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Know-Your-Customer

The International Monetary Fund has estimated that the aggregate size of money laundering in **the world is between two and five percent of the world's gross domestic** product. In a good year, that would be well in excess of one trillion dollars ($1,000,000,000,000), big enough to be one of the top-15 economies of the world[1].

In combating this, anti-money laundering (and counter-terrorism financing) activity expenditure by financial institutions in 2011 alone was estimated at over $5 billion. Between 15-25 percent ($750mm-$1.25bn) was spend on people-related Customer Due Diligence (CDD) operations costs[2].

CDD, more popularly known as KYC (Know-Your-Customer), is regulatory-required and vitally important in the fight against money laundering and terrorist financing and mitigating reputation risk. The costs associated with KYC are largely due to the necessary manual analysis checks that are usually performed in-house by banks and other such regulated institutions. These analysis steps are often based on self-designed processes, managed at varying levels of efficiency, often under-resourced and utilizing expensive internal staff and basic, but costly, self-built or bought-in IT systems.

The focus in this paper is on a process improvement framework that can help both improve quality and lower cost - an all-the-more necessary focus, as, in the 3 years up to 2011, these costs have risen by 45 percent[3] and continue to rise at an estimated 7 percent per year[4].

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[1] Nominal GDP list of countries for the year 2010. World Economic Outlook Database-September 2011, International Monetary Fund. Accessed on September 26, 2011

[2] Celent - Trends in Anti-Money Laundering 2011 - http://www.celent.com/node/28904

[3] http://www.kpmg.com/UK/en/WhatWeDo/Advisory/risk-consulting/global-aml-survey-2011/Pages/default.aspx

[4] Celent, op. cit.

Why KYC?

Simply put, KYC is a legal requirement. Regulated industries in the US and the EU have AML-CTF obligations as defined in the US Patriot Act or the national laws passed as a result of the EU 3rd Directive on Money Laundering. Non-US/EU banks usually have their own national regulations to meet - as well as having to meet their US and EU counter-party requirements.

The requirements are global and regulation is here to stay. The risks and costs of non-compliance are legion - fines, reputation damage and even license loss. The large multi-million dollar / euro fines that have been levied in recent years for failure to comply have made headlines across the world - Wachovia, Barclays, Lloyds TSB, RBS and Credit Suisse have faced penalties ranging from $160mm to $536mm[5] - with ING Bank the current record holder on $619 million[6]; a number of other banks are still talking to the regulators, with one bank facing a reported $1bn+ fine.

Along with an increased focus on financial, capital and liquidity risk, AML is another ever increasing burden. However, AML is not just a regulatory issue.

In addition to real and present financial penalties, institutional reputation damage can be great. Bad press reports, ridicule, perception of lack-of-professionalism etc. can quickly spin out of control, impacting market confidence and creating an impression of risk or uncertainty. Recently, AML has also started to become a consumer issue. As reported in the press[7] and as featured on activist web-blogs and online on You-Tube, the Non-Governmental Organization **"Global Witness" produced a report and video called "Undue Diligence: How banks do business** with corrupt regimes[8].

Global Witness' report presented evidence that linked a great number of renowned (and specifically named) banks to all kinds of shenanigans in the developing world.
Putting this in context: for every $100 million that is misdirected, 250,000 households could have water connections, 50-100 million drug treatments for malaria could be funded or 240 kilometers of two-lane roads paved.

This situation is reminiscent of the casual shoe and runner / sneaker manufacturers child-labor **scandals of the '90s. The resulting consumer unrest at that time lead to brand distress and the** subsequent implementation of wide-ranging and costly Corporate Social Responsibility programs.

Consumer sentiment cannot be underestimated. DSB, a Dutch bank, collapsed quickly in 2010 after a media campaign lambasted their allegedly "unfair" costs and "predatory" practices. A consumer-**activist call for "punishment" caused a (internet**-banking) run on the bank **–** and in this market, no one was willing to step in and buy the bank.

So, at a time when banks and bankers are already portrayed in a bad light, in the midst of consumer and customer unease, failures in AML-CTF can only make matter worse.

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[5] http://www.bankersonline.com/security/bsapenaltylist.html
[6] http://online.wsj.com/article/SB10001424052702303901504577462512713336378.html
[7] Banks, graft and development - Dancing with despots - http://www.economist.com/node/13278728
[8] http://www.globalwitness.org/pages/en/the_role_of_financial_institutions.html

The Need for Improvement

With changing regulation and increasing market competition and consolidation - especially within the context of the current financial crises - banks and other financial institutions need to better manage risk, reduce cost and increase revenues.

