

AN OVERVIEW OF KNOW YOUR CUSTOMER (KYC) MECHANISM AND THE BIRTH OF CENTRAL KYC REGISTRY

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OVERVIEW OF BACK END VERIFICATION OF DATA BY FINANCIAL INSTITUTIONS

The volume of dealings between financial institutions and individuals (or even legal entities) has substantially increased over the last decade. There has been a tremendous expansion in the scope of financial services provided in the market. We can safely say the financial market today is more than just 'loans' and 'deposits'. With such an expansion, the regulatory measures within the country and the role of regulators have also increased. Dealings or transactions in the financial market primarily can be categorized as the ones which are for the purpose of availing loan, opening accounts, etc. and the ones pertaining to investments, either in the money market or in the capital market.

Involvement of monetary aspect in transactions clearly follows the regulatory aspect too. It goes without saying that such dealings or transactions are also subject to certain procedures for ensuring transparency in the process. Thus, enters the role of record verification by banks and other financial institutions.

Pursuant to the money laundering and financial terrorism within the country, a need was felt for introducing a back end verification process of person/s records by such banks or entities dealing with the customers.

Curbing the threats of identity theft and identity fraud was also another major intention for introducing such a mechanism. This resulted in the introduction of one of many measures by RBI, known as the 'KYC' Norms.

Introduction of the KYC Norms has significantly eased the insecurity faced by banks and financial institutions, especially with respect to the threat of money laundering.

Currently, the system that is in place is that of collection of KYC records by banks and other financial institutions as required by the KYC norms. Though this system suffices the intention of customer identity verification, it must be noted that it is done by the entities individually for every transaction. The entities may cooperate and share this information, but the existence of a decentralized mechanism delays the process and duplicates the efforts of both, the customers as well as the financial institutions. Moreover, there is increased scope for laundering of money. These hurdles were the primary reasons for inception of the Central KYC Registry, a centralized mechanism to facilitate the storage, verification and retrieval of KYC records collected by various financial institutions.

KNOW YOUR CUSTOMER (KYC) NORMS

The Reserve Bank of India introduced the KYC guidelines in 2002 pursuant to the recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) and Combating Financing of Terrorism (CFT). These guidelines were issued under section 35A of the Banking Regulation Act, 1949 and Rule 7 of the Prevention of the Money Laundering Rules, 2005.

In 2005, all the banks were directed to comply with KYC provisions before 31st December, 2005. 'Know your Customer' norms were designed to help banks and other financial institutions know their customers better and also store their details for further usage and dealings with the said customers.

KYC norms are useful to manage risks more prudently, as detailed information of the customer is available at any time.

What is KYC?

'KYC' process is detailed verification of definite records of customers by financial institutions in order to prevent customer identity theft and money laundering. The identity and address of customers is verified by requiring them to submit certain documents and records which shall hold well as identity proofs. This process is generally initiated by banks when the customer intends to open an account with the bank. In addition, a bank may also initiate such a process for an existing account holder, where there has been a change in his/her records or any change in the regulation governing the requirement of KYC. In addition to banks, as per RBI guidelines, equal KYC obligations have been cast on NBFC's as well. The process of KYC is not limited to name matching. Another important aspect is to monitor and check the transactions of a customer against his profile.

Working of KYC is technically quite simple and methodical. Nowadays, the KYC process is technology dominated. The process is automated by use of software for same. The two commonly used software for the purpose of KYC verification are:

- 1) Name Analysis Software, and
- 2) Trend Analysis Software

In normal course of operation of dealings through accounts, the entities have a thorough process of 'Customer Due Diligence' (CDD) for all the dealings. The automated system helps not only in the verification stage, but also in the monitoring aspect. Thus, in case there is any unusual activity pertaining to a particular account, the system alarms the entity. Thereafter, the said entity can undertake 'Enhanced Due Diligence' (EDD) for the dealings through such account/s. The process of EDD uses

internal as well as external sources of information. Thus, it can be said that the KYC process ensures transparency in monetary operations taking place through the financial institutions.

Importance of KYC process

According to RBI's Master Circular issued in 2015, "the objective of KYC or AML or CFT is to prevent banks from being used, intentionally or unintentionally by criminal elements for money laundering or terrorist financing activities. KYC procedures also enable the banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently" This statement of RBI sums up the entire objective of inculcating KYC Norms in the verification process. Thus, significance of KYC is mainly to prevent identity theft, money laundering and terrorist financing.

