'KYC' and Anti-Money Laundering Measures

The concept of KYC (Know Your Customer) is 'to know the five basics', among others, of a customer—Nature, Source, Location, Ownership, and Purpose. KYC has become the utmost need of the hour for banks in the wake of the fast spreading money-laundering menace across the globe. This article attempts to summarise the various RBI guidelines on KYC and Anti-Money Laundering Measures, and the relevant provisions of Prevention of Money Laundering Act (PMLA) – 2002, from the angle of audit function.

The term 'Money Laundering' is self-explanatory. This is a menace in which a fraudster disguises the source and ownership of money earned from illegal activities and converts it into legitimate money by using banking channels. How to safeguard the banking system from this hazard has always been a great concern for every Government and Regulators, prompting them to take appropriate preventive and remedial measures from time to time. For instance, the Reserve Bank of India (RBI) has, among various steps, also prescribed—

(a) Fixing Monetary Ceilings on transactions (Cir. No. DBOD.BP.BC.114/C/469(81)-91 dated April 19,1991 prescribing that issue of TC, DD, MT, TT for Rs. 50,000 and above against cheques and not against cash), and

(b) Recording and internal monitoring of large cash transactions of Rs. 10 lakh and above on fortnightly basis (DBOD.BP.BC.57/21.01.001/95 dated May 4, 1995), etc.

In fact, the RBI has, particularly in last 4-5 years, issued several guidelines on KYC Norms and Anti-Money Laundering Measures in Banks. To comply with these guidelines, the Banks are seeking Reports/Certificates from their Concurrent/Internal Auditors with their comments on effectiveness of the related measures taken by their branches, in order to put up a Note on Compliance before ACB (Audit Committee of Board)/Board of Directors at quarterly intervals. The significance of this RBI exercise can be gauged by a series of punitive actions taken by the regulator in the recent past for Non-compliance of these norms and guidelines. Thus, it has become essential for Bank Auditors to keep themselves updated with these requirements.

— CA. Ishwar Chandra

(The author is a member of the Institute. He can be reached at ishwar_c1002@rediffmail.com)

KYC—Know Your Customer

Though no precise definition has been given for the term KYC, yet in the background of the concept, the meaning could be understood as "To know the five basics, among others, of a customer: 1) Nature 2) Source 3) Location 4) Ownership, and 5) Purpose."

RBI had issued a circular DBOD.AML. BC.18.14.01.001/2002-03 dated August 16, 2002 on 'Guidelines on Know Your Customer norms and Cash Transactions' emphasising the following, in addition to the above-mentioned ceiling and monitoring requirements:

(i) Formulation of KYC Policies and procedures specifying the objective of KYC framework as twofold:

  (a) appropriate customer identification, and

  (b) to monitor transactions of a suspicious nature. However, the term 'suspicious' is not defined.

(ii) Risk Management and Monitoring Procedures: stating specifically about

  (a) Having a system at branch level to exercise caution against the transactions by the terrorist entities as notified by the Government.

  (b) Identification and reporting of suspicious transactions.

  (c) Adherence to FCRA–1976, to open accounts or collect cheques only in favour of associations which are registered under the act ibid Government of India.

(d) Adequate internal control system to ensure full compliance to KYC programme.

(iii) Record keeping for five years after the transaction has taken place.

(iv) Training of staff and management.

Paragraph 5.3 of this circular mandates the duties of Internal Audit and Inspection function as:

"(i) An independent evaluation of the controls for identifying high-value transactions should be carried out on a regular basis by the Internal Audit Function.

(ii) Concurrent/Internal Auditors must specifically scrutinise and comment upon the effectiveness of the measures taken by Branch in adoption of KYC Norms and steps towards prevention of money laundering. Such Compliance Report should be placed before the Audit Committee of Board of Banks at quarterly intervals."

