Impact of Regulatory Changes in the Financial Sector

REPORT

For financial institutions, C-suite and business professionals

ShuftiPro
Identity Verification

Contents

Overview

Risk and Compliance management have become a concerning issue for banks and financial services of all sizes. Intense focus on operating efficiencies, new banking products (FinTech), and increased government scrutiny due to immense globalization, all contributed to bringing forth great risks and a larger set of rules and regulations. This report will be focusing on the current compliance environment and risks involved for banks and financial institutions (FIs) and how technology can be leveraged to adopt a holistic approach to mitigate risks and enhance compliance management.

Word from our CEO

"The financial landscape and the business models of financial institutions in advanced economies changed significantly in the run-up to the crisis. Financial institutions across the world, especially in advanced countries can largely benefit from adopting automation. Leveraging technologies like AI, machine learning and RPA is the key to adhere and adopt ever-changing regulations."

Victor Fredung

CEO of Shufti Pro

Introduction

If we look in today's marketplace, banks and other FIs have greatly expanded the scope of their services. From legalizing global transactions to approving Card Not Present (CNP) transactions. The financial sector has covered a long path but with this expansion, the financial sector has also increased the complexity of their activities and is now facing an ever-challenging and increasingly complex regulatory environment. On the other hand, state regulatory agencies, investors, legislators, and the general public are focused on institutions' consumer practices and regulatory compliance performance more than ever due to increased fraud rates.

In this highly challenging environment, compliance failure can result in financial penalties, regulatory constraints, indictment, and reputational damage that could badly impact an organization.
Ever-evolving regulations are creating challenges and complexities for the banks and financial institutions in both national and international markets.

According to an article published on Thomson Reuters, the financial sector deals with 200 regulatory changes daily and these numbers are still increasing [1].

While dealing with 200 regulatory changes it becomes hard for the businesses to keep track of these regulatory changes and as a result, they face heavy fines. KYC and AML compliance is among the highly focused regulations for the financial industry and since 2008, global banks have been fined more than $321 billion collectively for not following KYC and AML regulations [2]. This doesn't just stop at fines for not following regulatory requirements. Even with global compliance of almost $100 billion a year, crimes like money laundering, terrorist financing, and cyber payment frauds are increasing [3]. It is because of this increasing crime rate that a record-high $7.08 billion were charged as anti-money laundering penalties world wide in 2019 [3]. Financial Institutes (FI) don't only find it challenging to comply with KYC and AML regulations but increased fraudulent activities make things worse.

Anti-money Laundering Penalties in 2019

29 issued during **2018**

58 AML penalties in **2019** (ACFCS)

USA

25 penalties

£1.7 billion. (IBSintelligence)

UK

12 penalties

£292 million. (HSA&Co)

average **£110.9** million (SUFRAZ&CO)

largest single fine **£3.9** billion. (Swenta)

£6.2 billion AML penalties in **2019.** (Swenta)

Laundering money is a serious criminal act and unfortunately, has become so prevalent that it amounted to 3.6% of global GDP [4].
An undercover agent who infiltrated Pablo Escobar's drug cartel responds,

"You can launder money in so many different ways, it is as unique as snowflakes."

Financial Conduct Authority (FCA) imposed fines of £60m for compliance breaches in 2018 [5].
According to Fenergo, in the last decade, global fines imposed for non-compliance with AML, KYC, and other sanctions regulations reached $26 billion [5].

Fraudsters and launderers are exploring new ways of carrying illegal activities. However, regulatory authorities around the globe are constantly upgrading regulations to eliminate fraud.

Impact of Regulatory Changes on Banking and Financial Services Organisations

Banking regulations subject banks to certain requirements, restrictions, and guidelines to uphold the soundness and integrity of the financial system. Due to its facilitating roles in the economy and the instability of banks, the banking sector is regulated thoroughly. The major reason that the banking sector is fully and strictly regulated is that no government in the world could afford banking systems' failure.

The progression of the banking system could be traced back to ancient economies like Roman, Greek, and Indian. In the west, the foundation of the banking system could be traced back to ancient centers of trade in Europe including London, Hamburg, and Amsterdam. Modern banking, however, emerged during the late 20th century with the industrial revolution bringing up fundamental changes in the definition of banking. In that era, lending money was changed with business credit and equipment financing. This led to a stream of rules and regulations ensuring banks fulfillment of their roles as builders of the economy.

Banks were brought to greater focus after the great depression of 1929. A spate of rules and regulations were introduced to protect the common man when money supply and credit monitoring emerged in the economy.

