing importance being given may be due to a combination of factors such as FATF membership of the country, higher scrutiny of regulators, financial penalties on major global banks by respective country regulators and reputational risk associated with non compliance.

Globally there has been a downward shift, with only 62 percent of the respondents[3] citing anti-money laundering as a high profile issue for senior management; this of course could be attributed to the global financial crisis. In India, the risk of AML seems to be taken more seriously with 76 percent of the respondents stating that discussions relating to AML issues are undertaken at least quarterly.

We can attribute multiple reasons for this shift bucking the global trend. Over and above the FATF membership of the country, there have been multiple high profile instances of financial crime, corruption and black money investigations which have hit the Indian corporate world. This has led to serious questioning of corporate governance standards and increased pressure on organizations from enforcement agencies to focus on regulatory compliance. Moreover, India has been a target of terrorism from homegrown and separatist cross border terrorist groups and thus the greater need to manage financial channels and scrutinize the movement of funds.

In comparison to the western world, India has been a late entrant (34th member country of FATF) thus being lower in the AML compliance maturity curve vis-à-vis. other developed nations. Hence, in our opinion, the management focus in India will continue to remain on AML compliance as regulatory scrutiny will become more rigorous.

3 Statistic from the KPMG Global Anti-Money Laundering Survey 2011

Moving away from just a 'Tick in the Box'

While the current AML regulations are old, they are still evolving. A review of the survey results indicate that entities are still trying to find their way in relation to the implementation of an effective AML compliance program in their organizations. Though the senior management are actively involved in discussing and reviewing the status of AML compliance, the same may be because of heightened regulatory scrutiny and in light of imposition of fines by regulators across the globe.

AML has traditionally been a compliance topic and the financial services community however is yet to view it with all its potential as a risk management tool. Hence the objective has been basic compliance rather than using it as a risk management practice. In order of priority, AML compliance, if not at the same level, would fall after basic regulatory and financial requirements, Basel II requirements and financial crime (fraud) management requirements of an institution.

The Basel II requirements focus on credit and market risk and more recently operational risk area. As per Basel II guidelines, the operational risk area is the risk of direct or indirect loss resulting from inadequate, or failed internal processes, people and systems, or from external events. One of the key requirements of operational risk management is managing the risk of money laundering which is vulnerable to high regulatory action in turn effecting the reserve requirements and eventually the profitability of a bank. Hence, managing money laundering can be considered to be an integral part of the risk management function.

The perception of the industry is slowly undergoing a transformation. Regulators have become more active and are developing robust processes such as FIU India has signed MoU's with multiple geographies for sharing of information and data related to money laundering activities. These developments, along with the FATF umbrella, would eventually urge institutions to benchmark themselves globally on AML compliance procedures and processes, thus enabling them to make that strategic move from basic compliance to a risk management outlook towards AML compliance.

Know your customer (KYC)

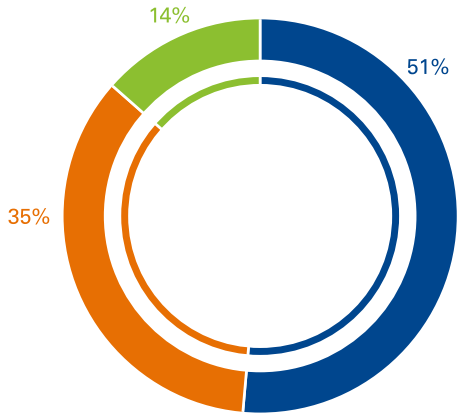
Policy

Global benchmarking

Financial institutions are increasingly becoming global in their approach by establishing branches, subsidiaries or promoting entities in multiple geographies. This creates a unique challenge to manage the regulatory requirements of multiple regulators. Hence, more and more institutions have been benchmarking their policies and procedures with global best practices. This was evident in our 2009 India survey wherein 66 percent of the respondents had stated that they benchmark their policies and procedures with global best practices which are implemented as consistently as possible across all locations.

However, there are only 51 percent respondents stating the same this year. *(refer to Figure 4)* This could be due to the turmoil in the financial markets across the globe which may have led multiple financial institutions to hold on to their global expansion plans. Indian regulators themselves are moving towards global standards as FATF requirements are being introduced in a phased manner by incorporating those guidelines in domestic regulations.

Figure 4: Which of the following best describes your organization's current AML policies and procedures?



51%
Based on local regulations, benchmarked against global best practices and implemented as consistently as possible across all locations

35%
Based on local regulations, NOT benchmarked against global best practices and implemented as consistently as possible across locations

14%
AML policies & procedures are developed and implemented at a regional/ local level

Source: KPMG in India's AML survey 2012

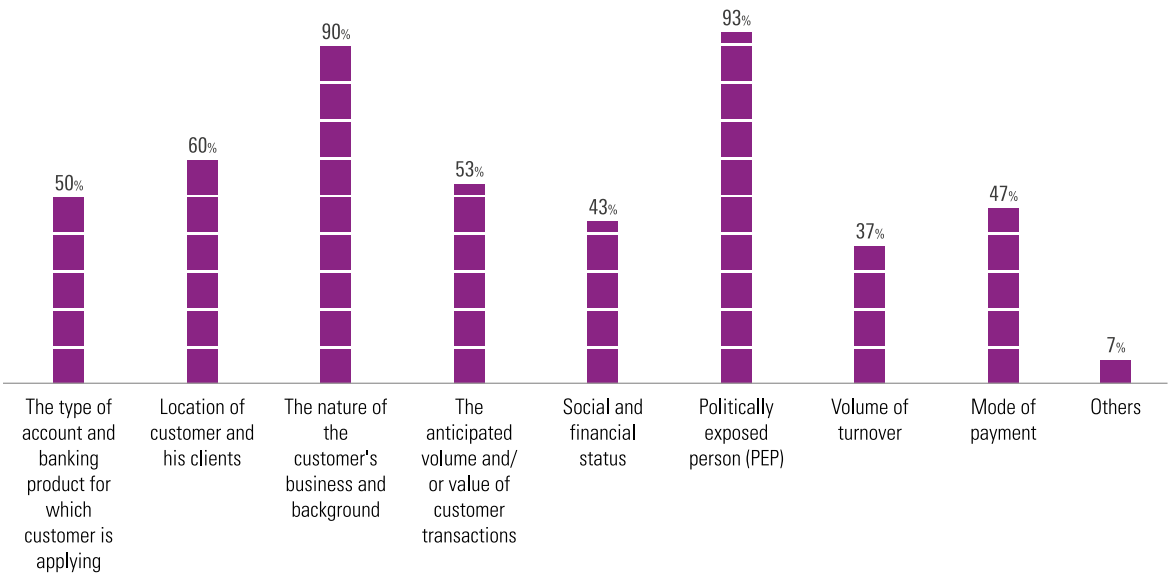
Risk based approach

A risk based approach helps to avoid additional cumbersome cost for the organization as it eliminates elaborate identification procedures and acceptance measures for all the customers who do not pose significant risks as perceived by the bank.

