Paths to optimize processes with third-party data: essential need or growth opportunity

Key regulatory and operational considerations for regulated organizations

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Contents

Introduction

Customer due diligence needs transformation to optimize regulatory and operational performance now, next and beyond

Regulated organizations' customer due diligence (CDD) processes aim to effectively collect, identify and verify customer data in line with regulatory obligations, while gauging the financial crime risk that customers could pose to the organization.

CDD is difficult, and is evolving at a pace that many organizations are struggling to keep up with. First, regulation is constantly changing, and the identification of new risks is driving continuous updates to policies and procedures. Second, there has been a boom in workflow and client lifecycle management technology which should be able to respond to the constantly changing procedures – but doesn't always. Third, organizations are placing more emphasis on customer experiences and digital channels, bringing high levels of change to operating models and CDD processes. Finally, complexity is growing as firms go beyond traditional due diligence of isolated corporate hierarchies and seek to assess relationships and economic inter-dependencies across the supply chain.

Performing CDD processes and building due diligence files is a time-consuming process. It involves multiple activities such as building customer profiles, identifying related parties and beneficial owners, and understanding the nature of the business and its expected activities. The number of steps in the process and the number of data attributes in each customer due diligence file mean that the process is prone to error and long average handling times.

These challenges are heightening the need for organizations to take a data-driven approach to CDD, enabling them to unlock significant gains in efficiency and effectiveness. This paper discusses these topics and busts some of the myths holding firms back from supercharging their CDD programs.

Now

With Brexit underway, Fifth Money Laundering Directive (MLD5) transpositions in force and the Sixth Money Laundering Directive (MLD6) in effect, now is the time to reflect on CDD. What does best practice CDD look like, and how do risk-based principles and regulations underpin it?

This paper takes a look at these questions and outlines the shifting regulatory context for CDD.

Highlights of some EU countries' central registry, third-party data usage, fifth directive activities and the inconsistencies in embracing technology and data

Country	Transposed fifth directive	Central beneficial ownership register	Using third-party data specifically mentioned in local guidance	Embracing financial crime technology and data innovation
UK	full embrace	full embrace	full embrace	full embrace
France	full embrace	full embrace	more than 70% embrace	half embrace
Germany	full embrace	full embrace	full embrace	having discussions
Spain	half embrace	having discussions	half embrace	full embrace
Latvia	full embrace	full embrace	half embrace	half embrace
Poland	having discussions	full embrace	half embrace	half embrace

Legend: ● full embrace · ◕ more than 70% embrace · ◐ half embrace · ◔ having discussions

Data based on observations and https://ec.europa.eu/info/publications/anti-money-laundering-directive-5-transposition-status_en

The regulatory landscape of anti-money laundering (AML) and CDD is vast. Depending on their activities, firms are subject to a wide array of rules and standards including:

▸ EU-level laws, notably the consolidated Fourth Money Laundering Directive (as amended by MLD5) and MLD6

▸ Local measures, such as the UK Money Laundering Regulations 2019 (MLRs) (as amended) and the Proceeds of Crime Act 2002

▸ Rules and guidance from supervisory authorities (including regulators, tax authorities and designated professional bodies)

▸ Guidance and best practice published by industry and other bodies such as the Joint Money Laundering Steering Group (JMLSG) and the UK Law Society

▸ International coordination and standards set by the Financial Action Task Force (FATF)

CDD obligations are specified in the UK MLRs. In simple terms firms must:

▸ Identify the customer (unless already identified)

▸ Verify the customer's identity (unless already verified)

▸ Assess the purpose and intended nature of the relationship or occasional transaction

▸ Where a customer is beneficially owned by another person, reasonable measures must also be taken to verify that owner and to understand ownership and control structures

Crucially - as MLD4 maintains - firms cannot rely exclusively on central registers to fulfil their CDD requirements. Instead, their requirements must be fulfilled using a risk-based approach.

Furthermore, firms are required to report any discrepancies between the beneficial ownership details they find on central registers and other information available to them.

CDD in numbers

- On average 150 data attributes are collected on a single complex corporate customer during customer due diligence

- Customer due diligence outreach requests can be stuck in a pending state for as long as 100 days waiting for a response

- Average handling times to build a customer due diligence case can vary from minutes in digital personal onboarding to more than 20 hours for full enhanced due diligence for non-personal customers

- Up to 70% of the data attributes required within internal systems or customer onboarding forms have data quality issues or missing information when third-party data is not used

- Third-party data providers can supply on average 73% of the data needed for identification and verification, reducing the effort and complexities of manual data collection and fixing data quality problems

* Figures are estimates observed from our desk based reviews, our experience and industry insights.

FATF standards define a "risk-based approach" as identifying, assessing and understanding AML risks in specific contexts, and as taking suitable measures to monitor, manage, mitigate and prevent those risks. This means that the practical meaning of CDD "measures" differs between firms and sectors.