Key Elements of KYC Norms

In the context of recommendations of Financial Action Task Force (FATF) on Anti Money Laundering Standards and on Combating Financing of Terrorism (CFT) and paper issued on Customer Due Diligence by Basel Committee on Banking Supervision, RBI had issued a Circular No. DBOD.AML.BC.58.14.01.001/2004-05 dated November 29, 2004 on 'Guidelines on KYC Norms and Anti-Money Laundering Measures'. This specified following four, amongst others, key elements of KYC policies to be framed at banks:

(i) Customer Acceptance Policy

(ii) Customer Identification Procedures

(iii) Monitoring of Transactions

(iv) Risk Management

And a broad definition of 'Customer' was adopted for this purpose and defined as:

- A person or entity that maintains an account and/or has a business relationship with the bank.
- Beneficial owner.
- Beneficiaries of transactions conducted by professional intermediaries such as stock brokers, CAs, Solicitors, etc.
- Any person or entity connected with a financial transaction—which can impose significant risks to/harm the reputation of the Bank—such as wire transfer or issue of a single high value DD.

Thus, it signifies that KYC norms are applicable to all persons having business relation and even not having any account with the bank.

(i) Customer Acceptance Policy

The RBI has advised Banks to formulate a Customer Acceptance Policy, keeping in view various factors including documentary requirements of PMLA-2002, and suggested the following broad aspects of customer relationship:

(a) Not to open an account in anonymous or fictitious/benami name(s).

(b) Parameters of risk perception in terms of nature of business, location, volume of turnover, etc. Risk has been considered as low where the identity and source of wealth are easily identifiable such as salaried employees, while in case of non-resident persons, trusts, companies, etc. as high.

(c) Documentation requirements on the basis of perceived risk.

(d) Not to open an account or close an existing account where bank is unable to verify the identity and/or obtain documents required as per the risk categorisation.

(e) Circumstances in which a customer is permitted to act on behalf of another person/entity. For instance, opening of account by intermediaries in fiduciary capacity.

(f) Necessary checks to be carried out before opening an account.

Since these are broad aspects to be incorporated in the Policy, it has been left to the banks to decide on the contents of policy. However, the intention of the regulator is clear—to scan the customer to understand the customer and his dealings. Audit and Inspection Function is to examine the existence of such documented policy and its awareness amongst branch staff. This policy needs to be duly demonstrated at branches to educate the customers.

(ii) Customer Identification Procedures

Customer Identification has been defined as identifying the customer and verifying his/her identity by using reliable, independent source documents, data or information. Emphasis has been laid on verifying customer identity not only while establishing a banking relationship but also at the time of executing a transaction or when the bank has a doubt about the authenticity/veracity or the adequacy of the previously obtained customer identification data. Circumstances of doubt/inadequacy of identification data are still subjective. Though a step-wise procedure has not been laid down by the RBI, yet it has been suggested that for natural persons, banks should obtain sufficient identification data to verify the identity of the customer, his address/location and also his recent photograph, while for legal persons/entities, extra caution has been suggested. An indicative list of documents/information to verify the identity, address and other features suggested in Annexure II of this circular is given in Table A on the next page.

As this list is indicative in nature, various banks have been adopting different practices of obtaining different documents to verify different features. For instance, a few accept a Ration Card as address proof, while others do not. So, while discharging their duties, auditors have to apply their own judgment about the reliability of the document and its source.

(iii) Monitoring of Transactions

This element suggests that banks should pay special attention to all complex, unusually large transactions and all unusual patterns, which have no apparent economic or visible lawful purpose. As a precautionary measure, the RBI has advised banks to maintain proper records of all cash transactions (deposits and withdrawals) of Rs. 10 lakh and above, with internal reporting of such transactions every fortnight. However, the terms 'unusually large transactions' or 'unusual patterns' are still relative terms, and no uniform limit could be fixed for all customers. To decide the unusual pattern will require much information from the customer such as volume of turnover etc. and auditors have to apply their own judgment.

(iv) Risk Management

This element suggests creation of Risk Profiles of their existing and new customers on the basis of various factors such as type of constitution whether individual, firm, company, trust etc and to apply various anti-money laundering measures keeping in view the risks involved in a transaction/account. In addition to this, the RBI has stressed proper

