KYC2020
W H I T E P A P E R

Effective AML compliance for emerging payments innovators

The Case for Moving from Traditional Screening Systems to Real-Time Hands-free Decision Services

Businesses are now on the frontlines of the battle against money-laundering and terrorist financing. Small and medium-sized enterprises (SMEs), specifically money service businesses (MSBs) and online merchants, are easy targets for criminal activity for several reasons. First, SMEs do not often have adequate anti-money laundering (AML) and/or counter-terrorist financing (CFT) compliance programs. These programs are basic and not suitable for intended purpose. Second, SMEs are generally online businesses that move from on-boarding customers to first-time transactions in a matter of seconds. Finally, the online transactions are usually automated, which means that there is little or no human supervision to screen for suspicious activity.

This Whitepaper discusses the AML/CFT compliance challenges faced by emerging payments innovators and recommends a "hands-free" approach to watchlist filtering that combines intelligent system design with outsourcing to offer a real-time cost-efficient solution to speed up customer onboarding and recurring review.

Emerging payments innovators are coming under increased scrutiny and enforcement action by regulators. This is evidenced by the increasing number of fines levied by the Financial Crimes Enforcement Network (FinCEN) since 2012 against small companies, from family-owned MSBs and casinos to online gaming companies.

As SMEs move to fortify their AML/CFT compliance regimes, the primary focus is on watchlist filtering (aka "sanction screening").

A review of available market solutions exposes a significant deficiency: AML/CFT systems are either too expensive, too integrated, or too disruptive to transaction flow and customer onboarding. The problem is that compliance systems have traditionally been aimed at financial institutions that have a larger burden of compliance.

Problem With Existing Compliance Systems

Financial institutions, specifically large banks, have been the traditional consumer of compliance systems and have dictated the evolution of most third-party compliance solutions. Banks generally use highly integrated systems that manage AML/CFT compliance as part of the Know Your Customer ("KYC") compliance lifecycle, from sanction screening and enhanced due diligence (EDD) to customer onboarding and ongoing transaction monitoring.
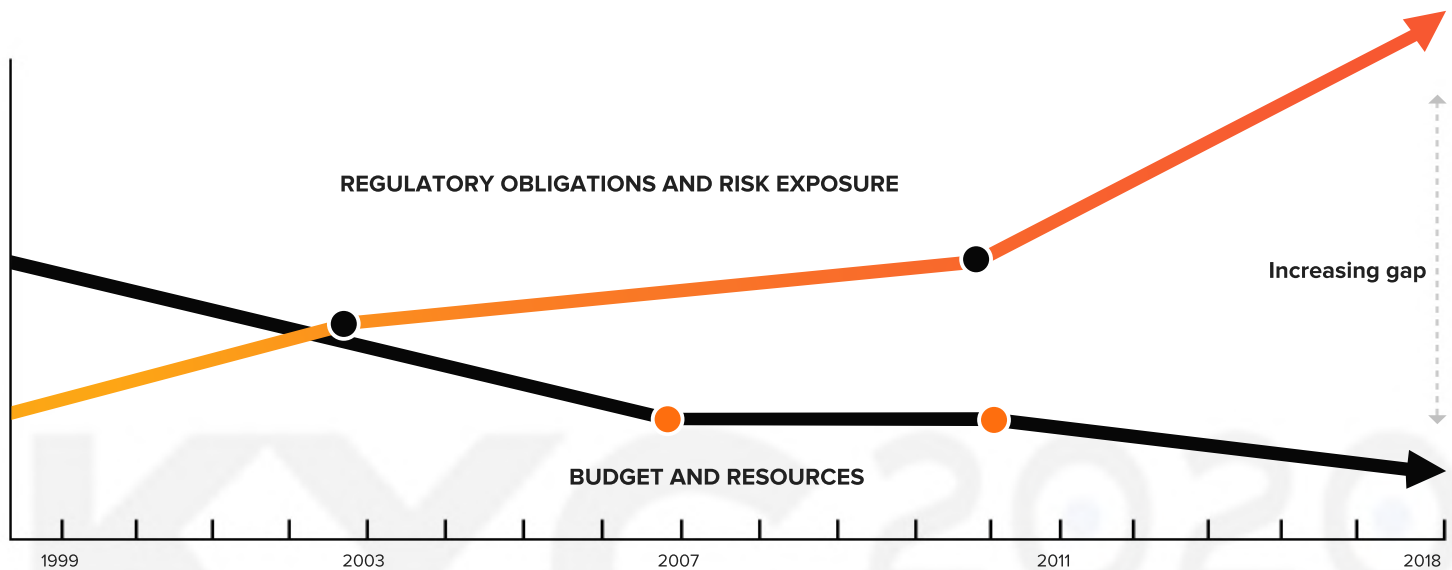
These systems are complex and expensive with semi-automated workflows that are driven by an army of compliance staff. Banking systems rely on manpower to clear false positives from sanction screening systems and invariably require human reviews prior to making customer onboarding decisions.

