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KNOW YOUR CUSTOMER NORMS: AN INDIAN SCENARIO

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ABSTRACT

Traditionally, the commercial banks in India were largely into the core banking business of accepting deposits and providing working capital funds to agriculture and allied, trade and industry sector. But ever since the financial sector reforms such as introduction of asset classification, prudential accounting norms, deregulation of interest rate and opening up of financial sector, the banking sector saw the emergence of new generation of banks which made Indian banking sector more competitive, with the increase in banking business, the risk involved has also increased. The notification of the Prevention of Money Laundering Act, 2002 underscores the need to identify the customer with his income and business profile, the act of money laundering and involvement of funds in terrorist activities have led the introduction of KYC (know your customer) in banking institutions. In general KYC is a client identification program that verifies and maintains records of the identity and address of investors. The adoption of effective know-your-customer (KYC) standards is an essential part of banks' risk management practices. Sound KYC policies and procedures not only contribute to a bank's overall safety and soundness, they also protect the integrity of the banking system by reducing the likelihood of banks becoming vehicles for money laundering, terrorist financing and other unlawful activities. The present papers focus on understanding the concept of KYC and discuss the need, process and its impact on customers as well as banks. The paper is concluded by giving suggestions for making this process more effective and easy for the customers.

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INTRODUCTION

Over the years, banking has undergone a sea change. The introduction of computerisation in banking has opened new vistas to be exploited and has given rise to the need to know one's customers (KYC) better so as to be able to cater to their requirements. Since needs and aspirations are best reflected by the social and economic standing of the customers, it is necessary for the bankers to know more about their customers — like knowing their occupation, income levels, credit needs, credit already availed, income-tax status and other details. However, with the increase in banking business, the risk involved has also increased. The notification of the Prevention of Money Laundering Act, 2002 underscores the need to identify the customer with his income and business profile.

Money Laundering refers to **"Conversion of money illegally obtained to make it appear as if it originated from a legitimate source".** Money laundering is being employed by launderers worldwide to conceal criminal activity associated with it such as drugs / arms trafficking, terrorism and extortion. All crimes that produce a financial benefit give rise to money laundering. In order to control this money laundering RBI decided to implement KYC norms in all Banks

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KYC is a client identification program that verifies and maintains records of the identity and address of investors. KYC norms were introduced in 2002 by the Reserve Bank of India. It directed all banks and financial institutions to put in place a policy framework to know their customers before opening any account.

The adoption of effective know-your-customer (KYC) standards is an essential part of banks' risk management practices. Banks with inadequate KYC standards may be subject to significant risks, especially legal and reputational risk. Sound KYC policies and procedures not only contribute to a bank's overall safety and soundness, they also protect the integrity of the banking system by reducing the likelihood of banks becoming vehicles for money laundering, terrorist financing and other unlawful activities.

Today other regulators too have made KYC mandatory. The Securities and Exchange Board of India (Sebi) has mandated it for mutual funds and broking accounts, the Insurance Regulatory Development Authority (IRDA) while buying insurance and the Forwards Markets & Commission (FMC) for commodity trading. You need to submit it even for making post office deposits

IN BRIEF

- KYC is mandated by most regulatory authorities
- Documents for proof of identity and address are needed.
- Certain investments may need PAN card details
- Duplication of documents in some cases is possible
- Investee firms may also incur compliance cost

WHAT HAS THIS GOT TO DO OPENING BANK ACCOUNTS?

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The first step in the laundering process for criminals is to get their money into an account with a Bank, often using a false identity and address. The funds so deposited will be transferred to other accounts locally or abroad or used for buying goods or services. These transactions would appear to be like any legally earned

Money and becomes difficult to trace it back to its criminal past. Banks under law should not only prevent this, but should stop criminals who wish to use the banking channel to launder the ill-gotten money from illegal / criminal activities.

HOW COULD THIS AFFECT YOU AS A CUSTOMER?

A key defense against money laundering is to prevent accounts being opened in false identities. Anyone wishing to open an account will therefore be asked for proof of their identity and address. These documents have to be essentially obtained irrespective of the type of account to be opened and the purpose for which the account is opened for. The fact that these documents are asked for opening of account does not mean that you are suspected of money laundering. Criminals try to appear to be normal law-abiding customers, for example they may try to open a number of accounts using small amounts of money. Hence it is necessary to identify all prospective account holders or customers. Anybody including a criminal could falsely use your identity, if these identity documents are not obtained.

