Knowing Your Customer in Cyberspace

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History of Know Your Customer (KYC)

- Bank Secrecy Act (1970) – Established first comprehensive anti-money laundering recordkeeping and reporting requirements banks and other financial institutions that form the foundations of KYC requirements. Subsequent legislation:
  - Expanded the applicability of these requirements beyond just banks and financial institutions.
  - Added additional transaction reporting requirements and new registration requirements for non-bank businesses.
  - Expanded information sharing and enforcement powers of overseeing agencies
  - Increased penalties for violations.
- USA PATRIOT Act (2001) – Vastly expanded the scope of what was considered "money laundering", increased private sector's burdens for preventing money laundering, and increased penalties for noncompliance.

Source: https://www.fincen.gov/history-anti-money-laundering-laws#:~:text=The%20BSA%20was%20established%20in,tools%20to%20combat%20money%20laundering.

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Importance of KYC Requirements

KYC requirements can be viewed as pain points in the customer relationship management process, but they can also be viewed as risk mitigators from an operational standpoint:

- Customer Verification – KYC requirements help financial businesses reduce risk by ensuring that customers are who they say they are.
- Due Diligence – KYC requires financial businesses to examine potential customers' risk factors prior to providing services to them
- Regulatory & Legal – Financial institutions are legally obliged perform KYC checks, but performing KYC checks can help other financial businesses avoid facilitating:
  - Identity Theft,
  - Money Laundering & Terrorist Financing, and
  - Other Financial Fraud

Financial institutions can push KYC requirements onto non-bank partners

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The 3 components of KYC

Customer Identification Program (CIP)

The customer is who they say they are

Customer Due Diligence (CDD)

Assess the customer's level of risk, including reviewing the beneficial owners of a company

Continuous monitoring

Check client transaction patterns and report suspicious activity on an ongoing basis

Source: The Financial Crimes Enforcement Network (FinCEN)

Customer Identification Program (CIP) 101

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Minimum Requirements Overview

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Minimum Requirements: Notification and Collection of Information

Customer Notification

- Must inform customer of identification requirements before account opening
- May be oral or written
- May be posted on the website or on the account application

Required Information

- Name
- DOB
- Address
- Identification Number

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Minimum Requirements: Customer Verification Process

Timing

- "within a reasonable time after the account is opened."

Customer Identity Verification

- Documentary Methods
  - Individuals - Unexpired government-issued ID
  - Businesses – Entity formation documents, business license, etc.

- Non-Documentary Methods
  - Contacting customer
  - Verification through comparison of information provided and credit report or other sources
  - Checking bank or other financial institution references

Additional Verification Requirements

- Business Accounts and individual authorities

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Minimum Requirements: Lack of Verification

Procedures must include response to inability to verify the true identity of the customer. This includes detailing:

- When not to open the account
- When to allow account use until verification is attained
- When to close an account
- When to file a SAR

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Minimum Requirements: OFAC Screenings

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Minimum Requirements: Recordkeeping and Retention

Records Required:

- All identifying customer information obtained
- Description of documents relied on
- Description of methods/results of verification
- Description of discrepancy resolution

Retention Requirements:

- 5 years after date account is closed
- Must be original documentation used to open the account

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Consequences of Customer Identification Failures

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Fraud in Online Loan Applications

- Business loan application fraud
  - Fictitious or non-existent businesses may obtain loans intended for illicit purposes or that they never intend to repay
    - Look for online reviews
    - Review social media for the company
    - Take steps to identify beneficial owners of companies
- Synthetic identity fraud
  - A real identity (usually a child or elderly person) that is modified to create a wholly new identity.
  - Red flags:
    - New phone number
    - New credit report/thin credit file
    - Fraud farm behavior
    - Timezone mismatch between network data and device data

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Common Consequences of Customer Identification Failures

- Failure to accurately identify applicants' identities leads to:
  - Increased operational costs
  - Negative impact on consumers whose identity was stolen
  - Direct Monetary Loss to the lender
  - Strain on IT capability
  - Lost customers
  - Risk of regulatory scrutiny

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The FTC's Toolkit to Pursue Purported Consumer Fraud