KYC is a niche business process and is often costly and inefficient. The real direct and indirect people costs are high and continue to rise. Staffing levels are usually fixed while volumes are volatile & unpredictable. Systems costs are usually a capital expense and a (non-core) distraction for IT. KYC also takes up far too much valuable commercial time from front office Account Managers.

KYC is also a non-core competency requiring the continuous (re-)training of a wide range of senior staff and (re-)investments in non-revenue-generating policy, procedure and process definition. As an often inefficient and infrequently performed non-core activity, quality and morale can suffer, leading to audit issues such as incomplete or out-of-date files and AML customer events going unrecorded or non-investigated.

Furthermore, KYC is also a great source of Client Dissatisfaction with regular annoyance caused by inexperienced or distracted Account Managers failing to complete client on-boarding and periodic reviews in a timely or efficient manner - with particular client irritation caused by confusion and numerous follow-up requests for clarifications, alternative or additional documents etc.

KYC process improvement needs to directly address these cost, efficiency, core, quality and satisfaction issues - and by so doing, improve risk management, reduce costs and support front office staff in their efforts to concentrate more on revenue generating activity.

Process Lessons Learned

Cost, efficiency, core, quality and satisfaction issues are also common problems in many other business process areas.

In looking to improve KYC processes, a number of IT and production quality frameworks can be considered. These may include:

- **CMM** - Capability Maturity Model
- **ITIL –** the Information Technology Infrastructure Library for Service Management
- **COSO** and **COBIT** - financial and IT control frameworks
- **Lean** (often associated with **The Toyota Way** production model) which helps drive organizational (and process) learning
- **Agile**, an iterative IT development methodology that guarantees the time and the cost and maximizes the scope
- **Six-Sigma –** a data driven approach to measurement and defect reduction
- **Balanced Scorecards –** a commonly used strategic performance management (and reporting) approach that usually covers a range of financial, operational, customer and organizational health measurements

It is encouraging to note that according to the Carnegie Mellon Software Engineering Institute (SEI)[9], home to the CMM(I) model, great benefit can be achieved through process improvement.

Costly and inefficient?
– *"measurement, risk management, and supplier (& resource) management incorporate lessons from additional areas of best practice"*

Non-core?
– *"management and engineering (review / approval) activities are linked much more closely to their business objectives"*
– *"additional organizational functions (value–added KYC) are addressed which are critical to an organization's products and services"*

Low Quality?
– *"more robust (and flexible) high-maturity practices are implemented"*
– *"compliance with relevant ISO (and regulatory) standards which embodies closer control"*

Client Dissatisfaction?
– *"scope and visibility of product (KYC) life cycle are expanded to make sure that the product or service always meets customer expectations through improved engineering activities"*

