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BRIEFING

The Evolving State of Compliance in Malaysia

JANUARY 2017

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Beyond Censorship – The Real Implications of Ignoring Fraud

Malaysia has been a hot topic in global discussions around bribery and corruption involving Politically Exposed Persons (PEPs) since the 1MDB scandal broke in mid-2015. The impact of investigations into Malaysian prime minister Najib Tun Razak's alleged funnelling of MYR2.67 billion (USD662.36 million) from the government-run development company to his personal accounts – with some reports that as much as USD4 billion has gone missing – has spread far beyond Malaysia.

Authorities in Hong Kong, the US, the UK, Switzerland and Singapore are looking into bank accounts and transactions allegedly linked to the case. In Singapore, a former employee of a Swiss private bank has been charged under the city-state's *Corruption, Drug Trafficking and Serious Crimes Act* with buying a property using money illicitly acquired from the fund. He also faces a raft of other accusations including fraudulently signing a reference letter to a major US bank's head of Anti-Money Laundering (AML), perverting the course of justice and cheating his former employer. Singaporean authorities have seized a large number of bank accounts as part of their investigations.

The case has also thrown up concerns among domestic institutions, although censorship has made it difficult to raise issues. Authorities in Malaysia recently said people seen to be critical of Malaysia's leadership's in relation to the 1MDB issue could be threatened with legal action under the country's Sedition Act, media law and penal code.

Improving Malaysia's compliance standing by effectively identifying risk

In spite of serious concerns raised by 1MDB scandal, Malaysia is seen by the Financial Action Task Force (FATF) as having made appropriate progress on AML and Countering Terrorist Financing (CTF). In February, Malaysia became Asia Pacific's eighth full member of FATF, with the organisation praising the country's "continued progress" on measures to improve its commitment to AML and CTF initiatives. The country's Know Your Customer (KYC) law covers not only banks and other financial institutions but also insurance, finance advisers, registered real estate agents and dealers in precious stones.

One of the key issues the 1MDB case illustrates is the challenge of identifying Malaysia's PEPs - seen by FATF as one of the major areas requiring scrutiny. Having a screening program in place to help proactively identify PEPs and determine their level of risk to your business is critical. LexisNexis® has developed a quick reference guide focused on best practices behind an effective PEP Screening Program, which you can review by clicking here.

Taking a data-driven approach to determine PEP risk

The FATF guidelines stipulate that financial institutions should take "reasonable measures" to find out if a customer or beneficial owner of an account is a domestic PEP or one who has been given a "prominent function by an international organisation". Risks occur where companies are found to be used for purposes such as hiding personal assets or are involved in corrupt business dealings. It can be difficult to determine beneficial ownership, particularly if the company is registered offshore in jurisdictions with secrecy laws.

For foreign customers, banks are required to have "appropriate risk-management systems" to determine whether, they or the beneficial owner, are a PEP. Once this is determined, they are required to obtain senior management approval to on-board a new customer or continue doing business with an existing one, "take reasonable measures to establish the source of wealth and source of funds", and use enhanced monitoring of the ongoing business relationship.

Radish Singh, AML leader at Deloitte Southeast Asia, suggests this is made particularly difficult by the region's different definitions and regulatory expectations. Some markets have a broad definition, which encompasses associated PEPs and people with a social connection to them; others stick to a narrower definition. "We see challenges for financial institutions that have a footprint across various jurisdictions in the region - or globally for that matter - in harmonising their internal policy with regard to the definition of PEPs," she observes and continues, "Our advice to financial institutions with global and regional footprints is to always adhere to the highest standard, and align their internal policies with that standard for consistency and to also manage the expectation of more stringent home or possibly host regulators."

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—Radish Singh, Deloitte Southeast Asia

Singh also points out that language and cultural issues can also be a barrier to effective screening. In Malaysia, as in other markets, results can generate a large number of false positives, "In some cases, we have seen this create additional operational challenges where the screening results in too many hits," Singh shares.

More generally, she notes, once a PEP is on-boarded, institutions need to introduce constant monitoring of accounts, with enhanced internal process to verify their sources of wealth and funds. “A financial institution has to exercise caution, ensuring it does not fail in identifying any corresponding risk it is being exposed to,” Singh adds, “Often, when a particular issue blows up, any weakness or perceived weakness in the compliance framework becomes a difficult discussion with the regulators”.