In the 1950s and 1960s, banks' role was expanded beyond the governments' control because several financial institutions like private banks, community banks, credit unions were introduced. Managing this complexity of the financial world made it necessary to ensure that risk and compliance management were managed properly. This led to the creation of multiple banking regulatory authorities at global, state, and local levels.

If we look at the present state of banking it clearly indicates that the risk and compliance management is becoming troublesome for the banks and other financial institutions. It has become important for the banks to have a robust Governance, Risk Management, and Compliance (GRC) program in place.

In countries which hold a strategic position in the global economy such as the United States, bank regulation is highly fragmented compared to other countries that usually have only one bank regulator. Banking and financial services in the U.S. are monitored at the Federal and State level.

Banks and the financial institution may be subject to numerous regulations depending upon the charter and structure of the organization. For example in the USA, 4 main regulatory bodies only at the state level namely the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. Additionally, state regulatory bodies and banking authorities play a vital role in the regulation of state-chartered institutions.

On the other hand, the European Union has also taken prevalent measures requiring companies to constantly evaluate their structures and approach to compliance, particularly in the light of penalties available for non-compliant organizations. Measures such as General Data Protection Regulation (GDPR), the Market Abuse Regulation (MAR), MiFID II, and the Anti Money Laundering Directives (AMLD) have changed the paradigm.

This plethora of regulators means that the list of regulations adds up very quickly for banks and FIs. Globally, different countries have their own set of rules, reforms, and regulations. This adds to the challenge for financial institutions to manage regulations and comply with all the regulations.

The same survey also shows that a global bank could face more than 350 regulatory exams a year. These results indicate that compliance becomes very cumbersome and expensive for a large or mid-size bank.

Recent global trends in KYC/AML

Global financial regimes evolved over the last past years (2015-2019). KYC and AML regulations were kept evolving across the globe. With the new and innovative ways of banking emerging, regulators are keen to extend the scope of KYC/AML regimes.

Canadian regulatory authority FINTRAC has changed the KYC/AML regimes to align them with KYC/AML recommendations of FATF. Online KYC is possible as scanned copies of identity documents can be used for due diligence. Also, Money Services Businesses (MSBs) and virtual currency businesses are added to the reporting entities list. They will be liable for typical KYC and AML rules that apply to businesses involved in fiat transfers.

The UK amended its Money Laundering Act (MLA-2017) and now requires the international affiliates and subsidiaries of UK-based businesses to exercise the EU AML regulations in non-EEA countries as well.

Five major Dutch banks are joining forces to develop a joint technological system to handle the due diligence data of their customers. Also, they plan to develop joint KYC/AML procedures by sharing the financial data of their clients, for better KYC and AML compliance.

Changing Regulations with the Changing World

In the aftermath of the 2008 financial crisis, regulatory authorities put forth several noticeable amounts of regulations, but now almost after a decade, some regulators and lawmakers think it is time to analyze what is working and what is not and make necessary amendments accordingly.

Banks and financial institutes are the protectors of the financial systems and the responsibility to prevent financial crimes lies with them. In the last decade, institutions have worked tirelessly to establish reliable KYC and AML procedures and systems. However, changes created by technology and globalization demand modifications in regulations.

For instance, the high demand for virtual currency has made regulators reassess in place regulations and make amendments to regulate cryptocurrency. As most of the cryptocurrencies are not backed up by any central government, the potential of its use in illegal activities, especially terror financing and money laundering, already threatens the authorities and businesses.

Consumer data protection regulations that emerged due to the breaches and misuse of personally identifiable information (PII) have also emerged and now the banks or FIs that access customers' personal data for KYC and identity verification need to ensure that the data is dealt according to the data protection regulations. General Data Protection Regulation (GDPR), for instance, made it compulsory for any organization that processes data of the individuals located anywhere in Europe. Similarly, California state also introduced the California Consumer Privacy Act (CCPA) for the protection of consumer data.

These regulatory reforms are helping to boost economic growth. **Ethan Tuab, CEO of Loanry** explains this impact as:

A study over a 5 year period set to test reforms found that for every reform that happened, there is a growth rate in the GDP of around 0.15%. This shows a lot of support for the theories, and that overall reforms are good for economic growth. In conclusion, reforms have a large impact on the economy, and these continued reforms will ultimately lead to a stronger, more stable economy.

The authorities are making amendments and the newest laws to regulate all these advances in financial systems. Here are some recent changes by notable global regulatory authorities:

FATF

Financial Action Task Force (FATF) is an intergovernmental organization, which strives to eliminate money laundering and terrorist financing globally. The organization has been very keen on recommending necessary changes required to comprehensively deal with financial crimes.