TABLE A	
Features	**Documents**
FOR INDIVIDUALS	
– Legal name and any other name used	Any one of the following: (i) Passport (ii) PAN Card (iii) Voter identity card (iv) Driving licence (v) Identity card (subject to the bank's satisfaction) (vi) Letter from recognised public authority or public servant verifying the identity and residence of the customer to the satisfaction of the bank
– Correct permanent address	Any one of the following: (i) Telephone bill (ii) Bank account statement (iii) Letter from recognised public authority (iv) Electricity bill (v) Ration card (vi) Letter from employer (subject to the bank's satisfaction)
FOR COMPANIES	
– Name of the Company	(i) Certificate of Incorporation and MOA & AOA
– Principal place of business	
– Mailing address of the Company	(ii) Resolution of the Board of Directors to open an account and identification of those who have authority to operate the account (iii) Power of attorney granted to its managers, officers or employees to transact business on its behalf (iv) PAN allotment letter
– Telephone No. /Fax No.	(v) Telephone Bill
FOR PARTNERSHIP FIRMS	
– Legal name	(i) Registration Certificate, if registered
– Address	(ii) Partnership Deed
– Names of all partners and their addresses	(iii) Power of attorney granted to a partner or an employee of the firm to transact business on its behalf (iv) Any officially valid document identifying the partners and the persons holding power of attorney and their addresses.
– Telephone no. of the firm	(v) Telephone Bill
FOR TRUSTS & FOUNDATIONS	
– Names of the trustees, settlers, beneficiaries and signatories	(i) Certificate of registration, if registered (ii) Power of attorney granted to transact business on its behalf
– Names and addresses of the founder, the managers/directors and the beneficiaries	(iii) Any officially valid document to identify the trustees, settlers, beneficiaries and those holding power of attorney, founders/managers/directors and their addresses (iv) Resolution of the managing body of the foundation/association
– Telephone/Fax No.	(v) Telephone Bill

management overseeing, systems and controls, segregation of duties and the requirement of ongoing employee training programmes regarding KYC procedures.

Paragraph 5 of this circular emphasised the role of Audit Function as "Banks Internal Audit and Compliance functions have an important role in evaluating and ensuring adherence to the KYC policies and procedures. As a general rule, the compliance function should provide an independent evaluation of the Bank's own policies and procedures, including legal and regulatory requirements. Banks should ensure that their audit machinery is staffed adequately with individuals who are well versed in such policies and procedures. Concurrent/Internal Auditors should specifically check and verify the application of KYC Procedures at the branches and comment on the lapses observed in this regard."

Besides the above four key elements of the KYC Policy, the RBI has also put emphasis on the requirement of adequate Customer Education and

Appointment of Principal Officer to monitor the compliance of these norms.

It is also pertinent to mention here that the deadline for being fully compliant with this circular's provisions has already expired on December 31, 2005.

Applicability to Existing Customers

These are applicable for both new and those existing customers in whose case the credit or debit summation for the financial year ended March 31, 2003 is more than Rs. 10 lakh or where unusual transactions are suspected. However, trusts, companies/firms, religious/charitable organisations and other institutions where the accounts are opened through a mandate or power of attorney have not been relaxed by application of KYC Procedures.

(DBOD.AML.BC.101.14.01.001/2003-04 dated June 21, 2004)

Simplification for Small Customers

If a person is unable to produce documents as mentioned in suggestive list given in Annexure II (reproduced as Table-A) of RBI Circular No. DBOD No. AML/BC.58.14.01.001 /2004-05 dated Nov. 29, 2004, a limited relaxation was extended (vide Cir. No. DBOD.AML.BC.28.14.01.001/2005-06 dated Aug. 23,2005), if:

(a) Balance is not exceeding Rs. 50,000 in all their accounts taken together, and (b) the total credit in all the accounts taken together is not expected to exceed Rs. 100,000 in a year, subject to introduction from another at least six-month-old account-holder gone through complete KYC Procedures and showing satisfactory performance. The photograph is also to be verified by such introducer. Thus, while relaxing the need to provide certain documents, RBI has not relaxed from examining the issue of identity and genuineness. Further, RBI has suggested stopping the transactions as and when balance reaches Rs. 40,000 and turnover reaches Rs. 80,000 by notifying the customer.

Here, it is pertinent to mention from the angle of Audit function that by this ceiling requirement, Banks have been suggested to keep all account information of customer in an integrated manner so that balances/turnover in different accounts could be known and notified to the customer. However, the circular does not specify whether this includes all types of accounts of a customer e.g. SB, CD, TD and Loan accounts or not. In my view, it should be interpreted to aggregate all deposit accounts or loan accounts separately.