As per the revised guidelines issued by RBI in relation to KYC, banks are required to incorporate the following four aspects in the KYC verification process:

- **Customer Acceptance Policy (CAP):** The CAP policy of the bank shall lay down the criteria for the acceptance of customers. Under this aspect, banks are also required to prepare risk profiles of each customer.
- **Customer Identification Procedure (CIP):** The CIP procedure as adopted by banks should ensure that sufficient due diligence is undertaken by the bank with respect to each customer. Here, 'sufficient due diligence' would mean diligence in adherence with the regulatory guidelines.
- **Monitoring of Transactions:** The banks must undertake ongoing monitoring for every customer and ensure that the transactions are in accordance with the customer's profile. In other words, banks must exercise ongoing due diligence of customers.

- **Risk Management:** It will be helpful if the banks create risk profiles of each customer. Such risk profiles shall also indicate the risk associated with that customer.

Categorization can be under the heads of 'low risk', 'medium risk' or 'high risk' customers.

Inclusion of these four aspects in the KYC process shall make the verification more efficient and effective.

Importance of the KYC process can be explained as below:

- **Prevention of Money Laundering:** When money which is obtained illegally is shown to have obtained legally, it is known as 'money laundering'. To deal with this problem, the Prevention of Money Laundering Act, 2002 and KYC guidelines were passed. A combination of both the regulations shall help financial institutions to know the face behind monetary transactions.
- **Management of Risk:** With the advent of KYC and guidelines pertaining to the same, financial institutions can now create risk profiles and categorize their customers accordingly.
- **Combating Financing of Terrorism:** The norms shall help entities to check transactions of dubious or suspicious nature. This will help combating financing of terrorist activities.
- **Check of Identity Theft:** The complete identity of the prospective customer is present before the financial institution. No accounts in fictitious name can be

opened. Furthermore, unless and until, all the requisite documents are submitted, the entity shall not process any application.

As it can be seen, KYC norms have proved to be highly beneficial for advancement of the record verification process.

Is KYC only limited to banks?

In common parlance, the word 'KYC' is generally related with bank dealings. However, we can say that it is a strict interpretation of the term. In a wider sense, KYC norms are required to be incorporated by Non-Banking Financial Institutions and other notified companies as well.

However, the degree of adherence to such norms by entities other than banks is not the same as required by banks. Recently, RBI relaxed the KYC norms applicable to NBFC's. It was observed that the non-banking financial institutions were facing practical problems since they were required to obtain KYC documents at definite intervals of short duration.

Previously, as per the KYC guidelines, NBFC's were required to undertake the KYC activity once in every 5 years for the low risk clients and once in every 2 years for the medium risk and the high risk clients. This requirement has been substantially eased for the NBFC's.

Now, the same activity can be conducted by NBFC's once in every 10 years for the low risk clients and once in every 8 years for the medium risk and high risk clients. Apart from such relaxations, the KYC requirements imposed by the guidelines remain the same for both, banks and the non-banking financial institutions.

The present mechanism

Currently, the banks and other financial institutions required to adhere to KYC norms, store such data and information for their use and also to mitigate customer identity risks. The guidelines by RBI provide requirement of definite documents for transactions with banks.

As far as a centralized system for information possessed by banks and financial institutions is concerned, there are guidelines for credit sharing between banks as recommended by the Indian Banks Association (IBA).

Interbank and inter organization communication is clearly a strong one and possesses unity, but having a centralized system in place is a much wider concept than mere exchange of information between banks.

This model is justified by the Central KYC Registry also known as the CKYC Registry.

CENTRAL KYC REGISTRY

Central KYC Registry

In July, 2011, the Apex Court ordered the appointment of Special Investigation Team (SIT) on Black Money. It was headed by former Supreme Court Judge BP Jeevan Reddy. The team was to report to the Supreme Court directly.

Out of several measures suggested by the team, the recommendation of setting up a Central Registry for KYC was most appreciated.

Central KYC Registry is a centralized repository formed to hold and store the KYC information as submitted by all the registered entities throughout the country. In other words, the entities shall submit the client related data and information on a common portal and the portal will store such information. The Central KYC Registry requires data as per the common KYC template to be captured along with the scanned copy of the certified supporting documents.