As explored below, there are increasingly capable technology solutions that can help to defend against CDD risks. Even so, firms must always maintain robust, dynamic risk and control frameworks tailored to their nature, size and complexity. In addition, firms should recognize the potential limitations of their processes and avoid applying a 'one-size fits all' approach to products, customers and locations with varying risks.

It follows that every firm will make different use of technology solutions and third-party data for CDD, depending on their individual risk assessments. Customer verification must be based on ID cards, passports, specialist licenses or information obtained from a reliable source that's independent of the customer or person being verified.

As the MLRs note, documents obtained from an official body are regarded as independent, even when they are provided by the person they relate to (e.g., passport). What is clear, however, is that relying exclusively on central registers or public material is not normally sufficient.

In the next section we will look at what is needed.

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Paths to optimize processes with third-party data: Essential need or growth opportunity | 5

Recent investigative journalism has put central registers such as the UK's Companies House under scrutiny for a lack of verification during entity formation. This has now become a critical issue for AML, with some governments across Europe consulting on corporate transparency and registration reform. It was announced in September 2020 that UK Companies House will receive more powers to query and reject information and to improve the quality of data on the register. Simply put, placing sole reliance on a central register is insufficient to support the build of a CDD file.

When building a CDD file, financial crime operations teams must follow complex processes to compile the required information.

Depending on whether it is a new customer review, a periodic review or an event-driven review, the number of required data attributes for the primary customer can number in the hundreds. Added to this, data must be collated on related parties such as company directors, shareholders and beneficial owners. Then, of course, these data attributes need to be verified.

To manage this process efficiently, organizations define their CDD sources at the attribute level in a comprehensive identification and verification (ID&V) matrix.

> "
> Each and every firm who is part of a transaction chain has a responsibility here, for example checking who their client or customer is. For some it's a mixture of machine and manual processes – technology is used to flag up risks but banks still rely on thousands of staff to manually review those flags.

Megan Butler
Executive Director of Supervision, FCA

''Turning technology against financial crime'', *FCA website*, https://www.fca.org.uk/news/speeches/turning-technology-against-financial-crime, accessed 9 March 2021.

The ID&V matrix is the golden source for all required customer data points, including entity name, address, registration authority, beneficial owner and nature of business. These data points are then mapped to primary and secondary sources for identification and verification. The ID&V matrix should be aligned with each organization's policies and procedures.

Premium third-party data plays a key role within the ID&V matrix, not only as a secondary source of customer collected data but in many instances as a primary source.

Third-party data is curated with multiple trusted data sources - including registry data such as Companies House in the UK, local data providers, specialist data sets and websites - to build a single view of the entity, its related parties and beneficial ownership structure. This aggregated approach identifies discrepancies in the data and presents a more accurate picture of each entity to the analyst. It also reduces the effort involved in manual collection of data due to the complexities of different formats and different access systems.

Having a combination of sources within the ID&V matrix is critical to effective due diligence. Over-reliance on a single source, or on sources unsuited to the organization's customer universe, will lead to regulatory and operational failure.

When designing the ID&V matrix it's important to consider the organization's customer segmentation. Analyzing customers' geographies, industries and entity types (such as large corporates, SMEs or sole traders) will help to focus data selection criteria, as will a detailed understanding of the data lineage of premium third-party data sources. Detailed, real time, data lineage is something that third-party data vendors aspire to achieve. Presently data lineage can be queried direct to the vendor on an ad hoc basis.

A common pitfall to avoid when using multiple sources is data arbitration between providers. This can arise when the refresh cycles of local vendors lead to delays in updating data, or when corporate actions prompt event-driven reviews. Clarity can be maintained by agreeing an order of preference for premium data sources, allowing teams to spend their time on valuable decision-making instead of resolving data conflicts.

There are many ways in which premium third-party data can boost the efficiency of ID&V matrixes and the effectiveness of CDD. That reflects its ability to aggregate broad, deep multi-sourced content that can't be found in a piecemeal single source approach.

Next

Harnessing the value of third-party data sets in CDD processes is often the first step in building a data-driven customer value chain. Doing this can accelerate an organization's strategic imperatives across growth, customer experience and cost reduction dimensions in addition to the risk dimension, where operational teams can gain value from improved identification and verification data from premium third-party data providers.

In this section we look at six components of good practice for improving CDD process execution: Nature of business, Beneficial ownership, Related parties, Data enrichment, Application of corporate actions and maturing usage of premium third-party data. These can transform CDD programs and bring wider benefits to any organization.

Nature of business

Nature of business is not always identified accurately at onboarding, due to rushed customer answers or relationship managers not asking enough questions. Over-reliance on Standard Industrial Classification (SIC) codes chosen by entities at incorporation often leads to incomplete questioning on the true nature of business and its expected activities. SIC codes may be unverified, and do not always cover all diversified activities. It is therefore important to achieve the right level of precision of SIC codes in order to allow them to be useful in interpreting the nature of the business. This is vital if strategic decisions will be taken on aggregate risk or exposure thresholds at industry level at any given point in time.

Third-party data sources leverage multiple industry classifiers and may employ supervised machine learning to classify activities described on business websites and build a fuller picture of the entity.