A structured due diligence procedure at the time of customer on- boarding ensures that the organization is taking adequate precautions in its anti-money laundering efforts. Encouragingly, 86 percent of the respondents have stated that their institutions follow a risk based approach.

Institutions should look to capture adequate data and information such as background, social and financial status, source of funds, nature of business, country of origin etc. in a bid to identify the customer. However there is disparity in the factors which are used by the financial institutions in applying the risk based approach, as highlighted by the respondents in *Figure 5*.

Figure 5: In relation to account opening, which of the following factors are considered while following a risk based assessment/ approach?

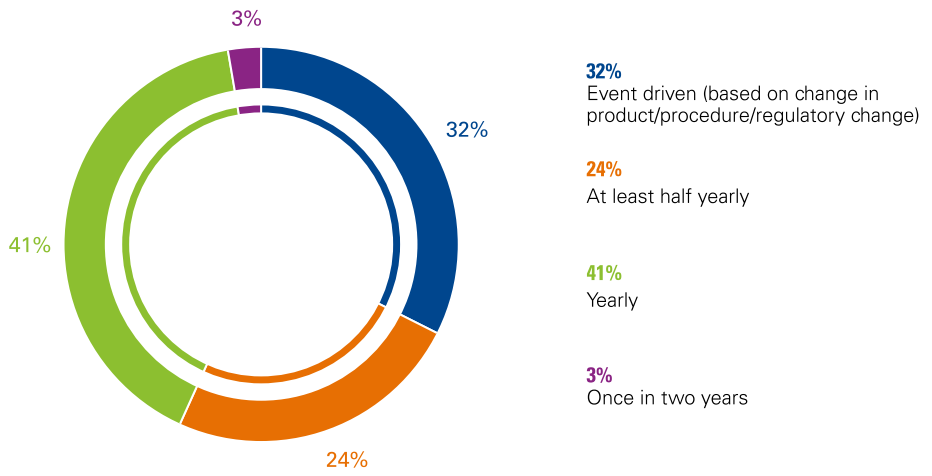


Source: KPMG in India's AML survey 2012

Having said that, it is critical for institutions to understand that there are inherent AML risks in their products and services/delivery channels/transactions; hence, they need to accordingly conduct a comprehensive assessment to identify their AML risk profile and how these are/can be mitigated.

With 65 percent of the respondents stating that AML risk assessment is conducted either half yearly or yearly *(refer to Figure 6)*; it is clear that the risk of money laundering is now being perceived as a major focus and organizations are gearing up to identify and insulate themselves from such risks. However, nearly one third of the respondents stated that a periodic risk assessment is not carried out and is instead event driven. In our experience global firms conduct annual and event driven AML risk assessments more frequently, owing to the fact that

Figure 6: How often does your organization conduct an AML risk assessment?



Source: KPMG in India's AML survey 2012

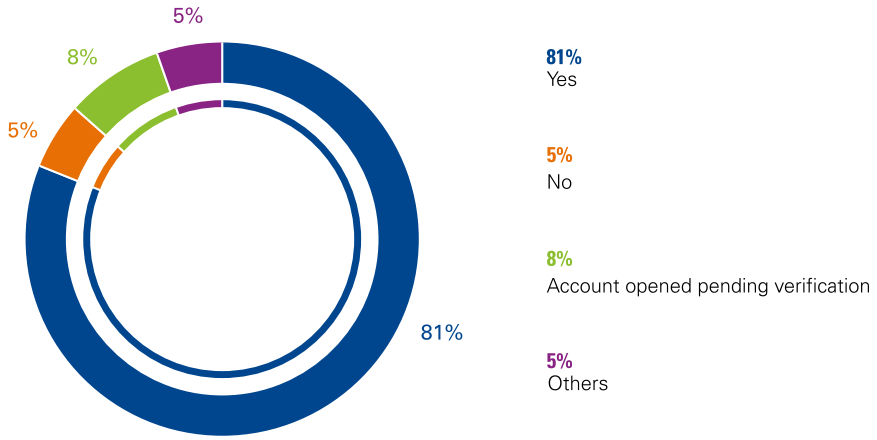
AML risk assessment is mandatory regulatory requirement in the western jurisdictions. In India, regulators are emulating global trends which is evident from the recent RBI circular[4], which has asked banking companies to assess money laundering/ terrorist financing (ML/TF) risks in their products/ services/ transactions/ delivery channels and thus make the AML/ CFT (Counter financing of terrorism) regime more robust.

4 Reference to the RBI Circular dated 19 December 2011

Documentation

A vast majority of respondents (81 percent) mentioned that customer documents are collected and verified before opening an account, however 13 percent open accounts without fully collecting or verifying the documents *(refer to Figure 7)*. While this might be a small percentage, it is worrisome because this is not in line with the regulatory requirements which clearly state that KYC documents should be collected before the commencement of an account based relationship. The KYC documentation process forms the foundation of a satisfactory due diligence process; with this missing even in a partial form, is a red flag that needs to be addressed.

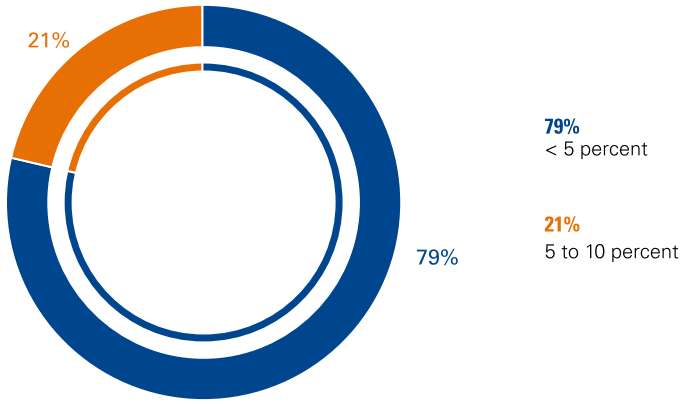
Figure 7: Are all customer documents collected and verified before opening an account



Source: KPMG in India's AML survey 2012

As a follow on, when asked about the increase in fraudulent documentation being provided at the due diligence stage, 21 percent of the respondents *(refer to Figure 8)* stated that fraudulent documents have been encountered in five to ten percent cases. While this number may be a conservative figure, there are chances of this percentage being higher since a large number of unverified documents *(as highlighted in Figure 7)* may also turn out to be fraudulent.

Figure 8: In the past two years, how many instances of fraudulent documents in account opening have been encountered?



Source: KPMG in India's AML survey 2012

Currently, India does not have any unique citizen identifier such as a social security number as in some of the western countries. The problem of fraudulent documents should hopefully reduce with the implementation of Unique Identification Authority of India (UIDAI)/ Aadhar project of the government. However, the implementation of this project will take some time and even once implemented, the same may need to be reviewed and tested before using it as a valid KYC option to be implemented by the financial institutions.