Cost and in-efficiency, non-core, quality and client dissatisfaction issues can all be addressed and mitigated through improved processes. It is also worth noting that since early 2008, KYCnet have demonstrated that these theoretical benefits are indeed real and achievable - in both a KYC-as-a-Service as well as Software-as-a-Service modes.
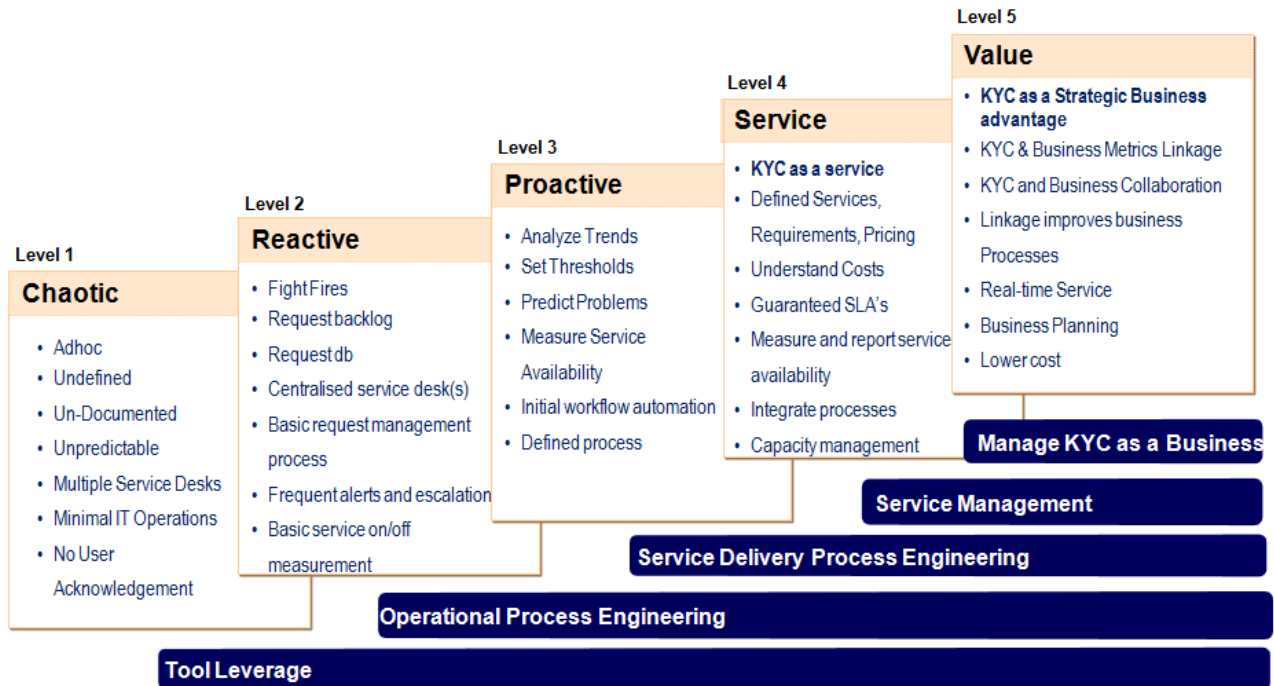
The KYC maturity Model described in this article is intended to serve as a resource and technology agnostic directional roadmap to improved KYC processes.

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[9] *SEI http://web.archive.org/web/20060514050051/www.sei.cmu.edu/cmmi/general/*

Levels 1 & 2 - From Chaotic to Reactive

The KYC Maturity Model is based on the typical 5 levels of a standard Capability Maturity Model.

These levels are typically described as Initial, Repeatable, Defined, Managed and Optimized and have very strict meanings. The KYC maturity level has been somewhat renamed and re-built for easier understanding and is depicted here:

Level 1

Chaotic

- Adhoc
- Undefined
- Un-Documented
- Unpredictable
- Multiple Service Desks
- Minimal IT Operations
- No User Acknowledgement

Level 2

Reactive

- Fight Fires
- Request backlog
- Request db
- Centralised service desk(s)
- Basic request management process
- Frequent alerts and escalation
- Basic service on/off measurement

Level 3

Proactive

- Analyze Trends
- Set Thresholds
- Predict Problems
- Measure Service Availability
- Initial workflow automation
- Defined process

Level 4

Service

- KYC as a service
- Defined Services, Requirements, Pricing
- Understand Costs
- Guaranteed SLA's
- Measure and report service availability
- Integrate processes
- Capacity management

Level 5

Value

- KYC as a Strategic Business advantage
- KYC & Business Metrics Linkage
- KYC and Business Collaboration
- Linkage improves business Processes
- Real-time Service
- Business Planning
- Lower cost

Manage KYC as a Business

Service Management

Service Delivery Process Engineering

Operational Process Engineering

Tool Leverage

Few organizations would be happy to find themselves at level 1, the **Chaotic** level. But the one good thing about this level is that the path out of this level is quite clear. The Chaotic attributes - ad-hoc activities, undefined responsibilities, undocumented processes, unpredictable demand, no central control, little systems support and no formal communication - can all be relatively easily addressed and each small improvement will make a quick and real difference.

One common initial step is to implement a "tool". While tools can be useful, they are seldom the only answer. Implementing a "tool" in a Chaotic process will usually result in the creation of a large (but, at least now, defined) backlog of work to do and may move the process level from chaotic to **Reactive**. But Reactive is still rough going - fighting fires, continuous distraction, always running behind the ball.