The Central Government has authorized the Central Registry of Securitization Asset Reconstruction & Security Interest of India (CERSAI) to perform the functions of such registry¹. The model was given legal backing by introducing a modification to RBI's 'Master Direction on KYC, 2016'.

Section 57 pertaining to 'Procedure and Sharing KYC information with Central KYC Registry (CKYCR)' was amended and thereby sharing of KYC information possessed by registered entities with the CKYCR was facilitated.

An amendment to the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 was also required. Therefore, according to Rule 9(1A) of the Prevention of Money Laundering (Maintenance of Records) Amendment Rules, 2015, every reporting entity shall within three days after the commencement of an account-based relationship with a client, file the electronic copy of the client's KYC records with the Central KYC Registry.

ABOUT CERSAI: THE FACE BEHIND CKYCR

Central Registry of Securitization Asset Reconstruction & Security Interest of India is a Government company, registered under the Companies Act, 1956 as a Section 25 Company.

It was set up under Section 20(1) of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI). CERSAI became operational on 31st March, 2011.

CERSAI was primarily created to check frauds in lending against equitable mortgages, wherein multiple loans were availed on the same asset. Thus, to curb practices of money laundering, CERSAI was set up to maintain a central registry of equitable mortgages. The existing CERSAI mechanism allows financial institutions and the general public to

¹vide Gazette Notification No. S.O. 3183(E), dated November 26, 2015

access the registry platform for a fee. This mechanism facilitates the lenders to ensure that the property against which loan is being extended, is free from any encumbrance. The most recent development to the CERSAI mechanism is that it has been authorized to perform the functions of CKYCR. Thus, the platform will serve as an intermediary to access the CKYCR.

ELEMENTS OF THE CKYC REGISTRY

1) Single Directory of KYC

The most essential feature of CKYC is that it provides the function of a central registry where all the KYC data across the nation is stored on a common platform. This can be retrieved by the registered users. It is a centralized repository of KYC records of customers. Such records can be accessed by authorized financial institutions or other notified institutions under the Prevention of Money Laundering Act or Rules framed by Central Government or RBI, SEBI, IRDA, PFRDA.

2) Inter usability of KYC records

It provides inter usability of KYC records. Inter usability means that once a KYC record or document of a customer is uploaded by the financial institution or bank, it can be accessed for further use by such entities that need it for transaction with the same customer.

3) Time limit for upload of KYC records

There is a time limit stipulated for upload of KYC records by entities dealing with such customer/s. According to Rule 9(1A) of the Prevention of Money Laundering (Maintenance of Records) Amendment Rules, 2015, every reporting entity shall

within three days after the commencement of an account-based relationship with a client, file the electronic copy of the client's KYC records with the Central KYC Registry.

4) Access by Digital Signature Certificate (DSC)

The access to CKYC applications is based on requirement of a Digital Signature Certificate by the registered user. The portal accepts the following Digital Certificates.

Class II: These certificates will confirm that the information in the application provided by the subscriber does not conflict with the information in well-recognized consumer databases.

Class III: These are high assurance certificates. They shall be issued to individuals only on their personal (physical) appearance before the Certifying Authorities.

5) Separate Classification of Individuals and Legal entities

There is separate classification of individuals and legal entities. There are two different types of KYC templates, one for the accounts of individuals and the other one for the accounts of legal entities.

Accounts of individuals are further classified as; Normal, Simplified and Small. Account classification is determined from the nomenclature of CKYC identifier issued to the customer.

6) Access Hierarchy of financial institutions

There is access hierarchy of financial institutions, namely; Institute, Region and

Branch.

Financial institutions can avail the services of CKYCR by making an advance payment to the account of CERSAI. For every service availed by the financial institution, the required amount is deducted accordingly from the said advance deposit.

THE MERITS OF CKYC REGISTRY MECHANISM

The CKYC Registry is a boon to the system of record storing and retrieval by entities. It contributes to the aim of data centralization.

Some of the merits of the CKYC mechanism are enumerated as below:

1) User Friendly Platform

It is a highly user friendly portal wherein uploading and retrieval of information can be done smoothly by the financial institutions. The platform is created to ease the process of record storing and sharing, and it thus, rightly serves the purpose.