Hence, organizations need to put in place robust processes and solutions to monitor any lapse in the KYC process and remediate the same at the earliest. There should be quality checks in place to identify anomalies in the documentation and procedures followed. Adequate training should also be imparted to the front office staff on customer identification and acceptance procedures.

Beneficial Ownership

The beneficial owner (BO) as per Rule 9 sub rule (1A) of the PMLA is the natural person who ultimately owns or controls a client and/or the person on whose behalf a transaction is being conducted.

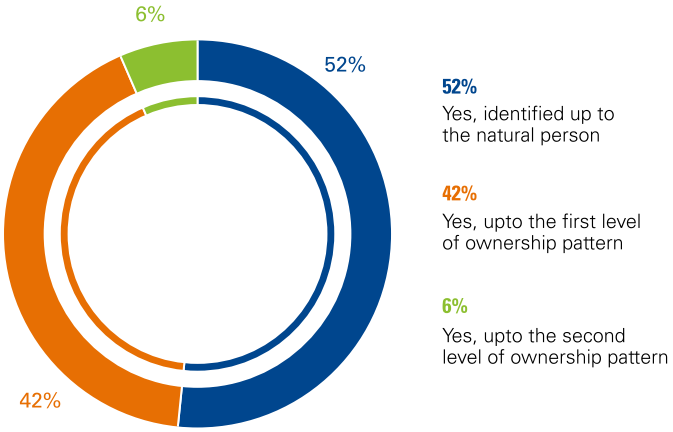
Thus it was interesting to note that only 52 percent of our respondents *(refer to Figure 9)* identify the BO up to the natural person. In light of non identification of beneficial owners up to natural persons, it is difficult to state whether adequate customer verification procedures are deployed before commencement of the relationship. It is also hard to judge how the screening procedures for identification of PEP and Sanctioned entities/individuals are implemented by the organizations.

KYC data refresh

Another key element of the AML monitoring requirement is the need to keep relevant KYC data attributes up-to-date.

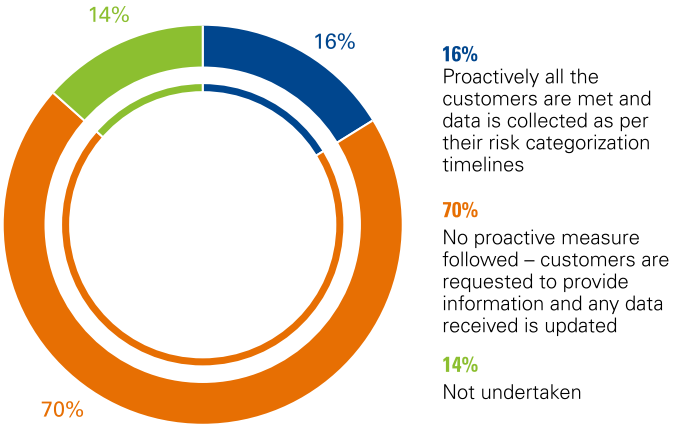
The local regulatory requirements state that KYC data refresh should be done once in two years for high and medium risk customers and once in five years for low risk customers. 70 percent of the respondents do not follow any proactive approach to collecting customer data. Surprisingly, 14 percent of the respondents do not undertake any periodic updation of existing KYC at all. *(refer to Figure 10)*

Figure 9: Which of the following best describes the procedures adopted by your organization?



Source: KPMG in India's AML survey 2012

Figure 10: Which of the following best describes your approach to periodic updation of existing KYC information?



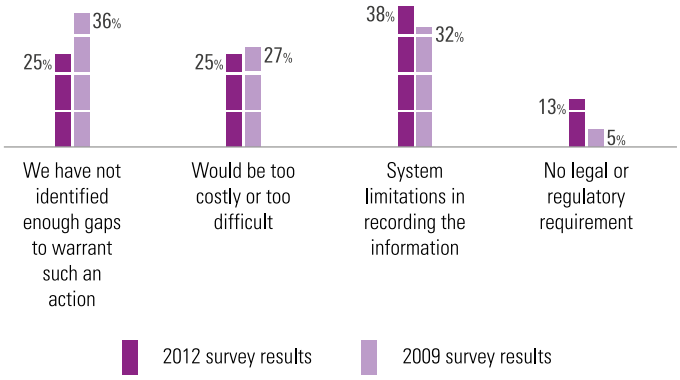
Source: KPMG in India's AML survey 2012

On-going due diligence

72% of the respondents stated that they have specific procedures in place for updating the principal information on an ongoing basis which comprises of collecting customer information and data to fill any gaps that might exist in the KYC process.

Other respondents who do not have a proactive strategy in place to update KYC records have cited various reasons such as system limitations, cost and lack of legal mandates *(refer to Figure 11)*.

Figure 11: Why is there no program in place to update the principal information?



Source: KPMG in India's AML survey 2012

On comparing the responses to the 2009 survey results, we note that this year only 25 percent of the respondents have stated that they do not have enough gaps in the system to warrant such an exercise against 36 percent in 2009. This shows that respondents have become aware of the need to have updated information about customers on an ongoing basis.

Another reason that also gets highlighted this year is the existence of system limitations – 38 percent this year versus 32 percent in the 2009 survey. This shows that instead of any fundamental policy level issues in not conducting the activity, the main hurdle in implementing an effective remediation policy is at the operational level.

Do we really know our customers?

A robust compliance program needs to take into consideration all aspects in the customer life cycle from customer identification to customer acceptance and periodic review of customer information. While financial institutions have come a long way in following requisite due diligence procedures and adopting global best practices, the survey results also lead us to question the extent of the level of control that organizations have on their KYC compliance programs.

As evident from the responses, many organizations are still struggling with basic issues like customer identification and acceptance programs and also few others such as beneficial owner identification, KYC refresh exercises and on-going due diligence programs. The frequent challenges faced by organizations in implementing adequate and robust processes in place is due to non-cooperative customers, inadequate strategy, employee training issues, co-ordination problems and inconsistent policies and processes across geographies. In addition, at a later stage, due to regulatory scrutiny they might also be mandated to conduct look back reviews and remediation plans. If customer behavior were static, then the entire process would be finalized once and for all; but in this scenario where customer profile and preferences keep changing with time, organizations need to have an ongoing oversight on the customer.

Regulatory scrutiny is bound to increase in the next few years as domestic regulations are being benchmarked against the global AML framework. This will entail that regulators might be more inclined to award fines/ penalties in the event of non compliance of the regulatory guidelines as is evident in some of the western geographies such as the US. Penalties applied in ASPAC jurisdictions have been relatively small by European and US standards[5].

A sizable majority of respondents have also stated that senior management is taking a keen interest in the development of their AML framework while making the effort to benchmark their policies and procedures with global best practices. While this is a good sign, organizations need to move away from the mindset of satisfying only the minimum regulatory requirements and actively take it forward to proactive levels of compliance. In our opinion, data gathering is only the first step in the process of identifying the customer. Once the required data has been captured, organizations need to convert this into meaningful customer profiles which would help to identify behavior and manage money laundering risks more effectively.