At some stage, the team needs to really start to think about process definition, engineering and reengineering. Process engineering and reengineering starts with an initial process definition - this can be very basic, but until it is written down or depicted, improvement will be difficult.
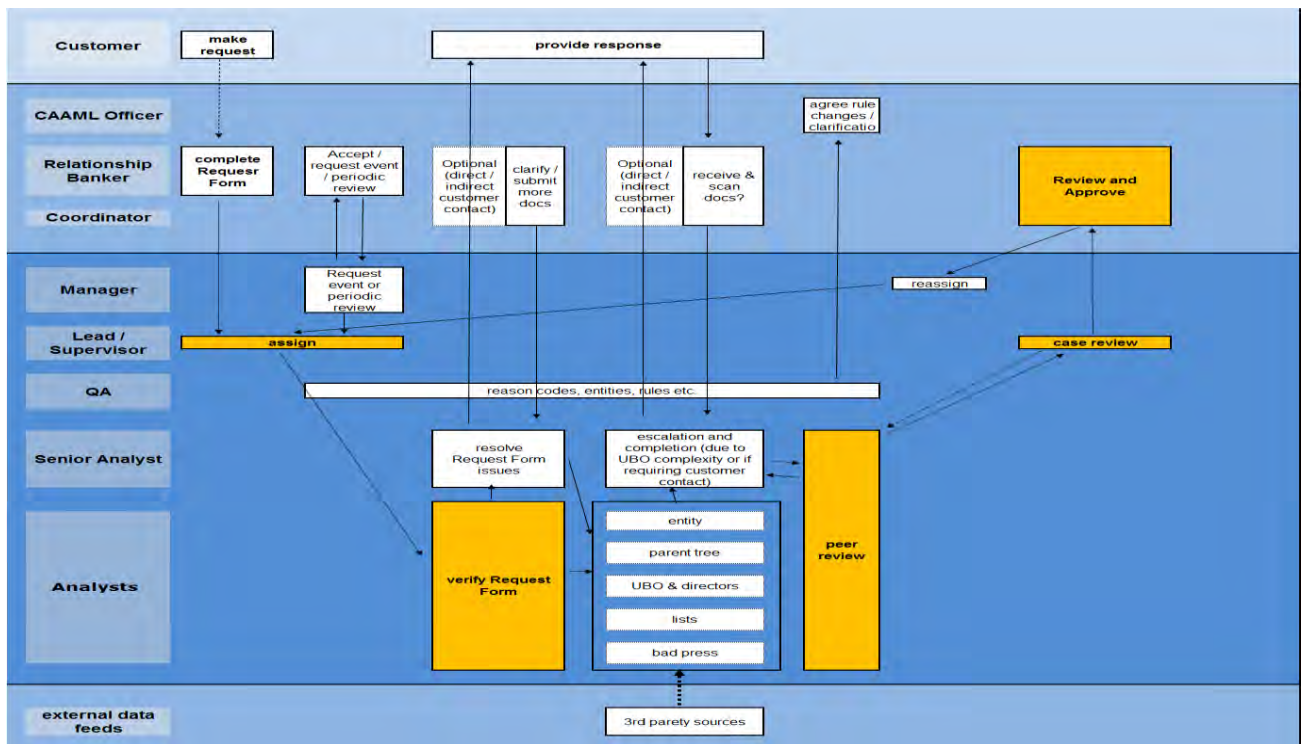
In the simple example depicted here we see the various players - customers, the front-office and the compliance and KYC analysts - all involved in a role-defined process. Task assignment and re-assignment, escalation, Quality Assurance checks, review and acceptance steps are identified.

Such a process definition may already exist, but may not be followed; or may be planned for implementation, but without any enforcement mechanism.

Level 3 - Proactive

It is not enough to just DEFINE the process. In order to become **Proactive**, you also need to ensure that it is being REPEATED and – a big step forward - MEASURED.

Workflow tools can help with enforcing a process - and there are many good workflow tools on the market. While workflow can ensure that a process is being repeated, it is also extremely important that the workflow can support reporting and process inspection and continuous change. Change is, after all, inevitable – and experimentation should be welcome.

With some level of a defined and improved process in place one can start trying to get ahead of the curve. Now that the process is not only Defined (what you want to happen) but is being Repeated with some degree of regularity and rigor, it can be better Measured.

Six-Sigma

The Six-Sigma methodology can be very helpful in any attempt to effectively and efficiently measure. The Six-Sigma DMAIC methodology with its Define, Measure, Analyze, Improve and Control stages can be mapped to various KYC process touch points and can help drive improvement by uncovering process variances.

