Shatter the hourglass: Strategies to implement ongoing due diligence

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Refresh challenges business opportunities - what to consider

Financial institutions should move now to adopt ongoing due diligence as the next wave of Know Your Customer (KYC) refresh risk management. Ongoing due diligence refers to a risk-based approach, based upon risk events and triggers, for maintaining KYC information that replaces traditional scheduled periodic refresh. Ongoing due diligence utilizes natural client touch points and ongoing monitoring to determine when refresh is necessary, and it targets refreshes that focus on the triggering events rather than a full, administrative-laden refresh. For most institutions, ongoing due diligence means a hybrid approach to refreshing customer files leveraging both trigger-based and scheduled reviews for customers representing the highest risk.

While this strategy is transformative, the underlying concepts are not new: monitoring for elevated risk rating change, an adverse media hit and new politically exposed person (PEP) exposure are common elements of refresh programs. Transformation will require investment in technology, data and people strategies; thoughtful leadership; and buy-in from multiple functions across operations, risk, compliance and audit. Transformation should be a "walk, don't run" approach, with a focus on defining, enabling and proving a concept that is specific to each institution. Financial institutions that successfully move to an ongoing due diligence program will benefit from more effective risk management at lower costs (large KYC program costs are significant; the corollary cost savings opportunities are equally significant).

Executing scheduled periodic refresh programs is an onerous and constant challenge for most financial institutions. Given the large operational footprint and impact on customers, significant financial and operational resources are allocated to perform scheduled periodic refresh, many of which require direct customer outreach. Based on our experience supporting financial institutions and on feedback from the industry, nearly all scheduled reviews are administrative in nature and do not result in differentiated risk management activities by elevating a risk rating, determining a need to perform enhanced due diligence, spurring an unusual activity report filing, or resulting in termination / exit of a customer relationship. One institution determined that less than 0.1% of scheduled periodic reviews resulted in differentiated risk management. Additionally, refresh activities are a frustrating experience for customers. Customers are typically asked multiple times for information or documentation and the process can drag on for months. Employee experience is equally low, and manual, cumbersome processes challenge financial institutions to complete large refresh volumes on time.

Most refresh programs are not enabled to perform event-driven assessments of customer risk. The resulting status quo is scheduled evaluation of all customer information, which results in imbalanced risk management. For example, the hypothetical on the following page illustrates how a scheduled refresh fails to capitalize on an opportunity to customize risk management:

[1]United States Department of Treasury. Customer Due Diligence Requirements for Financial Institutions, May 2016. https://www.govinfo.gov/content/pkg/FR-2016-05-11/pdf/2016-10567.pdf.

[2]United States Department of Treasury. FinCEN Announces Its Innovation Hours Program. Financial Crimes Enforcement Network, 2019. www.fincen.gov/news/news-releases/fincen-announces-its-innovation-hours-program.

[3]United States Department of Treasury. Frequently Asked Questions Regarding Customer Due Diligence (CDD) Requirements for Covered Financial Institutions. Financial Crimes Enforcement Network, 2020. www.fincen.gov/sites/default/files/2020-08/FinCEN%20Guidance%20CDD%20508%20FINAL_2.pdf.

[4]United States Department of Treasury. Anti-Money Laundering Program Effectiveness. Financial Crimes Enforcement Network, 2020. www.federalregister.gov/documents/2020/09/17/2020-20527/anti-money-laundering-program-effectiveness.

- ABC Restaurant, LLC located in Charlotte, North Carolina:
  - Product usage: 10-year term loan opened in 2019
  - No adverse media hits, PEP or sanctions exposure, or transaction monitoring alerts
  - Customer risk rating: Low
  - Scheduled refresh in 2024
- XYZ Restaurant, LLC located in Charlotte, North Carolina:
  - Product usage: 10-year term loan, Demand Deposit Account and Cash Vault all opened in 2019
  - No adverse media hits or PEP or sanctions exposure
  - Three transaction monitoring alerts reflecting material cash vault usage variances in 2020
  - Customer risk rating: Medium
  - Scheduled refresh in 2022

Scheduled refresh programs differentiate the above customers in one way: timing. Both customers would receive a full refresh, with XYZ receiving a refresh earlier and with more frequency than ABC on the basis of the customer risk scoring. Customized risk management would differentiate refresh of these customers as follows: (1) refresh XYZ to review the customer's increased cash vault usage and assess whether the nature and purpose of account can be reasonably understood and adjusted (e.g., Did XYZ benefit from favorable food-critic reviews and enjoy a corresponding uptick in business or are the observed activities apparently atypical?); and, (2) reduce refresh frequency for ABC until there's a reason to assess the customer's risk or KYC data (e.g., customer requests to add account signer while stating that there has been a change in beneficial ownership).