5 Finding iterated in the KPMG Global Anti-Money Laundering Survey 2011

Client screening, Transaction filtering and Monitoring

Global financial institutions have paid millions in financial penalties for breach in their sanction compliance programs, lapses in transaction monitoring and non-identification of PEPs. The financial sector in India needs to realize the growing importance of investing a larger portion of their resources in building world class operations in the areas pertaining to PEP identification, transaction monitoring and sanction compliance.

Politically Exposed Persons (PEP)

One of the major cornerstones in AML is screening of transactions and customers. The current regulatory guidelines require institutions to identify politically exposed persons and also carry out sanction screening against United Nations list.

Globally, there has been increased focus on PEP screening due to multiple factors such as recent events in the Middle East and Africa. While the Indian financial sector shares global concerns on PEP status, the ASPAC including the India region, lags behind on the actual identification and monitoring process of PEPs. In the ASPAC region only 73 percent of the respondents[6] identify and monitor PEPs. The trend in India is no different as only 77 percent of the institutions have specific procedures in place, using a combination of commercial lists and the vigilance of branch staff to identify PEPs *(refer to Figure 12)*.

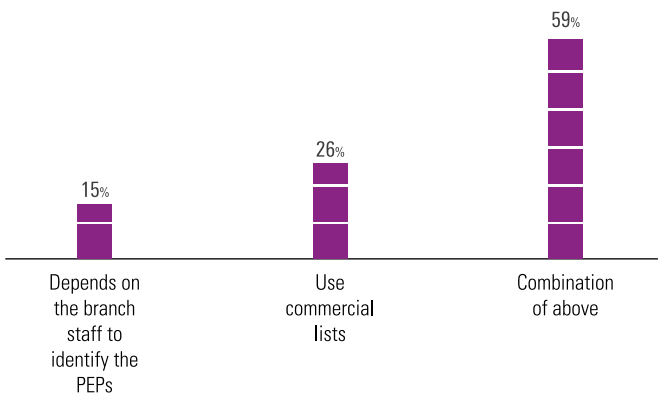
This lag can mainly be attributed to the fact that while the FATF has issued guidelines, there is no global definition of a PEP. There is ambiguity in terms of the definition of a person considered as a 'senior' as well as the extent of coverage towards family, relatives and friends. The definition also talks about prominent public function but does not give any indication as to what they refer to and thus adds more ambiguity to the whole definition of PEP.

In addition, the interpretation of PEP varies between countries. Some countries focus on foreign political figures while others limit the definition to the national level; also including regional politically exposed persons

Sanction screening

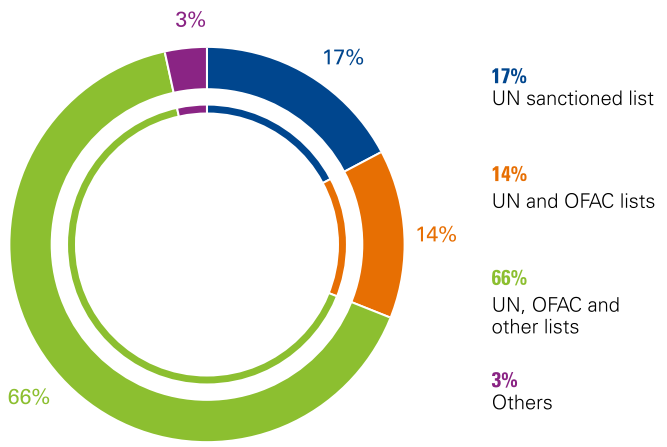
83 percent of the respondents have stated that they undertake sanction screening of customers before account opening, with a majority referring to the United Nations (UN) list, Office of Foreign Assets Control (OFAC) and other lists. The local regulation requires screening against the UN list while the global best practice is to generally use multiple lists such as the UN, OFAC, SDN (Specially designated Nationals list issued by the US department of Treasury) and Blocked list, Her Majesty's treasury list, EU terrorism list, Interpol, CBI (Central Bureau of Investigation) and others. Indian organizations have been using a combination of lists *(refer to Figure 13)* for the sanction screening process and hence have benchmarked this activity with its global counterparts.

Figure 12: How do you identify PEP's?



Source: KPMG in India's AML survey 2012

Figure 13: Which lists are used by you for the purpose of screening customers?



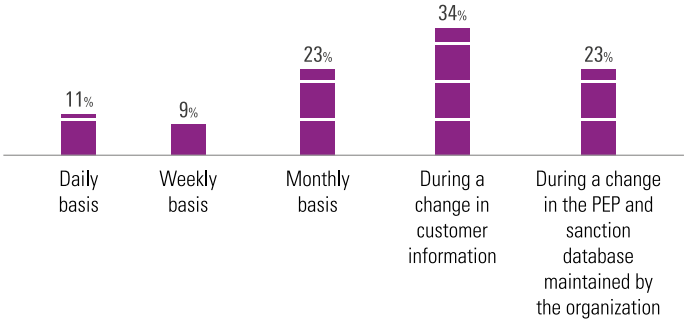
Source: KPMG in India's AML survey 2012

6 Statistic from the KPMG Global Anti-Money Laundering Survey 2011

While it is comforting to know that global practices are followed, 72 percent of the respondents have stated that they screen beneficial owners against sanction list. This needs to be considered under the given circumstances wherein 16 percent of them do not identify beneficial owners at all and a further 40 percent of the respondents do not identify the beneficial owners till the natural person. This questions the effectiveness of how the beneficial owners are screened if they are not identified.

By and large, while screening is conducted on at least a monthly basis, 34 percent of the respondents have stated that the process is undertaken at the time of change in customer information *(refer to Figure 14)*. This may be inconsistent with the global approach as the customer demographic information is primarily static in nature and undergoes changes on irregular intervals.

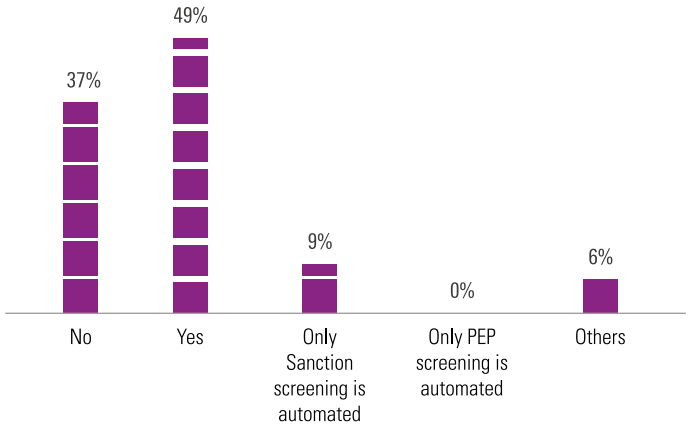
Figure 14: As part of the ongoing monitoring process, how often is a customer's data reviewed against PEP and sanction list?