In the example here, we see that an effort being made to reduce the number of customer and peer-review failures (or in Six Sigma terminology, variances).

Phases	Process Steps	Tools	KYC Process Touch-points
DEFINE	• Identify Problem • Define Scope • Select Team	• QFD • Brainstorming • Interviews	• Confirm request definition • Identify scope of analysis • Agree role and resp
MEASURE	• Id measurement system • Measure current process performance	• Gage R&R • Cost of poor Quality	• Track customer rejections and peer review failures
ANALYSE	• Id root cause of problems	• Process analysis • Fishbone diagram • Pareto chart	• One-time fix
IMPROVE	• Recommend / implement solutions	• FMEA • Benchmarking • Piloting	• Implement changes in rules, process etc.
CONTROL	• Implement process control • Determine process capability • Sustain improvement	• Control charts • FMEA • Cost of Poor Quality	• QA problem evaluation review • Remediation

The Six-Sigma phases are quite easy to understand, as are the process steps and the KYC touch-points. The Six-Sigma tools listed are, however, quite a different issue and without training in Six-Sigma - not in scope in this paper - may be quite unfamiliar. (For a quick description check out e.g., Wikipedia).

Other typical areas where variances could be Defined and Measured, and then Analyzed, Improved and Controlled might include the number and percent of KYC cases Not Resolved at first contact, Requirements Not Found in the knowledge base, Escalations to higher level for resolution, Wrong Escalations, Cases logged with Wrong Information, Cases Not Resolved within the agreed Turn-Around Time etc., etc.

The process is now Defined, Repeatable and Measured. The process maturity can be said to be Level 3 (Proactive). The defined process is being analyzed, thresholds are being set and some level of predictability is in place.

Level 4 - Service Managed

Level 4 (Service Management) takes the defined process and the proactive approach to a whole new level of professionalism. This is where some of the formal **ITIL** principles (for Service Delivery and Management), some **Lean** and **Agile** (process and planning disciplines) lessons and Balanced Scorecard reporting can come in useful..

While the Information Technology Infrastructure Library (ITIL) is more often thought of as a pure IT Service Management discipline, it does have some very practical uses in defining both reactive Service Delivery and proactive Service Management approaches for more general business services.

ITIL Service Delivery and Management

ITIL Service Delivery is broken-up into the tactical aspects of a Service Desk and Incident management as well as Problem, Change, Release and Configuration management. Service

Desk and Incident Management principles are perfectly appropriate for use in a KYC process environment while the latter principles may be useful in the initial set-up and continuous improvement of the KYC process itself.

Typical ITIL **service metrics** that are useful in a KYC process might include:
- **ABA** (Abandonment Rate): % of cases abandoned while waiting to be analyzed
- **ASA** (Average Speed to Answer): Average time it takes for a case to be analysed by the KYC service desk
- **TSF** (Time Service Factor): Percentage of cases analyzed within a defined time-frame, e.g., 80% in 4 hours.
- **FCR** (First Call Resolution): Percentage of cases that can be resolved without clarification or escalation or without having the KYC requester contact the service desk to finish resolving the case.
- **TAT** (Turn Around Time): Time taken to complete a certain task or case.

ITIL Service Management is broken-up into a number of more strategic principles - such as Service Level Definition and Capacity, Continuity, Availability & Financial Management. All of these principles may be used in defining the KYC service and planning the people, process and technology requirement necessary.

Service Catalog

One of the most important concepts in ITIL Service Delivery and Management is the "Service Catalog". In KYC terms this would be, basically, a menu-card of KYC activities and levels of Due Diligence required (or offered).

Each service definition would typically include:
- A description of the service
- Time-frames (or SLAs) for fulfilling the service
- Who is entitled to request / view the service
- Costs (if any)
- How to fulfill the service (detailed process guide with escalations, exceptions and sample deliverables)

These attributes would ideally be built into any supporting workflow and task / resource management technology. And these defined services are Priced based on a true understanding of costs (direct and indirect, fully allocated – possibly even Activity-Based-Cost).

With a defined service, priced, resource planned and managed, we can create and start to guarantee Service Level Agreements.

SLAs extend the Service Catalog to define the entire service delivery mechanism: a definition of services, performance measurement, problem management, customer duties, warranties, disaster recovery, termination of agreement etc.

One potential issue to deal with as services are defined, processes optimized and SLAs implemented, is reporting overhead. The increase in admin overhead and reporting requirements needs to be anticipated and planned for.