Obligations Under Prevention of Money Laundering Act, 2002

Section 12 of PMLA-2002 casts following reporting obligations for Banking Companies, to Director, FIU-IND, and Financial Intelligence Unit - India, besides obligations of record keeping and preservation of information.

(i) Cash Transaction Report (CTR)

- (a) all cash transactions of the value of more than Rs. 10 lakh or its equivalent in foreign currency;
- (b) all series of cash transactions integrally connected to each other, which have been valued below Rs. 10 lakh or its equivalent in foreign currency where such series of transactions have taken place within a month and the aggregate value of such transactions exceeds Rs. 10 lakh;
- (c) all cash transactions where forged or counterfeit currency notes or banknotes have been used as genuine and where any forgery of a valuable security has taken place. However, individual transactions for below Rs. 50,000 are not to be included in CTR.

(ii) Suspicious Transactions Report (STR)

Suspicious transactions mean a transaction whether or not made in cash which, to a person acting in good faith:

- (a) gives rise to reasonable ground of suspicion that it may involve the proceeds of crime, or
- (b) appears to be made in circumstances of unusual or unjustified complexity, or
- (c) appears to have no economic rationale or bona fide purposes.

Principal Officer of banking company has to record the reasons of suspicion and to send the report.

CTR and STR are mandatory to be submitted by 15th and 7th of next month respectively.

Suggested Checklist

In addition to verifying various documentary/ other evidences while opening/closing of an account of customer, the following checkpoints (see Table-B), are suggested to verify the compliance of these norms:

Conclusion

The various KYC and anti-money laundering measures like ceilings, internal monitoring, reporting and ongoing neck-deep verification of customers amply prove the tough stand of the RBI and other Regulatory Bodies. Further, by spelling out the duties of auditors as an independent evaluator of policies & procedures, the RBI has stressed the need for Audit Function to have highly focused approach while discharging its duties. However, subjectivity of various audit judgments and ambiguity on various matters still create practical problems for audit & compliance function. Yet, the effectiveness of these measures will be tested on ground by ensuring strict compliance in letter and spirit and a whole-hearted commitment of the Managements. ❐

TABLE B

S.No.	Checkpoint
1	To check that all relevant circulars of RBI/HO/IBA and other statutes such as PMLA-2002 etc. are available at Branch and Front-staff is aware of them.
2	To check whether list of bodies registered under FCRA-1976 to accept foreign contributions is available at Branch. To check whether a Certificate of Registration with GOI is obtained from such organisation to accept foreign contribution.
3	To check whether Branch is maintaining a list of terrorist entities/individuals as notified by Govt./RBI/ IBA. For instance: List notified under POTA-2002.
4	To check whether there is any documented policy of the Bank on KYC Norms and it is duly circulated among staff. To check whether under this Broad policy, provisions on Customer Acceptance Policy are available mentioning circumstances of closure of account by the Bank and stages of customer verification are also mentioned therein e.g. while opening an account, during banking transaction or at the time if any document/information is found to be inadequate.
5	To specifically check wheth er this policy is duly communicated to the Customers. To check whether there are adequate arrangements for Customer Education about these policies and programmes by way of pamphlets/brochures, etc.
6	To check whether any training has been imparted by Personnel Department/ Inspection & Audit Department or any Department and record of such training is available at the Branch.
7	To check if signatures are obtained on reverse of photographs for proper identity verification. Preferably, RBI suggested specific photo-identities are accepted. To check that photographs are strictly not returned while closing the account.
8	To check whether a register of all cash transactions of Rs. 10 lakh & above is maintained and is reported to Controlling offices on fortnightly basis. To check whether computerised system in the Branch enables such report as exceptional Transactions report. If such reports are not generated by the system, it must specifically be mentioned by the Auditors. Besides this, to check if the report on transactions in newly opened accounts is scrutinised by the Branch and heavy/unusual transactions are monitored adequately.
9	To check that cheques/instruments of high value for collection in newly opened accounts are monitored adequately.
10	To check that money transfers of Rs. 50,000 and above (single transaction or in aggregate in a day for a customer) are not done in cash and against cheques only.