Source: KPMG in India's AML survey 2012

Another important factor that emerges is that only 49 percent of the respondents have an automated system in place for PEP and sanction screening *(refer to Figure 15)*. This makes it difficult to understand the robustness of the periodic sanction screening process for the customer database as generally the names existing on sanctioned lists have multiple aliases and data sets for individuals and entities.

Figure 15: Do you have an automated system for PEP and sanction screening?



Source: KPMG in India's AML survey 2012

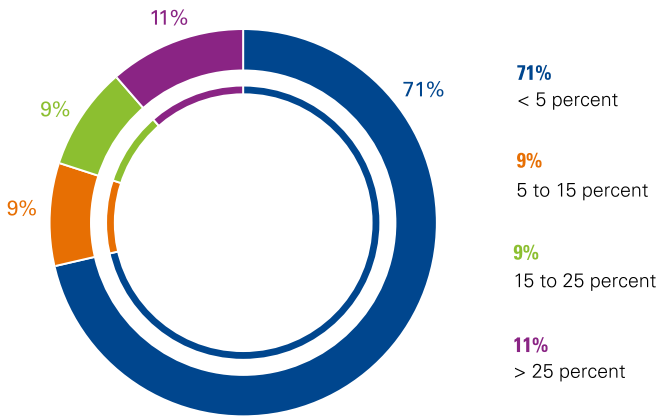
One of the advantages for automating screening procedures is that there would be very minimal chances of manual errors. The automated system would be able to handle multiple lists and use fuzzy logic and phonetics approach to reduce false positives.

Payment filtering

Payment filtering is screening or filtering of relevant payment instructions and is a real time activity. This involves screening of payment information to identify payment instructions involving potential sanction targets and geographies. Surprisingly, only 37 percent of the respondents stated that their organization has an automated system for payment filtering, with the rest either having a manual system in place or planning to introduce an automated system sometime in the future. In the absence of robust controls of real time monitoring of the payments, it cannot be ruled out that potential sanction violations may occur.

63 percent of the respondents replied in the affirmative when questioned whether they include originator information in the SWIFT messages sent to other banks. On asking whether they receive SWIFT messages with originator information from other banks *(refer to Figure 16)*, majority (71 percent) of the respondents stated that they have faced less than 5 percent cases where this information is incomplete.

Figure 16: What percentage of SWIFT messages received by you has incomplete originator information?

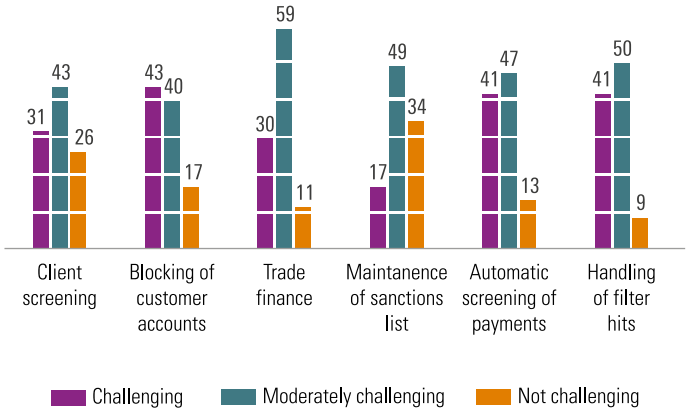


Source: KPMG in India's AML survey 2012

The absence of complete originator information for transactions affected through SWIFT puts a question mark on the payment filtering process. With organizations relying on their counterparts for adequate due diligence on the originator information which is not shared with them, this lacuna hole could be used by money launderers to circumvent the financial systems.

Challenges being faced in Sanction compliance

Figure 17: How would you describe the following areas of sanctions compliance?



Source: KPMG in India's AML survey 2012

In excess of 70 percent of the respondents found client screening and the handling of filter hits either challenging or very challenging, while 35 percent of the respondents did not consider sactions list management to be a challenge *(refer to Figure 17)*. This is surprising, given the regular complaints about duplication of names on different lists, lack of identifier information and the difficulty of getting lists uploaded into filtering systems with the 24-48 hours timeline that the authorities expect adherence to. These findings are complementary and in proportion to our Global Anti-Money Laundering Survey 2011 as well.

Similarly, in relation to payment filtering, the key challenge lies with automatic screening of payments and handling of filter hits. The difficulty arises in relation to management of false positives which increases in number due to incomplete customer information available with organizations.

Transaction monitoring

The monitoring of transactions to ensure that they are consistent with the institution's understanding of the customer behavior is the cornerstone of any financial institutions' AML systems and controls.

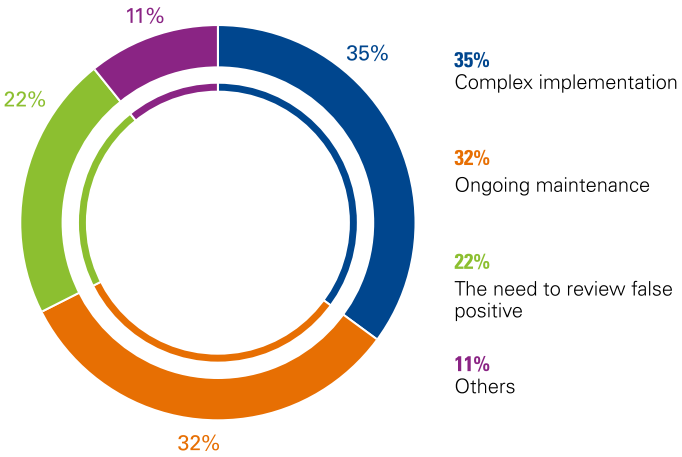
Almost 63 percent of the respondents appear to be satisfied with their transaction monitoring system. A large number of respondents also depend on the vigilance of their staff to identify suspicious activity or by investigation of exception reports *(refer to Figure 18)*.

Figure 18: Which of the following methods are used by your organization to monitor transactions in order to identify potential money laundering?

Source: KPMG in India's AML survey 2012

An overwhelming number of respondents (89 percent) mentioned that increased levels of human and financial resources were required. This was due to multiple factors such as complex implementation, ongoing maintenance and need to review the false positive *(refer to Figure 19)*.

Figure 19: Increase in the level of human and financial intervention is due to?



Source: KPMG in India's AML survey 2012

On delving further into transaction monitoring, it appears that customer profiles and risk categorization does not reside in the transaction monitoring system as indicated by 49 percent of the respondents. Additionally, 46 percent of the respondents have indicated that they do not have the capability to view single customer transactions and account status across products and business. This also questions the use of IT systems developed internally instead of using externally developed IT systems which generally encompass an overall IT framework in relation to the organization. The inability of a financial institution to monitor transactions across different products or business, calls into question their capability of a consolidated and comprehensive AML transaction monitoring system.