"Closer regulatory scrutiny and soaring fines are pressuring financial institutions to enhance their watch list screening programs," observes a report from Price Waterhouse Coopers (PWC).

> " Many organizations have responded by implementing new systems and investing in necessary resources, but their programs often lack adequate risk-based standards or strategies. The result is agnostic screening regimes that tend to generate excessive false positives. "

Another study by Ernst & Young notes that most current compliance programs are cost and resource intensive and are geared towards "over-screening," which results from lowered thresholds to avoid missing a true positive. "Over-screening is prevalent," notes the Ernst & Young report, with unnecessary manual screening for false positives.

Over-screening is an acceptable practice for banks because they serve customers with whom they have long-term relationships, and must conduct enhanced due diligence as a component of KYC. This practice, however, is cost-prohibitive and unnecessary for many emerging payments innovators that often conduct one off transactions with their customers.

REGULATORY OBLIGATIONS AND RISK EXPOSURE

Increasing gap

BUDGET AND RESOURCES

1999   2003   2007   2011   2018

Increasing Regulation For SMEs

In today's global marketplace, companies working with international customers or conducting cross-border transactions must be aware that sanctions screening must be conducted at a minimum to be compliant. This includes any business that can be a conduit for illicit financial transactions, from money service bureaus, online gaming companies and virtual currency exchanges to real estate brokers, car dealers and private equity firms.

Compliance is a new cost of doing business for virtually every business. "Regulators have tightened their focus on effective watch list screening programs and are levying significant penalties," notes the PWC report. "Since 2004, financial institutions have received fines totaling $14.8 billion for violating U.S. economic sanctions alone."

> The big question that SMEs must answer is,
> **How do we find and implement the right compliance program?**

The Goldilocks Dilemma

SMEs faced with the added cost of regulatory compliance must find the right balance between effectively managing compliance exposure, and providing the best customer experience at a reasonable cost. A "too little" approach increases the risk of a regulatory fine, while a "too much" approach creates cost inefficiencies. An acceptable AML/CTF compliance program for SMEs includes a good watchlist filtering program with a set of sanction lists tailored to the organization's risk profile. Solving the "Goldilocks" dilemma for SMEs means finding alternatives to traditional compliance solutions that are designed for money center banks.

Traditional sanction screening solutions are designed to filter a set of watchlists, with the search results then manually exported and reviewed for decisioning or fed into more sophisticated KYC workflow management and banking decision systems. In order to remain competitive, SMEs must move from screening tools built around integrated manual workflows to stand-alone "decisioning" systems that yield screening decisions in real-time, without requiring manual review, including for clearing false positives.

The Goldilocks Solutions

TOO LITTLE

In-complete or Outdated Watch Lists with rudimentary search algorithms leads to significant penalties.
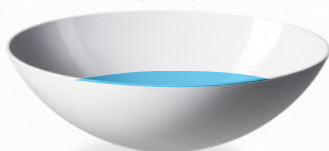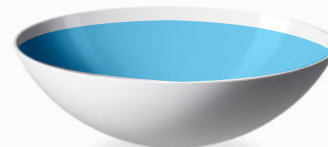
JUST RIGHT

- ✓ PASS/FAIL Screening Decisions
- ✓ Real-Time Response Rates
- ✓ Configurable by Risk Profile
- ✓ Integrates at Transaction Level
- ✓ False Positive Screening can be Out-sourced to service provider
- ✓ Produces Transparent Proof-of-Work for decisions
- ✓ Retains all Audit Documentation for minimum 5 yrs
- ✓ Cost-Efficient

TOO MUCH

Over-Screening leads to excessive number of False Positives that must be manually cleared, and result in high friction to transaction flow and customer onboarding, leading to loss of customers.