KNOW YOUR CUSTOMER – WHAT YOU MUST KNOW

What is KYC?

Know Your Customer - KYC enables banks to know/ understand their customers and their financial dealings to be able to serve them better.

As per RBI, KYC is a process by which banks obtain information about the identity and address of the customers. This process helps to ensure that banks’ services are not misused.

Who is a customer of the Bank?

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For the purpose of KYC Policy, a Customer is defined as-

1) A person or entity that maintains an account and/or has a business relationship with the Bank;
2) One on whose behalf the account is maintained (i.e. the beneficial owner);
3) Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and
4) Any person or entity connected with a financial transaction, which can pose significant reputation or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

REGULATORY AND LEGAL REGUIREMENT

Regulatory: In terms of the guidelines issued by the Reserve Bank of India (RBI) on November 29, 2004 on Know Your Customer [KYC] Standards – Anti Money Laundering [AML] Measures, all banks are required to put in place a comprehensive policy framework covering KYC Standards and AML Measures.

Legal: The Prevention of Money Laundering Act, 2002 (PMLA) which came into force from July 1, 2005 (after "rules" under the Act were formulated and published in the Official Gazette) also requires Banks, Financial Institutions and Intermediaries to ensure that they follow certain minimum standards of KYC and AML as laid down in the Act and the "rules" framed there under

NEED FOR KNOW YOUR CUSTOMER

- To prevent identity theft, financial fraud, money laundering and terrorist financing.
- To enable banks to know and understand their customers better and help them manage their risks prudently.
- To prevent criminal elements from using banking channels for money laundering activities and / or financing of terrorism related activities.

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- To check frauds that sometimes unscrupulous and criminal elements try to perpetrate on banks and unsuspecting members of public.

KYC (KNOW YOUR CUSTOMER) INFORMATION FOR CUSTOMERS INTENDING TO OPEN BANK ACCOUNT

The Reserve Bank of India (RBI) has advised banks to follow a 'KYC guidelines', wherein certain personal information of the account-opening prospect or the customer is obtained. The objective of doing so is to enable the Bank to have positive identification of its customers. This is also in the interest of customers to safeguard their hard earned money. The KYC guidelines of RBI mandate banks to collect three proofs from their customers. They are

1. Photograph
2. Proof of identity
    - Passport
    - PAN Card
    - Voter's Identity Card
    - Driving License
    - Photo Identity Card*
    - Letter from recognized Public Authority or Public Servant
    - Letter issued by UIDAI containing details of Name, Address and AADHAR Number
3. Proof of address-
    - Passport
    - Voter's Identity Card
    - Driving License
    - Photo Identity Card*

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- Bank Account Statement
- Telephone Bill on Client's Name
- Electricity Bill of Client
- Letter from recognized Public Authority or Public Servant
- Letter issued by UIDAI containing details of Name, Address and AADHAR Number

*(subject to the satisfaction of the bank)

BANKS ASK FOR PROOF OF IDENTITY AND ADDRESS-WHY?

The identification of a customer is a very critical process with a view to protect the customer interests by preventing from fraudsters who may use the name, address and forge signature to undertake benami / illegal business activities, encashment of stolen drafts, cheques, dividend warrants, etc. This also helps to safeguard banks from unwittingly used for the transfer of deposit of funds derived from criminal activity or for financing terrorism. Identification of customers will also help to control financial frauds, identify money laundering and suspicious activities, and for scrutiny / monitoring of large value cash transactions

CIRCUMSTANCES WHEN KYC IS REQUIRED

KYC will be carried out at the following stages:

1. Opening a new account
2. Opening a subsequent account where documents as per current KYC standards not been submitted while opening the initial account
3. Opening a Locker Facility where these documents are not available with the bank for all the Locker facility holders
4. When the bank feels it necessary to obtain additional information from existing customers based on conduct of the account

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5. When there are changes to signatories, mandate holders, beneficial owners etc. KYC will also be carried out in respect of non-account holders approaching the bank for high value one-off transactions

e-KYC (ELECTRONIC KNOW YOUR CUSTOMER)

When someone wants to open bank/mutual fund & other account, the biggest challenge faced is submission of multiple documents such as address proof, ID proof and others. But Ministry of Finance, Government of India has given their approval for paperless authentication or eKYC.