Lean, Agile and Balanced Scorecards

Lean and Agile are two complementary and very powerful service delivery approaches that can also be used to facilitate process optimization and reengineering in leading to improved Service Management.

Lean is important in:
- adding easy-to-understand **Visual Controls**
- identifying **process flow** blockages
- really embracing the idea and practice of **organizational learning**

Agile is important in:
- recognizing iteration and the need for **planning** in reasonable timescales
- being open to the need for **prioritization** and re-prioritization, task assignment and re-assignment

More information on Lean and Agile can be found readily on the internet.

Visual Controls and Balanced Scorecards can help in maximizing control and clarity in process management and communication.

Balanced Scorecard reporting can greatly aide in communication.

The traditional Balanced Scorecard is comprised of simple tables broken into four sections:
- Financial **–** cost, budgeted and actual
- Customer **–** are we meeting the externally communicated SLA?
- Internal Business Processes **–** throughput, bottle-necks, stress points etc.
- Learning & Growth **–** are we learning from experience and improving?

The definition and accurate reporting of meaningful Key Performance Indicators (**KPI**s) across a wide range of strategic domains will provide a more holistic overview of the impact of KYC operations in the business.

The screenshots shown here are examples of the kinds of "at-a-glance" and real-time drill-down possibilities that are possible.

Such reporting formats allow for strategic review, general course-correction and more frequent, tactical situation reports as well as detailed exception-based reporting.

Such reporting ability is desirable in any operational environment - front-office-only, or front-office / back-office or, indeed, internal / external service provider.

With balanced, lean and agile services agreed and in place, a KYC operation can start to better integrate into other business processes – e.g. **Just-in-Time** KYC within New-Client-Take-On. The team can also plan to handle peaks in demand by flexing capacity within predefined parameters to continue to maximise (prioritised) on-time delivery.

The process improvement journey leads from DEFINED to REPEATABLE and MEASURED and then to PREDICTABLE, PLANNED, BALANCED and PRICED (COSTED). Continued process improvement and optimization over a period can lead to Level 5 (Value Management).

Level 5 - Value Management

Level 5 is "managing KYC as a business", a goal worth aiming for in any organisation.

The Value Management level is where we have not just identified and minimised the COST of KYC but have also identified, captured and shared the VALUE of KYC – and indeed, **created value** through KYC.

In addition to Just-In-Time integration as mentioned earlier, one can also look to close the loop on, for example, "commercial information":
- information of a potentially commercially-actionable nature that is discovered during KYC analysis can be fed back to the master Customer Relationship Management system
- parent tree information, specifically key directors and persons-of-influence can be communicated back as possible new leads, contacts or influencers

- any media-**monitoring put in place to trap "significant AML-r**elevant events" (e.g., M&As, board changes, new business activities) can be widened to also identify commercially-relevant events (e.g. new deals, partnerships, international expansions etc.)

Likewise, one can also try to close the loop on operational risk information, market and product trend information through various business intelligence reports etc.

The goal here is true integration with the business – as fast as the business can handle, as smart as can be managed and as cost-effective as possible.

So, that's the model. It is intended to be as simple and practical as possible – as a way of quickly identifying **one's** current state and as a simple roadmap to further process improvement.

The right mix

Implementing this simple model can be done with a few simple principles in mind - these principles concern the right mix of **People**, **Process** and **Technology**.

KYC is all about People. Many Enhanced Due Diligence activities cannot be automated - no tool can analyse and verify parent trees, sift through false-positive PEPs and really understand bad press. Only people can do that. People are not cheap and People get distracted. A good resourcing model can maximize morale and limit cost. A professional environment with a focus on experimentation and improvement is also important.

Great processes supported by good technology are important. Not necessarily great technology and good processes - but great processes and good technology. The process should always drive the technology choices. What are great processes? Above all they are capable of Continuous Process Improvement

And what is good technology? Basically, it needs to be "enabling" and open to change. Secure is a must; flexibility should be built in - intuitive is helpful.

Closing words

Now, more than ever, KYC is necessary and is growing in importance - and in cost.
Now is the time to improve our processes, adopt Service and Business Value approaches to KYC; to Better Manage Risk, Reduce Costs and free-up resources to generate more Revenue.

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The team at KYCnet BV in Amsterdam wish you well in your process improvement journey and welcome any feedback or questions you may have.