In our view, ongoing monitoring is an essential requirement and only a few organizations are able to use the data collected and profile created for customers to leverage the identification of suspicious transactions. KYC and transaction monitoring processes are distinctly separate functions which operate in silos. Hence the holistic view of the customer and related transactions are not available for the purpose of transaction monitoring in turn reducing its effectiveness.

Are we doing enough?

A comprehensive review of the survey responses has made us question if the industry is doing enough to combat money laundering and terrorist financing.

The transaction monitoring system needs to be geared to have a single view of the customer across products and services so that a holistic view of the customer relationship can be judged. This would ultimately help to comprehend whether the customer transaction is suspicious or not. Similarly, the customer risk categorization should be strong enough to decide the extent of monitoring for different types of customers (RBI regulatory guidelines state that transaction monitoring should be high for higher risk categorized customers). With half of our survey respondents stating that their customer risk categorization resides outside the transaction monitoring system, this needs to be reviewed.

The threshold for transaction monitoring is another area which may be improved by using statistical modeling and judging the risk perception of the organization to identify the right mix of thresholds for different types of customers and their risk categorization.

Sanctions screening for customers and payments to date have focused almost exclusively on screening official lists. Knowledge of this fact, coupled with the publicity surrounding financial penalties across the globe means money launderers seeking to evade sanctions will inevitably adopt an approach to circumvent these controls. It will become increasingly important to conduct screening against lists containing relevant geographic indicators such as cities and ports, particularly when dealing with trade finance.

The key concern for sanction screening is the duplication of names on different lists and the perennial concern about the amount of identifier information included in such lists. Surprisingly, only 17 percent of survey respondents stated that they find maintenance of sanctions list challenging. Globally, firms spend enormous amounts on screening customers and payments. In this environment, firms have to focus on ensuring effective screening of payments. Institutions should look to get their own houses in order before tracking others in the market that do not provide the necessary information for screening. The effectiveness of this screening is reduced, however, if everyone is not doing the same.

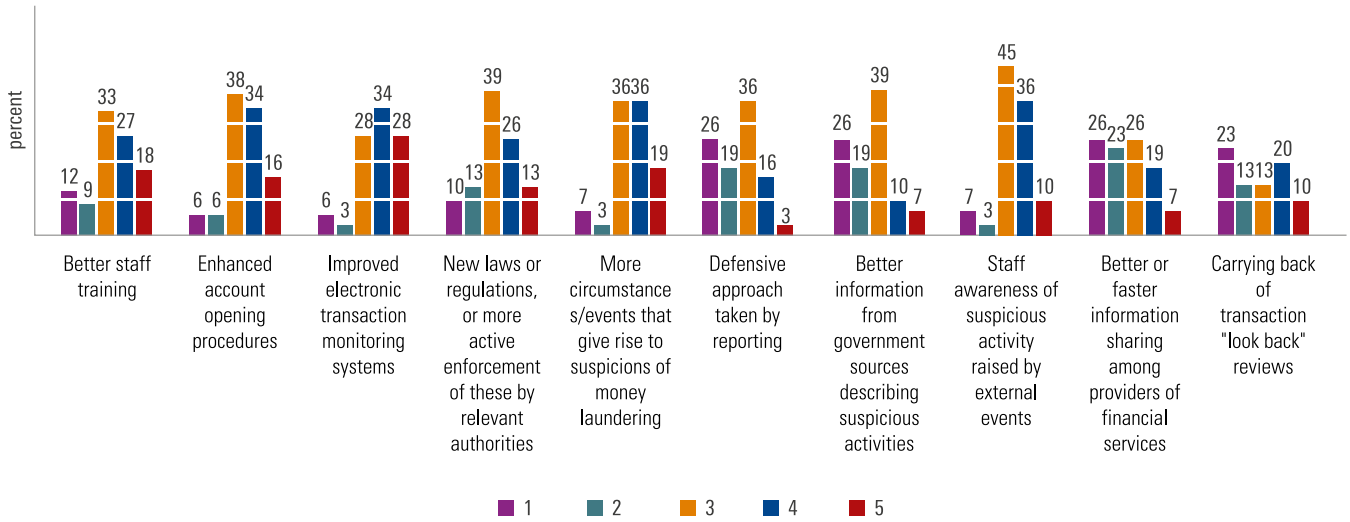
The challenges highlighted above in both the areas of Transaction Monitoring and Sanctions Compliance indicate an underdeveloped or rudimentary system which would require investment to be made in areas of building IT capabilities encompassing the customer profile, risk ratings and financial transactions. Non availability of expert tools for transaction monitoring, customer and payment screening can hamper the AML program of an organization. Thus we believe that Indian organizations need to realize the importance of fully integrating AML as a risk management practice keeping in mind all the various AML related processes such as transaction monitoring, sanction and PEP compliance.

Reporting

More than half (60 percent) of the respondents indicated that there has been an increase in the STRs filed by the organization to the FIU.

A major attribute to this *(refer to Figure 20)* is staff awareness, improved interactions with regulatory bodies, increased regulatory scrutiny and enhanced due diligence procedures following suit. A defensive approach to reporting more cases is also a significant factor.

Figure 20: If there has been an increase in the STRs filed to FIU, could you define the impact each of the following 8 reasons had on the increase, on a scale from 1 to 5, where 1 is no impact at all and 5 is very strong impact.



Source: KPMG in India's AML survey 2012

Training

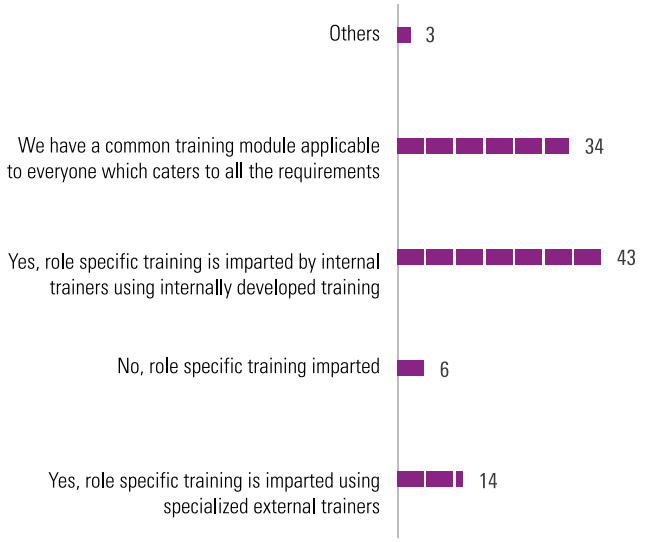
It is essential that financial institutions are equipped with the appropriate resources to tackle money laundering risks. This does not only include technological solutions, but also the provision of training and tools to assist those in the 'front office' who are best placed to identify riskier transactions, such as relationship managers and private bankers.