Noticing the recent trends of money laundering (ML) and terrorist financing (TF), FATF recommends member states to perform legal screening of Ultimate Beneficial Owners (UBOs) of every business. Owing to the exploitation of virtual currency by criminals, FATF also recommends regulating cryptocurrencies. According to a report, $4.26 billion worth of cryptocurrencies were stolen by cybercriminals, only in 2019 [8]. FATF expects members to implement these regulative reforms in their respective states for combating ML and TF. FATF also issued a guide on digital identity offering directions for regulatory authorities to develop independent digital identity systems for AML/CFT purposes.

European Commission’s AMLD5 and AMLD6

As a part of an action plan against money laundering and terrorism, the European Commission has introduced new regulations in the 5th and 6th AML directives. Every European country is required to implement these regulations as a part of its national action plan on AML and CFT.

AMLD5

The most prominent law in AMLD5 is the regulation of cryptocurrency exchanges and service providers. Before this directive, e-wallet providers and crypto exchanges were not covered under the financial regulations. AMLD5 made it compulsory for crypto businesses to perform KYC for identity verification. Furthermore, member states are required to maintain a central register for Ultimate Beneficial Ownership (UBOs) of the crypto businesses.
AMLD5 also lowers the threshold for the prepaid cards to decrease the risks of money laundering through these cards. According to the U.S Federal Bureau of Investigation (FBI), drug cartels use prepaid cards as a source to launder money earned from illegal drug sales in the USA [9]. AMLD5 was fully implemented on January 10, 2020.

AMLD6

While the European Union’s member nations are striving to implement AMLD5, the European Commission published a new directive i.e. AMLD6 in their journal. This new directive will make AML and KYC regulations more stringent. By setting a clearer definition of money laundering and increasing the minimum liability for predicate offenses, the EU aims to make AML and KYC more robust.

Transforming Compliance in Financial Services

Over the last ten years, Compliance functions have increased their resources and have widened their range of tasks, with a dramatic increase in their monitoring and surveillance activity, whether manual or substantially automated. This growth has reflected, in part, the post-crisis regulatory reform agenda (including not only resilience and – for banking – resolution requirements, but also a host of retail conduct, wholesale conduct, anti-money laundering, governance, culture and – in the UK – individual accountability requirements), more intensive and intrusive supervision, and Brexit. x laundering, governance, culture and – in the UK – individual accountability requirements), more intensive and intrusive supervision, and Brexit.

Compliance functions now have an increased profile and higher expectations placed upon them. However, a changing business environment, tough economic and competitive conditions, evolving risks, and cost pressures on financial institutions have led to increasing pressure on compliance functions to re-align to business strategic goals and to transform into a more value-add service line that can deliver more effectively and efficiently.

Moreover, despite having strengthened the control environment and enhanced compliance with regulatory requirements over the last decade, the focus and mindset of Compliance in many firms remain overly risk-averse, conservative and still struggling with the remediation of past problems, resulting in limited bandwidth to support – as well as continuing to challenge – the business. This focus may be partly the result of perceptions of regulators' expectations.

In addition, in some firms, there is a lack of clarity over the mandate and role of compliance, how it fits within the three lines of defense, and the relationship between compliance and the business.

Leveraging Technologies

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According to a report by the Metia Group entitled, "FinTech Insight 2014", technology has helped financial services address the increased burden of compliance in innovative ways which have also yielded other benefits, including improved decision-making, better risk management, and enhanced user experience for the consumer or investor.

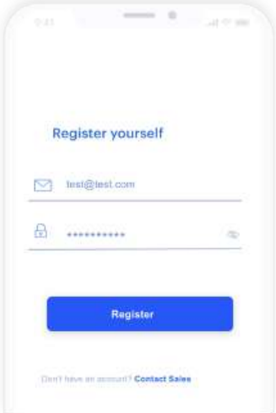
For example, the Metia Group report noted, "The increasing levels of regulatory complexity and change are driving financial institutions to look more and more at software-as-a-service (SaaS) solutions for risk and compliance – some observers are referring to this as compliance-as-a-service (CaaS).

Continued advancement in technology is geared toward addressing the evolution of financial compliance, including risk data governance, the use of artificial intelligence to manage risk, and further cybersecurity tools to protect financial data. Focus has turned to develop solutions for regulatory change management that involve rules mapping, dynamic modeling, and qualitative and quantitative risk metrics.