2) Easy Upload and Retrieval of Information

The entire system is based on facilitating convenient uploading and retrieval of data by banks and financial institutions in order to ensure that such data can be of immediate use.

3) Advanced user authentication mechanism

The platform provides an advanced user authentication mechanism. This is evidenced by the requirement of Digital Certificate by the users.

4) **No scope for duplication**

Under the system, there is no scope for duplication of documents and KYC information.

The KYC information provided by customer to one financial institution is sufficient for further correspondence with any other financial institution.

5) **Less Hassle to Customers**

The hassle of producing KYC documents and information time and again is substantially reduced under the CKYCR system. A customer has the obligation to produce the KYC records only once to the financial institution he is dealing with. Once, this requirement is fulfilled, the obligation then rests on the said financial institution to upload the records on the CKYCR. Therefore, there will be less hassle to customers.

6) **Reduced probability of record loss**

There is reduced probability of loss of data or information stored by the entities as there is a centralized mechanism for the storage.

7) **Reduced burden of storage on entities**

The financial institutions no longer bear the burden of storing information related to customers. This information is now required to be stored on CKYCR which can be retrieved as and when required.

CKYC REGISTRY: THE DOWNSIDE

The CKYC Registry Model intends to centralize the customer information and data collected by the reporting entities. So, it follows that it shall provide ease to the customers and entities and at the same time, put an end to the traditional method of customer data submission every time there is a transaction between the customer and the entity. While that is true, the mechanism has its own downside as well. There are some drawbacks which need to be taken into consideration before hurrying to declare the system flawless.

Some of the drawbacks of the CKYCR as follow:

1) Extent of liability of CKYCR

The CKYCR operating guidelines, 2016 pin down the functions and obligations on the registry as well on the reporting entities. One of the most important obligations on the reporting entities, as enumerated in the guidelines is that the reporting entity shall not use the KYC data for purposes other than verification and shall not transfer the same to any third party. While this obligation is with the reporting entities, the guidelines are absent about such restriction on the registry. Even though the guidelines state that the registry shall be responsible for electronically storing and safeguarding data and shall ensure that integrity of the data be maintained, the obligation on registry to not use KYC data for other

purposes or share such data with third parties is not set out in clear words, as in the case of reporting entities.

Such an obligation on the registry as well shall provide a high amount of assurance to the public. Therefore, the extent of liability of CKYCR is absent.

2) Threat of Data theft

The threat of data theft always remains when there is involvement of large volume of information. Once again, referring to the CKYCR Operating Guidelines, 2016, the guidelines provide adequate safeguards for ensuring security of data by reporting entities as well as the registry, but the possibility of data theft or tampering cannot be ruled out, since large volume of data in the form of KYC records will be stored in one place.

Storage of all the data in one place would also mean that even a slight threat would prove to be harmful to the data records of the entire nation. It is unclear how the mechanism intends to tackle such a potential danger to the security of records. The registry has been obligated to ensure that integrity of records is maintained, but the real question is, **will the registry be held liable in case of such an event?** As far as the guidelines and directions issued by RBI are concerned, there is mere imposition of duty on the registry, but there is no reference to the imposition of actual liability in such scenarios. Moreover, the directions and guidelines so far have been silent on the issue of handling the problem of data hacking and specific precautionary measures to deal with it.

3) Payment of fee for availing CKYCR services

For availing the services of the CKYC Registry, the entities shall be required to pay a requisite amount of fee to the CERSAI. Initially, the entities will be required to deposit an advance amount with the CERSAI. Thereafter, for every service availed, the requisite amount will be deducted from the advance payment made and if the balance is insufficient, the reporting entity will not be able to avail the services.

Presently, the transaction between a financial institution and a customer is executed at a nominal cost under the head, 'processing fee'. This 'processing' stage also includes verification of KYC records, as submitted by the client. However, under the new centralized mechanism, the reporting entity is required to pay a fee to the CERSAI for availing each service. The quantum of such fee is not clarified, but what remains a bigger hurdle is that whether the burden of this expense will be passed on to the customers or not. Currently, there are no directions for the same. Therefore, the issue of quantum of fee to be charged for every service availed remains ambiguous. Moreover, will such a mechanism increase the burden of the customer, since the entities may pass the burden on the customer under the head of 'processing fee' or any other head, not to forget that this may be in addition to the actual costs incurred by the entity to verify records.