- Section 5 Unfairness Claims: Section 5(a) of the FTC Act provides that "unfair or deceptive acts or practices in or affecting commerce . . . are . . . declared unlawful." 15 U.S.C. § 45(a)(1).
  - **"Unfair" Element**: When an act or practice "causes or is likely to cause *substantial injury* to consumers which is *not reasonably avoidable* by consumers themselves and *not outweighed by countervailing benefits* to consumers or to competition." 15 U.S.C. § 45(n).
- Telemarketing Sales Rule (TSR), 16 C.F.R. Part 310:
  - **Assisting and Facilitating**: When a person substantially assists or supports a seller/telemarketer and "knows or consciously avoids knowing" that the seller/telemarketer engages in an act or practice that violates the TSR.
  - Note: The CFPB has authority to enforce the Telemarketing Act and TSR too.

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The CFPB's Toolkit to Pursue Purported Consumer Fraud

- Unfairness Claims: Section 1031(c)(1) of the Consumer Financial Protection Act (CFPA)
  - When there is a "reasonable basis" that an act or practice: (1) causes or is likely to cause consumers substantial injury; (2) that is not reasonably avoidable by them; and (3) "such substantial injury is not outweighed by countervailing benefits to consumers or to competition." 12 U.S.C. § 1031(c)(1).
    - Strikingly similar to the FTC Act's standard
- Fair Credit Reporting: The Fair Credit Reporting Act (FCRA) and its implementing regulations, Regulation V (12 C.F.R. pt 1022)
  - Furnishers of information to consumer reporting agencies must establish and implement written policies and procedures for ensuring the accuracy and integrity of furnished information regarding consumers. 12 C.F.R. § 1022.42(a). This includes ensuring that information furnished pertains to the appropriate customer.
    - Lenders should be able to "[p]rovide consumer reporting agencies with sufficient identifying information in the [lender's] possession about each consumer about whom information is furnished ot enable the consumer reporting agency properly to identify the customer." 12 CFR Appendix E to Part 1022 III.(k).

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The CFPB's Toolkit to Pursue Purported Consumer Fraud

- **Non-bank Supervision & Examination** – The CFPB has the power to assert supervisory authority over non-bank consumer financial services companies it has "reasonable cause to determine . . . [are] engaging, or [have] engaged, conduct that poses a risk to consumers." 12 U.S.C. 5514(a)(1)(C).
  - Once a non-bank is subject to the CFPB's supervisory authority, it may become the subject of a supervisory exam, which can be a grueling process.
  - The CFPB has not exercised this authority since the passing of the Dodd-Frank Act, but Director Rohit Chopra recently signaled the Bureau's intention to start invoking it.

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FinCEN: Civil and Criminal Liability

CIVIL LIABILITY

- Recordkeeping Violations:
  - Maximum penalty of $23,011 (assessed after 1.24.22)
- General Penalty for BSA Violations:
  - Between $62,689 - $250,759 (assessed after 1.24.22)
- Personal Liability may be imposed on employees/officers
  - Haider Case

CRIMINAL LIABILITY

- Recordkeeping Violations:
  - $1,000 fine, imprisoned for 1 year, or both
  - $10,000 fine, imprisoned for 5 years, or both
- Currency and Foreign Transactions Reporting Act Violations:
  - $250,000 fine, imprisoned for 5 years, or both
  - $500,000 fine, imprisoned for 10 years, or both
- False Statements/Representations:
  - $10,000 fine, imprisoned for 5 years, or both

Increasing Efficiencies in the Customer Identification Process

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Increasing Efficiencies: Third-Party Verification Services

Benefits:

- Decrease costs
- Business can focus on developing and implementing profitable lending strategies

Risks:

- Third-party vendors may not be in full compliance with KYC/CIP requirements
- Third-party vendors may not adequately updated technology as requirements change
- Lenders may not be able to pass on liability to the third-party vendors

Lender Requirements:

- monitor and review third-party compliance
- Identify red flags with third-party vendors

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Changes on the Horizon

Source: https://www.fincen.gov/news/news-releases/fincen-seeks-comments-modernization-us-amlcft-regulatory-regime

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Questions/Discussion

If you would like to ask a question, you can ASK or type your question into the CHAT feature NOW.

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