Most organizations today impart AML training directly to their staff – majority of who concentrate on role specific training using an internally developed training module *(refer to Figure 21)*.

While face to face and computer based training appear to be the most popular methodologies *(refer to Figure 22)* adopted, 85 percent of the respondents have their internal compliance team taking the ownership of AML training. Thus, organizations have not had the benefit of industry best practices as they have primarily been internally developed and conducted.

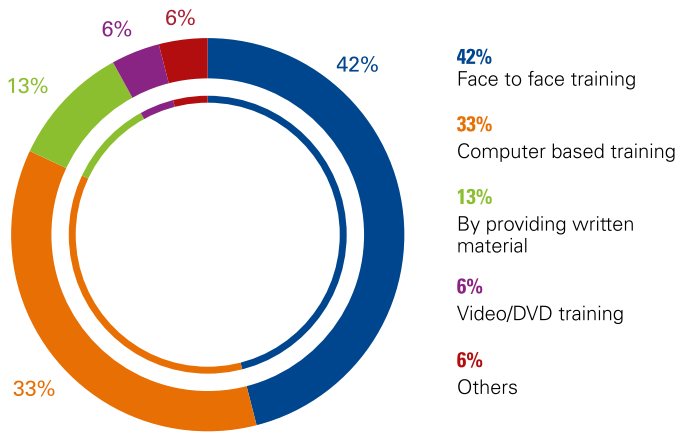
The mindset however does seem to be changing for the better with a majority of the respondents having specified training to be a major area for investment in the days to come.

Figure 21: Do you conduct role specific training for staff handling transaction monitoring/cross border payments/ branch staff/AML compliance division and operation teams?



Source: KPMG in India's AML survey 2012

Figure 22: What methods are used to deliver AML trainings?



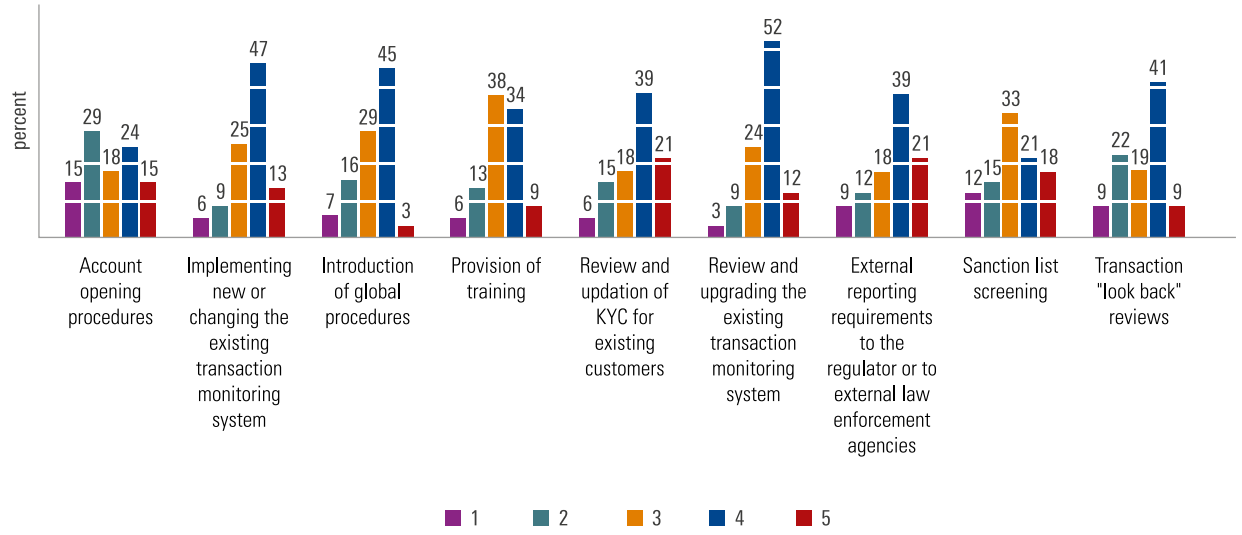
Source: KPMG in India's AML survey 2012

Cost of compliance

To keep up with the regulatory environment, sound investments are required in customer due diligence, customer identification & acceptance procedures, monitoring suspicious transactions and related AML processes and procedures. This will lead to improved confidence amongst various stakeholders domestically and allow organizations to explore greater business opportunities in the international arena in developed economies which may have stringent AML regulations.

An overwhelming 82 percent of respondents indicated that the cost of AML compliance will increase over the next 3 years, with investment being mostly in the area of 10 to 20 percent. The majority of the increase would be *(refer to Figure 23)* in the area of implementing/upgrading their transaction monitoring system followed by implementing global policies and remediating/refresh exercise.

Figure 23: Out of the nine areas of anti money laundering activity, could you define relatively how much investment each area will need in the next three years, including all direct and indirect costs on a scale from 1 to 5, where 1 is no investment at all and 5 is great investment required



Source: KPMG in India's AML survey 2012

It is surprising that not many respondents feel that the cost of sanction screening will be very high which is slightly in variance with the current status of implementation. As per the responses 37 percent of the respondents do not have an automated system for PEP and sanction screening. Similarly, customer screening is conducted as and when there is a change in sanction and PEP databases, as indicated by 34 percent of the respondents. In our opinion, the respondents have under estimated the cost to be incurred towards screening activity.

However, it is interesting to note that institutions are increasing their focus towards transaction look back reviews. This can be considered as a maturing of the compliance program and a welcome proactive step.

While in the 2009 survey, more than 73 percent had indicated that cost will increase over the next three years, in the current survey, over 82 percent have indicated the same. Compared to the 2009 survey where introduction of global polices and transaction monitoring were indicated as the major focus areas needing investment, the current survey also indicates the same in addition to remediation/refresh exercise. This indicates that the cost of AML compliance is going to keep rising and institutions may be underestimating costs or deferring the investments required.

Tightening the noose: Recommendations to amend the PMLA, 2002

Regulators and the Indian Ministry are definitely taking charge, with amendments currently in progress on the Prevention of Money Laundering Act, 2002 and Unlawful Activities (Prevention) Act, 1967 to make them more effective in dealing with money laundering and terror funding. With the act having been amended twice in 2005 and 2009, the proposal of this new amendment bill is a positive sign. It will help to bring us at par with international standards and to obviate some of the deficiencies existing in the act. The amendment is necessitated by the fact that India is an important member of the FATF and chairs its Asia Pacific group.

The PMLA amendment act 2011 plans to bridge the gap between the FATF recommendations and the Indian regulatory requirements with respect to enacting of strong and effective anti money laundering laws and to remove operational difficulties for the regulators and government agencies implementing these regulations. Thus eventually make the existing PMLA in tune with the practice being followed world over.