Thus, the CKYCR, though an effort to centralize the lengthy process of data verification, has certain drawbacks which need to be addressed, in order to make the system flawless.

CKYC REGISTRY: HOW DOES IT FUNCTION?

The CKYC Registry functioning is solely based on upload of KYC records by the financial entities on the platform. The 'live run' of the CKYCR started from 15th July, 2016. To understand the process in detail, the following steps guide the way:

- 1) The banks or financial institutions shall collect the KYC records from the customer as required and upload the same on the Registry within 3 days of commencement of account-based relationship with the customer. The upload is to be executed using the Digital Certificate. This is required when the customer is submitting KYC records for the first time or there has been a change in his records. In all other cases, the entity shall directly access the customer KYC records on the basis of the identifier submitted to the entity. The entity collecting records and documents has the onus to verify the same.
- 2) In the second step, CKYCR would process the KYC records received in order to eliminate duplication of records. This is known as de-duplication of records. It is done on the basis of demographics and identity details of the customer.
- 3) The CKYCR, after verification of records received, shall issue a KYC identifier for the customer to the reporting entity. 'KYC identifier' means a unique identifier for the customer generated by the Central KYC Registry and notified to the reporting entities. It is a 14-digit unique number.
- 4) The entity shall then communicate the KYC identifier issued to the customer.
- 5) Now, when the customer submits the KYC identifier to another reporting entity, then that entity can accordingly retrieve the KYC details from the registry using that identifier. There is no need for re-submission of documents by the customer. Thus, the step-by-step procedure involved in the CKYCR mechanism is simple to interpret and encourages the drive of centralization very effectively.

The operating guidelines for the operation of the CKYCR were issued in 2016. These guidelines provide the framework for the functioning of the registry.

The highlights of the guidelines are as follows:

1) **Functions and Obligations of the KYC Registry**

The functions and obligations of the registry are defined by the operating guidelines.

Processing of KYC records is the primary function of the registry. The CKYCR shall ensure that the integrity of electronic systems for records is maintained. Thus, CKYCR shall be responsible for storing, safeguarding and retrieving the KYC records.

2) **Functions and Obligations of the reporting entities**

For the reporting entities, registration with the CKYCR is the primary responsibility.

The reporting entities are also required to verify the KYC records collected. There is an obligation on the reporting entity to not use the KYC information downloaded from the registry for any purpose other than verification. Services of CKYCR are available on payment of fee. For this purpose, the system of 'advance payment' is in place.

3) **Operating guidelines to the reporting entities**

The operating guidelines to reporting entities enumerate the procedure for reporting entities to get registered with the CKYCR. Upload, Search and

Download and Update of Records are some of the functions that can be accessed by the reporting entities.

4) **Grievance Mechanism**

The registry also provides for grievance mechanism of the reporting entities. Thus, the complaints of such reporting entities can be redressed in a timely and effective manner.

The Operating Guidelines, 2016 pave way for the operation of the registry and the system. The guidelines address the basic aspects of the registry and the working. The entire operation of the CKYCR system is enumerated by the guidelines, which shall prove to be helpful to a number of groups.

CKYC REGISTRY: A BIRD'S EYE VIEW

The CKYCR initiative has been highly appreciated by the reporting entities. Bringing the 'KYC Mechanism' beneath one roof is going to benefit the administrative aspects of record collection and storage very efficiently. The responsibilities of entities are not completely zeroed down. The duty of verification of documents in the process shall still rest with the entities.

With the advent of the central registry mechanism, the aim is to store all sensitive data in a secure manner in one place. This will also reduce the time of operations taken by financial institutions.

The process will start by the customer submitting his unique 'identifier' to the institution and the institution accessing such customer's KYC records from the registry. The lengthy process of every entity collecting the same records from the same customer again and again will no more cause inconvenience.

Certain aspects of the mechanism which may prove to be a threat to the successful execution of the project like danger of data theft and the extent of liability of registry must be addressed. A detailed structure including these aspects may prove to be highly beneficial.

From an overview, CKYCR, a project to centralize the digital data storehouses, seems to justify the aim of KYC records centralization, however, the functionality of such a centralizing mechanism will be seen with the passage of time.