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KYC2020 **DecisionIQ™** Just Right!

Moving from Screening to Decisioning

Sanction Screening Solutions

GOOD DATA
The ability to aggregate, normalize, and continuously update the hundreds of sanctions, criminal, terrorists, PEP and other watchlists

CONFIGURABLE
The ability to selectively group these watch lists for different risk profile and screening criteria
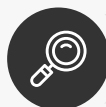
RISK BASED
The ability to configure custom watchlist groups at the organization level, or based on transaction type, size, and other criteria

CUSTOMIZABLE
The ability to create "white-lists" for cleared customers

POWERFUL SEARCH
A sophisticated scan capability, with ability to conduct searches based on Name, DOB, Address, and Identification

RISK SCORING
A risk-based scoring system to categorize flagged records and facilitate the clearing of false positives

Table 1

Real-time Decision Systems

EASY INTEGRATION
Open APIs and plug-ins for easy integration with transaction workflows

INTELLIGENT & SELF LEARNING
Additional sophistication in filtering technologies, such as AI, Natural Language Processing, and machine self-learning to reduce the number of false positives

REAL-TIME PROCESSING
A transaction processing system architecture for real-time response times on verification decisions

ALERT & TRACKING
Built-in alert systems to capture and rapidly process exceptions that require manual attention for decision

INTUITIVE USER INTERFACES
Intuitive user interfaces for rapid clearing of false positives by in-house staff, or by an outsourced third-party

AUDITABLE DECISIONING
A transparent and auditable decision system that maintains a rational, readable, and accessible proof of work for each decision.
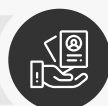
Table 2

The basis of a good sanction screening verification decision system is the underlying watchlist filtering technology. Table 1 presents the best practices for sanction screening solutions.

Moving from the filtering framework to a real-time decision system architecture requires the underlying sanction screening solution to adopt more robust features. Table 2 presents the best practices for real-time decision systems.

An expertly designed intelligent sanction screening decision system should render 95% of all verification decisions automatically, and within a 60-second response time. The decision error should be insignificant to not miss a "true positive."

For records that must be manually screened, the system design should accommodate the manual clearing of decisions within minutes for those SMEs who want to compete on speed of service.

Going 100% Hands-Free

Automation is the key to rapid verification decision response rates and lower transaction costs. According to a CFI report, 80% of the business costs incurred for AML screening results from the manual processing of false positives.

Unfortunately, false positives are inherent in screening system design. The number of false positives depends on the sophistication of search algorithms and the degree to which the system is designed to avoid missing true positives. That means even the most sophisticated or highly tuned systems with exception rates of less than 1% will require trained compliance experts to conduct manual reviews.

Most SMEs do not have the scale to need full-time compliance staff. Outsourcing to third-parties who provide compliance expertise eliminates significant in-house overhead and reduces the overall compliance liability for companies. Fully compliant third-party services also reduce exposure to government penalties and fines. While the need for accurate, fast, and cost-effective screening is important for obvious operational reasons, the need for transparent decisioning and auditable documentation is the critical requirement for any outsourced solution, especially from an examiner's point of view. This includes compliance with the Bank Secrecy Act in the U.S., the Proceeds of Crime (Money Laundering) and Terrorist Financing Act in Canada, and the requirements of other international regulatory bodies.

Outsourced Service Centers — Best Practices

CERTIFIED STAFF
Uses certified AML compliance officers and well trained staff. Executive management includes a qualified Chief Compliance officer

INTEGRATED
A complete 'hands-free' service with manual workflows for exception processing seamlessly integrated with the automated sanction screening decision system

SECURE 24X7 OPERATION
Operates a 24x7 service that is certified per ISO 27001:13 standards

FLEXIBLE AND AFFORDABLE
Offers multiple service level agreement options and pricing plans, so that verification decisions that require manual review can be done in minutes, hours, or days depending on SME needs.