While the problem statements are widely understood, the question persists: Will regulators expect scheduled periodic refresh as part of a risk-based anti-money laundering (AML) program? Over the last several years, the Financial Crimes Enforcement Network (FinCEN) has acknowledged that ongoing due diligence can be an effective risk management model:

- May 2018: Customer Due Diligence Requirements for Financial Institutions (informally "CDD Rule") issued stating that the requirement to update customer information is risk-based and occurs as a result of "normal monitoring."[1]
- May 2019: FinCEN launches an "innovation hours" initiative to support financial institutions presenting their innovative products, services, and approaches that are designed to enhance AML and counter the financing of terrorism efforts.[2]
- August 2020: FinCEN in consultation with the federal functional regulators, issued a frequently asked question (FAQ) in response to three FAQs regarding customer due diligence requirements. Among the FAQ responses: "There is no categorical requirement that financial institutions update customer information on a continuous or periodic schedule. The requirement to update customer information is risk-based and occurs as a result of normal monitoring."[3]
- September 2020: FinCEN: Advanced Notice of Proposed Rule Making seeks "to modernize the regulatory regime to address the evolving threats of illicit finance, and provide financial institutions with greater flexibility in the allocation of resources, resulting in the enhanced effectiveness and efficiency of anti-money laundering programs."[4]

Refresh program benefits

Ongoing due diligence creates opportunities to advance risk management, enhance customer experience and right size operating costs:

Agile risk management

Ongoing due diligence supports an agile approach to risk management by refreshing specific aspects of a customer file during a customer interaction (e.g., product or service add) or when an event occurs demonstrating that the customer's use of an account or a change in data should be reviewed to assess customer risk.

Improved customer experience

From a customer's perspective, scheduled refresh activities occur at random and are fraught with unclear requests that typically require multiple interactions to resolve. Leveraging ongoing due diligence to refresh the KYC information when the customer is already interacting with an employee or when there is an identifiable basis for refresh enables a customizable, natural and more efficient customer experience.

Reduced operating costs

Replacing the administrative task of fully refreshing every customer with ongoing due diligence reduces overall spend and results in opportunities to invest in smarter tools and systems and enhancing methods to focus on higher-risk customers.

Competitive advantage

Tailored and less frequent customer outreach will differentiate early adopters from peer organizations.

Defining a strategic vision

AML programs are defined by the approach to risk. This principle persists for ongoing due diligence; there is no one-size-fits-all solution. As leadership within an institution looks to address the risks of their business, it should consider the following design criteria:

Ongoing due diligence as an extension of risk appetite/tolerance

Ongoing due diligence and scheduled refresh approaches are not mutually exclusive; financial institutions should implement ongoing due diligence and scheduled refresh strategies that reflect program risk appetite. For most institutions, this means deploying a hybrid approach: customers representing the highest-risk KYC profiles (e.g., financial institution customers) should retain a scheduled (often annual) touch point.

Defining the right triggers and actions

An ongoing due diligence trigger is an event prompting an action to review a customer's due diligence profile. Triggers should come from a range of different sources, either internal or external systems or prompted by employees, and implicate the entire customer life cycle (e.g., resulting from addition of account owner, transaction monitoring disposition, external data feed update, and manual updates from frontline employees or customers).

Triggers should both highlight when data has changed (e.g., change in customer incorporation address) and address a more complex understanding of customer risk (e.g., discovery of an indirect link to a high-risk industry or detection of a complex ownership structure) that will ultimately drive tailored reviews focusing on only KYC aspects driving potential risk factors. As a starting point, financial institutions should consider triggers reflective of the following categories:

Risk – A change to the customer's risk profile, such as an apparent change in the nature and purpose of the account or an elevated risk rating. These triggers should target deviations from the customer's inherent and observed transactional data elements (e.g., new high-risk country transactions), as well as specific typologies indicating a heightened money laundering risk (e.g., third-party payment processor with high-volume payment activity to high-risk jurisdictions).

Products and services - Based on changes in the customer's utilization of products and services, including new "accounts" as defined under the CDD Rule.

Policy change - Resulting from changes in policy position (e.g., new policy requirement or risk-rating methodology).