WHAT IS e-KYC

1. e-KYC service is offered by UIDAI and its main objective is for the verification of his/her credentials digitally
2. Aadhar card holders can now get following personal details verified at various organizations while applying for new account:
   - ID & Address Proof
   - E-mail Address
   - Mobile Number
   - Gender
   - Photograph
3. This way, paper documents which had traditionally been mandatory for verification won't be required which save time, efforts and cost of bank employees and customers.

PROCESS

WHAT CUSTOMER NEED TO DO?

In order to free themselves from carrying hard copy of required documents everytime; Aadhar card holders will have to give their consent to the banks banks to

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HOW BANKS WILL VERIFY CUSTOMERS ELECTRONICALLY?

- Organizations wanting to use eKYC service will have to get approval and authorization by UIDAI
- For verification, these organizations will have to use biometric scanning devices approved by Unique Identification Authority of India (UIDAI) and register the device with UIDAI so that data can be accessed through the device
- These organizations will then need just the unique Aadhar identification number and then scan fingerprints of the customers through biometric readers.
- This will fetch customer details such as – full name, address, date of birth, mobile number, gender and photograph and will also access and copy all the KYC documents from the UIDAI servers and save electronic copy of all the documents for opening the account in their database for future use.
- Once these details are verified, accounts will be opened instantly which otherwise takes atleast a week.
- As of now, the device is offered at no cost.
- Data would be accessed online in a highly secured environment.

WHICH ORGANIZATIONS MAKE USE OF AADHAR e-KYC?

As of now, following financial service providers are using e-KYC facility while opening new accounts:

- Banks
- Fund houses
- Trading Account
- Insurance companies

As time progresses, Aadhar e-KYC will make every Indian's life hassle free as overall processing will become easy.

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CONSEQUENCIES OF NOT PROVIDING KYC INFORMATION TO THE BANK

The Bank will be entitled to refuse to open the account (if you are a prospective customer) or discontinue its relationship with you citing non-providing of KYC information / documents (if you are an existing customer). If you however, require reasonable time to furnish certain non-critical documents you can approach the branch / sales staff. **If you are a small depositor, would you still have to go through the stringent KYC requirements?** While the internal procedures of the Bank and the guidelines of RBI require that satisfactory proof of your identity and address, RBI has simplified the KYC procedure with the objective of greater financial inclusion, i.e. making available the basic banking facilities to those persons who intend to keep balances not exceeding Rupees Fifty Thousand (Rs. 50,000/-) in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed Rupees One Lakh (Rs.1,00,000/-) in a year. Indian Regulations on Prevention of Money Laundering – A customer must know Under the Prevention of Money Laundering Act (PMLA) 2002, and the Rules thereof, the banks are required to report:

a. All cash transactions (deposits and withdrawals) of the value of more than Rupees Ten Lakhs or equivalent thereof in foreign currency;
b. All series of cash transactions integrally connected to each other, which have been valued below Rupees Ten Lakhs 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 Rupees Ten Lakhs.
c. All cash transactions were forged or counterfeit currency notes or Bank notes have been used as genuine and where any forgery of a valuable security has taken place;
d. All suspicious transactions whether or not made in cash and by way of as mentioned in the Rules.

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UNDER REGULATORY INSTRUCTIONS ISSUED BY THE RESERVE BANK OF INDIA IN CONSULTATION WITH THE GOVERNMENT OF INDIA AND INDIAN BANK‟S ASSOCIATION

a. Demand drafts, mail transfers and travelers cheques for Rs. 50,000/- and above can be issued by banks only by debit to the customer‟s account or against cheque or other instrument tendered by the purchaser and not against cash payment;
b. Demand drafts, mail transfers and travelers cheques for Rs. 50,000/- and above can be paid by banks only by credit to the customer's account or through other banking channels and not in cash.

IMPACT

Impact for Customers: Although the effort towards strengthening identification norms has helped in preventing money laundering and reducing fraud, it has had a negative impact in an unexpected quarter. The growth in investor numbers in various instruments is either stagnating or reducing. Apparently, the KYC norms are proving restrictive because of the hassles of documentation. The KYC requirement sometimes leads to unnecessary and repetitive work, delaying operations. Customers complain about the paperwork involved. Ultimately, it means customers have to run from pillar to post for complying with the KYC norms. Investors complain of being asked to provide details repeatedly or face a freeze on their accounts

Impact for service providers: Companies and distributors say, KYC requirements have burdened them with substantial administrative obligations. The verification rules place a financial burden on banks, insurance companies and mutual funds due to the involved costs. Currently, every entity has to individually conduct this verification which results in duplication of effort for customers as well as the institutions.