FATF also calls for a risk-based approach to efforts to combat money laundering and terrorist financing. This involves key indicators where a financial institution needs to look more closely into the potential risks it is exposed to. For Deloitte’s Singh, this means taking a strategic view of risk-assessment outcomes but also identifying the underlying trends rather than just “inherent and residual risk”. “Institutionalised governance, with sound documentation and audit trail for all due diligence and decisions made on AML/CFT, goes a long way,” Singh continues, “My view is that the beefing up and sharpening of the second line of defense assurance is extremely critical for a financial institution to be more agile in addressing and closing gaps. Financial institutions do not have the luxury to wait for the internal audit or third line of defense findings,” she concludes.

Fortifying risk identification with proven data

Determining PEP risk is largely dependent on the quality and coverage of the data a company screens against. Chris Foye of LexisNexis® Risk Solutions points out key considerations for screening data, “A PEP database must adhere to the highest standards in terms of its PEP definition and must have robust maintenance processes in place to ensure the quality and currency of the data. Equally important is to ensure the presence of secondary PEP information, e.g. date of birth etc., to assist in the screening process.” Foye observes that screening can create one of the biggest challenges faced by institutions: managing the number of alerts generated by such systems. He continues, “Technology can help reduce the false positive rate, but even more important is the data driving it. Institutions are realising they cannot continuously expand their compliance resources and so they are looking at more innovative ways to address the challenge through greater collaboration with third parties.”

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—Chris Foye, LexisNexis

Balancing due diligence essentials with financial inclusion

The challenge of KYC is not only an issue for financial institutions. Earlier this year, FATF issued guidelines on how the risk-based approach should be applied to money and value transfer services—one of the main instruments of financial inclusion in Southeast Asia.

Financial services providers in Malaysia and Southeast Asia would be forgiven for thinking this puts them in an impossible dilemma. If they de-risk, making certain to deal only with customers who can satisfy all their KYC requirements, this makes it extremely difficult to target the unbanked and thereby match the government's desire to boost financial inclusion.

Managing customer resistance to standard KYC inquiries

Effectively combining KYC requirements with efforts to expand financial inclusion can be challenging for many institutions. "If you look at it from a risk perspective of either compliance or capital cost, these are not good clients, but they do bring additional revenue. Lots of banks are thinking about how to balance this factor with the need for financial inclusion," concurs Aliette Leleux, Asia Pacific managing director and head of finance and risk at Accenture. Several roadblocks impede an institution's ability to collect adequate KYC information, many times stemming directly from the customer. According to a senior figure at the Remittance Association (Singapore), it can be difficult to convince customers to deliver the required information. "We have no issue collecting information, but customers do. They will ask why we want to know their father's name or residential address, and it is very difficult to persuade them to release information like that," he says. Indeed, it has been said to be "practically impossible" for correspondent banks in Singapore and Hong Kong to conduct proper KYC, because of their relationships with higher risk developing jurisdictions, including Malaysia.

Turning effective KYC into competitive advantage

Paul Gwee, secretary general of the ASEAN Bankers Association, feels that in the long run, KYC is as much a business imperative as a regulatory one for institutions in Southeast Asia. Gwee feels that efficient, credible and authoritative KYC can be a source of competitive advantage. "It's something we need to embrace for the good of financial institutions. It is also good for customers because they know they are dealing with banks that will work with them and understand them." He continues, "The most important thing in dealing with customers in any banking situation is you must know the customer, irrespective of AML or KYC issues. For higher risk jurisdictions, you do probably need to be a bit more vigorous, but this is well understood, and will need to have more stringent on boarding procedures and ongoing monitoring."

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Chris Foye agrees effective KYC protocols strengthen compliance and can improve core business operations, “Having robust KYC processes is an imperative for all financial institutions and it can help foster financial inclusion by making it easier for individuals to have access to the financial system. Also, if done in a collaborative manner at a local level between institutions and the regulator it could drive greater efficiencies whilst still being sensitive to local requirements and privacy laws.”

LexisNexis can help you navigate global PEP risks when dealing with third-party vendors and business partners. We offer industry-leading PEP database access, augmented with Adverse Media flags, specifically designed to help your business quickly identify PEP risk that may impact your business. Our PEP data complements the OECD and Transparency International recommendation on Bribery & Corruption.

Let LexisNexis streamline your entire KYC workflow and enable your business to avoid compliance process delays, reduce costs and concentrate on capturing more market share. Our solutions are designed to deliver a synthesized picture of your customer and the risk they may, or may not, pose to facilitate faster, more well-informed decisions across the entire customer lifecycle. We can help your business truly know your customer and understand the intricacies of their critical relationships and connections. Understand where your business stands in regards to PEP and AML risk exposure and make well informed decisions to protect your business and mitigate risk with LexisNexis.