Key changes under PMLA amendment bill 2011
Introduce and recognize corresponding law provisions of other countries in respect to money laundering offences and to provide for transfer of proceeds of foreign offences in any manner in India
Increase in power of directors to call for records and conduct inquiries and direct audits in cases of non compliance of obligations
Reporting entity to include banks, financial institutions, intermediaries or a professional including persons engaged in real estate business and/or jewelry business
Money-laundering definition widened to include concealment, acquisition, possession and use of proceeds of crime
Removal of upper cap for fine of INR 5 lakh and no caps prescribed
Attachment and confiscation of the proceeds of crime without conviction in proven cases of offence
Provision for appeal against appellate tribunal's order directly to the Supreme Court
Responsibility of omissions and commissions on reporting entity, Board of directors and employees
Addition of multiple persons/ entities including members of ICAI, ICWAI, ICSI to assist the authorities in the enforcement of this Act.

Conclusion

The integrity of the banking and financial services marketplace depends heavily on the perception that it functions within a framework of high legal, professional and ethical standards. A reputation for integrity is one of the most valuable assets of a financial institution. A damaged integrity of a financial institution can lead to a damping effect on a country's growth aspects when a country's commercial and financial sectors are perceived to be subject to the control and influence of organised crime. Fighting money laundering and terrorist financing is therefore a part of creating a business friendly environment which is a precondition for lasting economic development.

This is not to say that we are not headed in the right direction. We are on the right path with India having tripled the manpower of the Directorate of Enforcement[7] which spearheads the money laundering investigations in the country; presence of the Financial Intelligence Unit which tracks and analyses money laundering risk through its reporting mechanism; and the recent updation of the legislative framework through the proposed changes. Some of other positive signs are the existing unified KYC platform for the mutual fund industry and a similar platform being mooted for the insurance sector.

However what needs to be done further is increased enforcement and action against the entities violating them. Further, financial institutions need to bring in additional levels of control in relation to few areas highlighted in the survey like transaction monitoring, annual review and periodic updation of accounts that is legally mandatory. It is clear that the maturity of the AML environment is varied between MNC, public sector, private sector, co-operative banks etc. and the challenge for regulators would be to plug the regulatory arbitrage that money-launderers are able to utilize and eventually exploit the system. However, cost factors would also play a significant role as budgets for institutions do vary, leading to a reduced focus and thus high AML risk.

With India being a member of the FATF which was not an easy process and was only granted after a very stringent evaluation process by the officials of the FATF, we need to be geared up for the increased responsibility and the road that lies ahead. While this might present its own gamut of challenges, regulatory requirements and risk mitigation has to be a key area of focus and cannot be given secondary status.

7 Source: Article in The Times of India dated 19 July 2011 (http://articles.timesofindia.indiatimes.com/2011-07-19/india/29790686_1_money-laundering-act-financial-action-task-force-laundering-and-terror-funding)

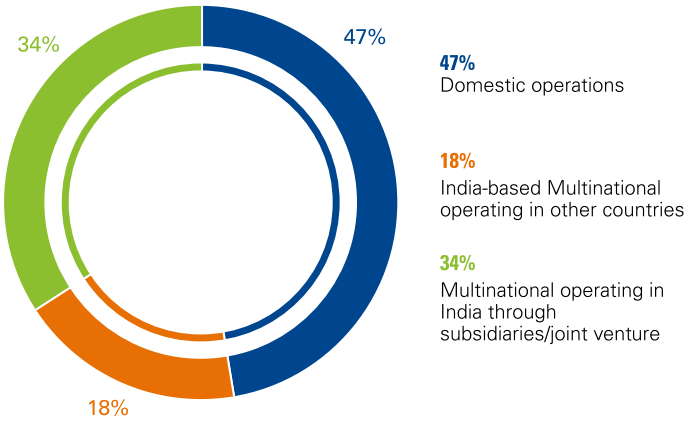
Profile of respondents

We have made a conscious attempt to include a variety of institutions with different sizes and type of operations in order to obtain a detailed picture and an in-depth understanding of the AML regime in India.

The survey was conducted across the financial services sector covering public sector banks, private sector banks, foreign banks, general and life insurance companies, mutual funds, non-banking financial companies and other institutions in the FS sector covered under PMLA.

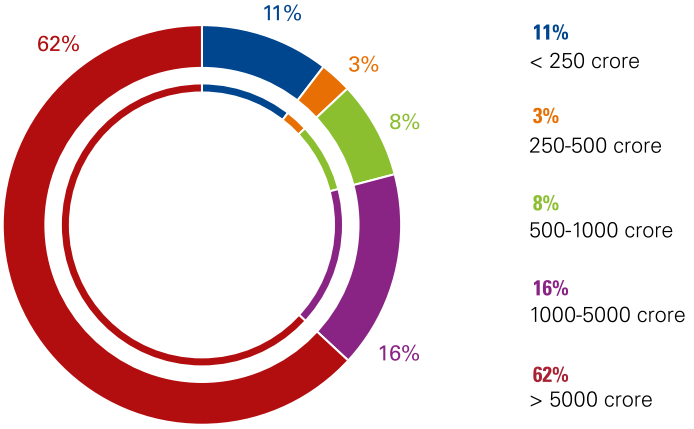
The primary target respondents of the survey were senior and mid management members from Compliance, Audit, Risk Management and AML departments. The respondents were also senior management members from the business and operation functions.

Figure 24: Scope of respondent organization's operations



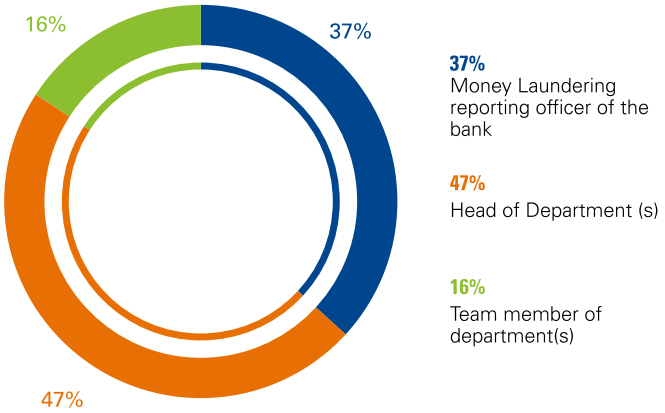
Source: KPMG in India's AML survey 2012

Figure 25: Annual turnover of respondent organizations (in INR)



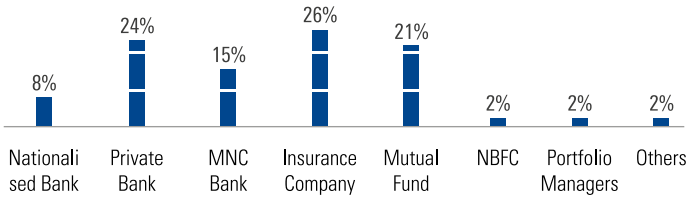
Source: KPMG in India's AML survey 2012

Figure 26: Designation of respondents



Source: KPMG in India's AML survey 2012

Figure 27: Type of organization that respondents represent



Source: KPMG in India's AML survey 2012

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