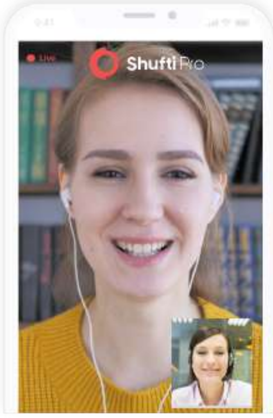
An example is the introduction of Video-KYC, which is enabling banks to perform overseas operations without sacrificing customer experience or over-looking regulations.

Video KYC offers realtime interaction between end-user and KYC experts and has the capability to replace physical interaction required for customer verification.

How our video onboarding process works

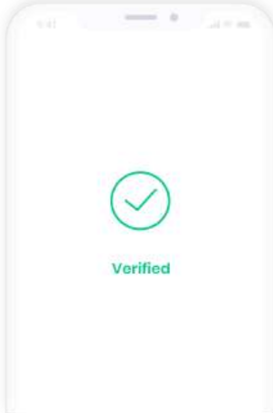


End-user registers on your platform



Live video call with KYC expert

End-user shows the identity document



Verification results are delivered

RegTech

While the aforementioned are major regulatory changes in the world, many countries are also regulating businesses to perform enhanced due diligence and KYC at national levels. The Financial Sector is obliged to follow these regulations. However, the financial sector is not lagging and is taking measures to remain compliant with rules. Since the finance sector always remains one step ahead in adopting innovative technology. One of the latest additions to the finance sector's arsenal is Artificial Intelligence (AI). It is adopting AI to make KYC/AML screening more robust, cost-effective, and time-efficient.

RegTech (Regulatory Technology) refers to the use of technology-based solutions to help in compliance with financial regulations. RegTech is enabling rapid development in the financial sector regarding compliance. AI-based identity verification and AML screening solutions are both cost-effective and time-efficient. Businesses should adopt AI-based KYC and customers due to diligence solutions (CDD) when onboarding customers to remain compliant with regulatory changes and avoid any offense.

Conclusion

Although the post-crisis wave of regulatory change is subsiding, there is much to attract regulatory and supervisory attention in 2020 and firms should not expect the scrutiny to abate. Against a darkening economic background, there will be an increased focus on firms' financial and operational resilience, how they adapt to technological change and innovation, and how they respond to political and social pressures in areas such as sustainability and financial inclusion. In an environment where boards and individual senior managers are increasingly being held to account for their actions, financial services firms will need to ensure they have the foresight, governance, skills and operational capabilities to adapt and respond effectively.

Shufti Pro's KYC and AML verification technology is built to secure online identification process because we believe "True Identity Builds Trust"

Learn More on How Shufti Pro's Identity verification and AML screening can help your business in enhancing KYC AML compliance efforts?

Discuss with an Expert

Have questions? Contact us and learn how we can help you.

www.shuftipro.com

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Resources

1. https://legal.thomsonreuters.com/en/insights/articles/cost-compliance-changing-world-regulation

2. https://www.thebanker.com/Corruption-cybercrime-and-compliance-managing-the-risks

3. https://www.thetradenews.com/banks-spent-close-to-100-billion-on-compliance-last-year/

4. https://www.fatf-gafi.org/faq/moneylaundering/

5. https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/risk/deloitte-uk-regulatory-outlook-2020.pdf

6. https://www.fenergo.com/press-releases/global-financial-institutions-fined-$26-billion-for-aml-kyc.html

7. https://www.eiu.com/n/

8. https://www.forbes.com/sites/jeanbaptiste/2019/08/15/hackers-stole-over-4-billion-from-crypto-crimes-in-2019-so-far-up-from-1-7-billion-in-all-of-2018/

9. https://www.fbi.gov/news/testimony/combating-money-laundering-and-other-forms-of-illicit-finance

Shufti Pro True Identity Builds Trust

Expanding services to 230+ countries and territories in a short period of time, Shufti Pro envisioned playing a pivotal role in creating cyberspace where every transaction is verifiable and secure. With enough experience in technologies like machine learning (ML), OCR, artificial intelligence, and Natural Language Processing (NLP), Shufti Pro strives to provide the best identity verification services to verify customers and businesses online.

Shufti Pro's cost-effective solutions help businesses to prevent fraud and illicit crimes that can ruin the integrity and brand reputation of your business. Our perfect solution suite consisting of KYC verification, AML screening, ID verification, Facial Recognition, Biometric Authentication, Video KYC, OCR, and KYB helps to improve your company's fraud prevention, Know your Customer (KYC) and Anti Money Laundering (AML) regulatory efforts by automating the workflow. With single API integration, Shufti Pro empowers you to verify customers with document checks from 3000+ ID templates and business entities from 200 million companies data.