Customer reference data change - Internal data changes submitted by the customer or employee (e.g., addition of an account owner) or externally identified data changes (e.g., public listing or regulated status of customer).

Related parties - Introduction of new third parties to the relationship/customer profile (e.g., new beneficial owner).

Not every trigger should receive the same scrutiny. Financial institutions should define tailored journeys ranging from straight-through processing (e.g., physical address update via external data feed to reflect "street" versus "st."), to maintenance journey (e.g., a new beneficial owner is identified), full refresh (e.g., customer's product and service usage demonstrates a material variance from prior cycles), customer exit (e.g., exposure to prohibited industry type identified), and all appropriate actions in between (e.g., simplified due diligence journey, obligation to report, enhanced due diligence and monitoring).

Ongoing due diligence solution design

An effective ongoing due diligence solution requires an ecosystem of technologies and data as opposed to a single out-of-the-box solution. This solution should address process changes, integrated systems, data cleanup, third-party data sources and workflow to enable end-to-end performance built with the proper controls. An effective ongoing due diligence solution will require baseline technology focused on the following:

- **Trusted data sources —** Implementing an ongoing due diligence framework requires a reliance on trusted data sources to identify changes to customer information, such as a name change or exchange delisting, which may vary in reliability depending on global footprint and customer types.
- **Orchestration layer —** Integrated data feeds, trigger events, and decisioning logic will need to connect to a case management tool that manages tailored journeys based upon an initial risk triage:
  - **Event hub —** As the orchestration layer connects the ecosystem of data sources, the event hub uses a series of business rule logic to determine whether review is required and, if so, what level of review based on the trigger event that has been identified.
  - **Straight-through processing —** As a default mechanism, a sophisticated system will determine appropriate actions based on the trigger and attempt to resolve systematically through activities such as automated data sourcing and validation of updated customer information. Hands-on analyst intervention would occur only when straight-through processing rules did not resolve the trigger.
- **Digitized customer experience —** Ongoing due diligence programs will need to be agile. Whether assessing customer information as part of a new product or service or based upon a risk event, the outreach process and customer experience should be enabled by digital portals that support a direct and interactive experience. This is particularly true for commercial banking and corporate and investment banking customers with cross-border and multi-person outreach within a single organization to efficiently process refresh activities.

Definition and monitoring of risk triggers will require integration with transaction monitoring or frontline monitoring programs assessing customer behavior. Leading firms should take this principle forward and continually assess segments of customers (e.g., charities, pawn shops, cash-intensive businesses) to understand anomalous versus expected activity within peer groups. These typology findings should inform additions or updates to risk triggers.

Beginning the journey

Transformation to ongoing due diligence will be a multi-quarter journey with significant complexity. Organizing around the below core concepts will support an ordered journey to ongoing due diligence:

Assess current program and approach — Evaluate opportunity to use a trigger-based approach by assessing effectiveness of the current scheduled refresh process. This evaluation should include current refresh risk management outcomes (e.g., frequency of risk-rating elevation) and the type and nature of updates being made (i.e., whether updates are frequently impacting risk-rating attributes or are administrative in nature). Additionally, financial institutions should identify any gaps in the overall AML/KYC program that would need to be addressed (e.g., ability to enable a full suite of triggers), the extent of current technology and data enablement to support a change to ongoing due diligence, and how a trigger-based approach aligns with risk appetite.

Engage key stakeholders — Regulators should be engaged to cultivate transparency and opportunity to receive constructive feedback while mitigating the risk of future findings during exams.

Agree on customer segment mapping to trigger categories — Analyze the customer population and confirm the categories of triggers to be applied to each customer segment. Once a baseline inventory of triggers is defined, assess the overall impact on refresh (i.e., how many customers would receive a touchpoint over one, two, or three years based upon trigger events). Engaging compliance and audit for challenge, as appropriate, will support a clear enterprise vision.

Select a pilot population — Initial strategies should focus on a pilot/challenger model by identifying a lower-risk population of customers with a relatively static information and risk profile to test data and technology builds and the overall control framework.

Review technology and integration impact - Evaluate usage of third-party data and application programming interface connectivity for the pilot population. Determine simplified journeys required and size the effort to configure the KYC tool. Build control framework leveraging technology.

Determine roll-out and maintenance – A broader rollout of an event-based approach could first support the smoothing of refresh populations by pulling forward scheduled refresh populations while later transitioning to a truly trigger-based refresh program, which will require periodic tuning and evaluation.

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