TRANSPARENT AND AUDITABLE
Provides complete transparency on the manual decision-making process with anytime access to documentation.

COMPLIANT
Facilitates accurate and affordable decisioning that is compliant by international standards

Table 3

Table 3 presents the Best Practices for outsourced service centers that provide KYC/AML compliance services.

Introducing DecisionIQ™

KYC2020 offers a frictionless and inexpensive way for SMEs to incorporate the appropriate level of screening for their specific transactional and industry requirements. DecisionIQ™ is sold as software-as-a-service (SaaS) for real-time transaction screening and decisioning. DecisionIQ™ is built upon the four design principles for sanction screening decision systems: 1) Accuracy, 2) Affordability, 3) Rapid Response, and 4) Auditability.
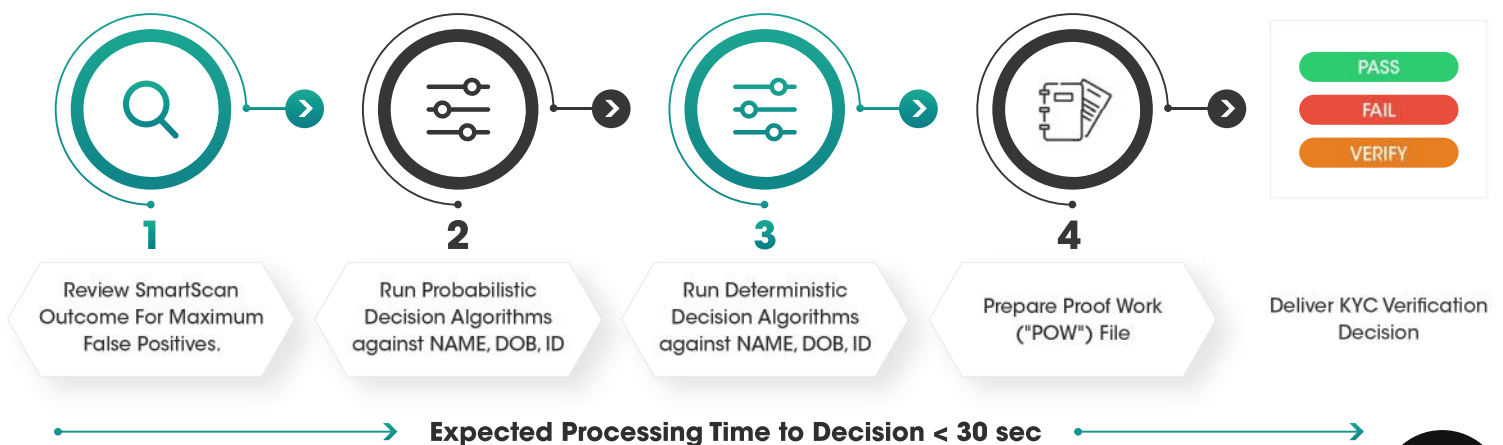
The **DecisionIQ™** service is built on the rails of KYC2020 **VisionIQ™**, a comprehensive global watchlist database, and **SmartScan™**, the best-in-class sanction screening solution. The VisionIQ™ database contains over 910 global watchlists, including sanction, terrorist, criminal, no-fly, and PEP that are continuously monitored and updated, ensuring a single source for watchlists for SMEs in any international jurisdiction.

SmartScan™ is built on Elasticsearch™ technologies, a sophisticated search and analytics engine available under GPL. SmartScan™ has multiple smart search algorithms (probabilistic and deterministic), a sophisticated scoring system, and plenty of configurability to allow SMEs to tailor the program to their risk profiles and avoid over-screening.

DecisionIQ™ Achieves

- ✔ **Accuracy of decisions** via sophisticated search algorithms that use the latest concepts in AI, NLP and self-learning.

- ✔ **Rapid Response** via use of transaction processing system architecture.

- ✔ **Affordability** via automation, and where manual review is required, it can be outsourced to competent low-cost centers.

- ✔ **Auditability** with use of a "white-box" decision system design, where decisions are accompanied by rational, readable, and readily available proof of work.