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STRONG STEPS BY RBI **FOR NON IMPLEMENTATION OF KYC**

The Reserve Bank of India (RBI) imposed penalties on ICICI Bank and Bank of Baroda for violating 'Know Your Customer' (KYC) as well as anti money-laundering norms (ALM). The central bank fined ICICI Bank Rs 50 lakh, BoB Rs 25 lakh, and cautioned State Bank of India, Axis Bank and State Bank of Patiala that they should review and comply with KYC norms in December 2014.

As per RBI they imposed the penalty because of, "Failure on the part of these banks (ICICI Bank and BoB) to take timely remedial measures had aggravated the seriousness of the contraventions and their impact."

August 2013 -RBI reviewed the KYC and ALM processes of these banks after it received a complaint from a reputed statutory organisation. This complaint included details of a fraud perpetrated in the five banks censured, with the connivance of certain officials of the statutory organisation.

January 2014 - The fraudsters had managed to open fictitious accounts in the name of the statutory organisation in the above five banks and operated the accounts, mainly for encashing cheques/ demand drafts/ postal orders of which they were not the rightful owners, for periods ranging from

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one month to two years, without being detected by the banks," the RBI statement read, without naming the organisation. The central bank conducted a scrutiny of these five banks in January 2014.

The scrutiny revealed non-adherence to certain aspects of Know Your Customer or KYC norms and non-adherence to instructions on monitoring of transactions in customer accounts. The central bank decided to impose a monetary penalty on ICICI Bank and BoB after issuing a show-cause notice and reviewing their response. State Bank of India, Axis Bank and State Bank of Patiala were not fined "as the banks' explanations regarding the circumstances which led to the fictitious accounts getting opened and operated without detection, were judged to be reasonable".

This is not the first time private sector banks like ICICI Bank and Axis Bank have been pulled up by the central bank for violation of KYC norms. In 2013, RBI had imposed a penalty of Rs 1 crore and Rs 5 crore on ICICI Bank and Axis Bank, respectively, after an expose by the website, CobraPost, in which undercover reporters sought bank staff's assistance in legitimising black money. Those fines were also for non-adherence to KYC, antimoney laundering and filing of Cash Transaction Reports (CRTs).

Most recently, in July 2014, the central bank had imposed a combined fine of Rs 1.5 crore on 12 banks, for not conducting adequate due diligence on loans granted to Deccan Chronicle Holdings, which led to a loss of Rs 4,000 crore to the banking sector.

CONCLUSION

1) Banks doing KYC monitoring for anti-money laundering (AML) and checks relating to combating the financing of terrorism (CFT) increasingly use specialized transaction monitoring software, particularly names analysis software and trend monitoring software.

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2) Know Your Customer processes are also employed by regular companies of all sizes, for the purpose of ensuring their proposed agents', consultants' or distributors' anti-bribery compliance. Banks, insurers and export credit agencies are increasingly demanding that customers provide detailed anti-corruption due diligence information, to verify their probity and integrity. Some specialist consultancies help multinational companies and SMEs conduct Know Your Customer processes when entering new market.
3) The adoption of effective know-your-customer (KYC) standards is an essential part of banks' risk management practices.
4) There is no escaping the paperwork while investing in financial products. Be it, opening a new bank account, demat account or buying insurance, filling the Know Your Client (KYC) documents is a mandatory procedure today.
5) RBI is also taking regular Strong steps to punish Banks , those who are not properly implementing KYC norms by fining them with heavy penalty.

SUGGESTIONS

There is a need to simplify KYC requirements. The authorities could opt for centralization of the KYC norms to make investing easy for those not well versed with paperwork. Uniformity in requirements for KYC prescribed by all authorities would help make the filing easier. One important document that will make life simpler is - 'Aadhar', the unique identification number to be provided to each citizen by Unique Identification Authority of India (UIDAI), a government initiative. But there is still some time before it will be implemented. By making KYC norms simpler, it will make investments simpler.

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