DecisionIQ™ Automated Workflow

1
Review SmartScan Outcome For Maximum False Positives.

2
Run Probabilistic Decision Algorithms against NAME, DOB, ID

3
Run Deterministic Decision Algorithms against NAME, DOB, ID

4
Prepare Proof Work ("POW") File

PASS
FAIL
VERIFY

Deliver KYC Verification Decision

Expected Processing Time to Decision < 30 sec

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Built on Proven Technologies

KYC2020 adds significant enhancements to its underlying technology to improve on transaction speeds and reduce outcome errors for the decision system. Enhancements include pre-processing of VisionIQ™ data at the time of update so that the resource intensive natural language processing routines used to decipher comments fields do not slow down response rates at runtime.

DecisionIQ™ adds artificial intelligence and a self-learning rule engine to SmartScan™ for decision analysis, essentially building a decision tree that is similar to a human approach to arrive at the sanction screening decision to Approve or Deny. Internal tests for DecisionIQ™ have produced results where 98% of decisions are made within 20 seconds with just 2% requiring manual review. This is impressive given that industry false positive rates are closer to 10%, with no accounting for processing speeds.

Smart Options for Hands-Free Operation

For the 2% to 5% of decisions that require manual follow-up, KYC2020 has a team of certified AML/KYC experts dedicated to verifying exception records in real-time. The integrated alert system, a 24x7 processing center, and the intelligent user interfaces are all designed to support a rapid response service for manual screening. This means that KYC2020 can offer service level agreements to support most online business requirements.
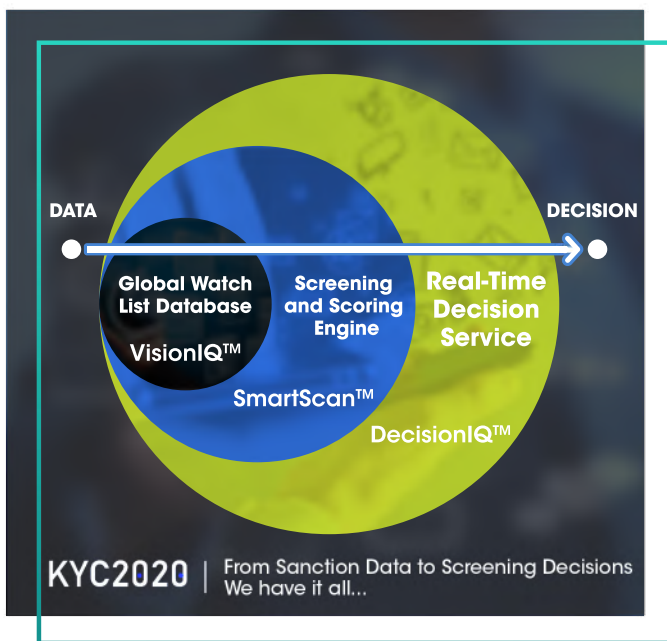
The combination of automated screening and manual verification of exceptions eliminates the need for SMEs to have staff dedicated to sanction screening. KYC2020's services model enables companies to outsource the burden of regulatory compliance, freeing-up internal resources to focus on other core business operations.

Transparent and Auditable

The core to the DecisionIQ™ service is its "white-box" decision system, in which the entire decision-making process is fully transparent and auditable. The result is a structured record-keeping system as a proof-of-work file that meets regulatory requirements and facilitates the ongoing review and improvement of decision algorithms.

The 4th pillar for DecisionIQ™ is decision auditability

DecisionIQ™
Decision Service

Accuracy | Speed | Affordability | Auditability

KYC2020

Flexible and Affordable

DecisionIQ™ offers users the flexibility to customize the service to align with specific risk profiles, transactional needs, and budgets. The user-friendly service enables SMEs to import their own private screening lists, create white lists, handles batch processing, or uses the KYC2020 API to integrate with the transaction flow to go completely hands-free.

The 21st century marketplace is transactional, and KYC2020 delivers an automated sanction screening verification service for SMEs that is compliant, auditor-friendly, and cost-effective. DecisionIQ™ is the only solution that SMEs need to streamline the process of moving from screening to decisioning – in real-time.

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CAMS
Certified
Anti-Money
Laundering
Specialist

<u>Learn about the benefits of using DecisionIQ to automate your Sanction Screening decision-making and speed up your customer onboarding.</u>

Contact us at sales@kyc2020.com or connect with us online on

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