Beneficial ownership

Defining beneficial owners, ultimate beneficial owners and persons of significant control (PSC) from registries alone is difficult. Multiple, complex, cross-border corporate structures can be hard for analysts to identify and understand.

Premium data providers aggregate from multiple data sets, piecing together or calculating ownership percentages and overlaying risk indicators such as circular ownership or links to high-risk jurisdictions. This enables analysts to identify potential risks early.

Related parties

Related parties are required to be identified and screened as part of a CDD process. For small to medium non-personal customers we have found through recent UK KYC remediations that the average number of related parties can vary from three to eight, depending on entity type. Directors, shareholders and key principals are often duplicated across registries with no single view. Manually building up a view of related parties can often take time, especially if there are a number of levels to discover, as the complex structure of related parties may not always be foreseen or obvious when CDD begins.

Premium third-party data providers consolidate related parties and append secondary identifiers where available. Social network analytics can identify relationships between other entities and related parties, enhancing the analyst's CDD activities.

Enrichment of critical data attributes

Customer outreach for CDD can negatively effect customer experiences. The right third-party source can enrich data captured at onboarding, reducing time spent on desktop research. Frequently enriched data attributes include examples such as company registration or incorporation date and country, the names of company directors or significant shareholders, etc. If outreach is required, it can provide a side-by-side view for the customer rather than a blank questionnaire.

Enrichment can also identify exceptions and red flags, for example if customer provided data at onboarding is poor and does not match third-party data, or where third-party data for an entity is not available.

Application of corporate actions

Identifying and applying corporate actions such as entity creations, mergers, acquisitions and divestments is key to an effective CDD strategy. This can be challenging due to data latency, reliance on relationship managers or the need for dedicated corporate actions teams. A data-driven approach to detecting and applying corporate actions during case review minimizes the chance of risk exposures going undetected. The smart use of market data also creates value by filtering out false positives, for example by distinguishing the launch of investment funds from the creation or acquisition of business units.

Organizations should link their event-driven review strategy to corporate actions data, triaging and acting on corporate actions and avoiding the need for operations teams, relationship managers or account support staff to address this.

Maturing usage of premium third-party data

Maturing usage of premium third-party data can often evolve through three levels. The first maturity level typically takes a build-based approach, where internal customer data sources are procured to periodically link together the internal customer data with the premium third-party data provider's data. This creates immediate value based on the freshness of the data, but then deteriorates over time when the data is not refreshed on a regular cycle.

Many firms are moving to the second maturity level, where they are developing capabilities to manage and maintain the refresh of a small number of third-party data sources. This capability is supported by an internal data operations team that resolve conflicts or exceptions as the premium third-party data provider's customer information is matched against the internal data on a cyclical basis. The level of maturity here is most often observed with organizations that pursue a periodic review cycle for CDD.

Many organizations need to move to a third-generation solution, where value-added services from third-party data providers help to drive compliance, cost savings and competitive advantages, allowing the firm to focus on providing core business services. This is delivered "as a service" and is most compatible with an event driven review strategy, given the opportunities to integrate with the premium third-party data providers. An ecosystem-based approach that integrates premium third-party data providers into key workflows will enhance the quality and transparency of customer experiences and leverage the specialist knowledge. It enables access to dedicated teams and experiences developed by the premium third-party data providers over many years of refining their products and services.

Beyond

The European Banking Authority (EBA), BaFin and the FCA have stressed the importance of technology in combatting financial crime and are actively involved in fostering developments in this area. Technology can transform the CDD process, for example by automating data collection or by using behavior-led event driven reviews as part of on-going due diligence (ODD).

At the start of the CDD process there is a clear opportunity to automate the capture of customer data and the enrichment of attributes by blending premium third-party data with internal customer data. This will cut the time CDD analysts spend on desktop research, reduce outreach and resulting customer dissatisfaction, and standardize data quality for increased effectiveness.

At the other end of the CDD process, innovation can transform simplistic periodic reviews such as one, three and five year cycles into automated ODD processes, introducing customized responses to changes in customer behavior based on a broader view of customer risk and context.

Events that trigger a review of customers' due diligence file are usually behavioral changes. These initiate tailored responses, such as reviewing a customer's risk rating, a light-touch due diligence or a full enhanced due diligence. Triggers can come from many sources, including customer reference data changes, transaction monitoring and suspicious activity reports. Since triggers can sometimes be 'false positives' they need to be reviewed not in isolation but with reference to other triggers.

Premium third-party data can significantly enhance firms' event-driven review strategies, especially in combination with other triggers. Premium data providers can provide real-time triggers for customer reference data (such as entity name changes, the addition or removal of directors or changes in industry or geographical locations) as well as other risk indicators (such as changes in entity status from active to dissolved, the addition of a payment service provider license, or a new beneficial owner in a high-risk jurisdiction). Combining automated customer reference data updates with triggers such as transaction monitoring can be highly effective in improving firms' risk management and customer understanding, and means that organizations are not reliant on customer notifications.
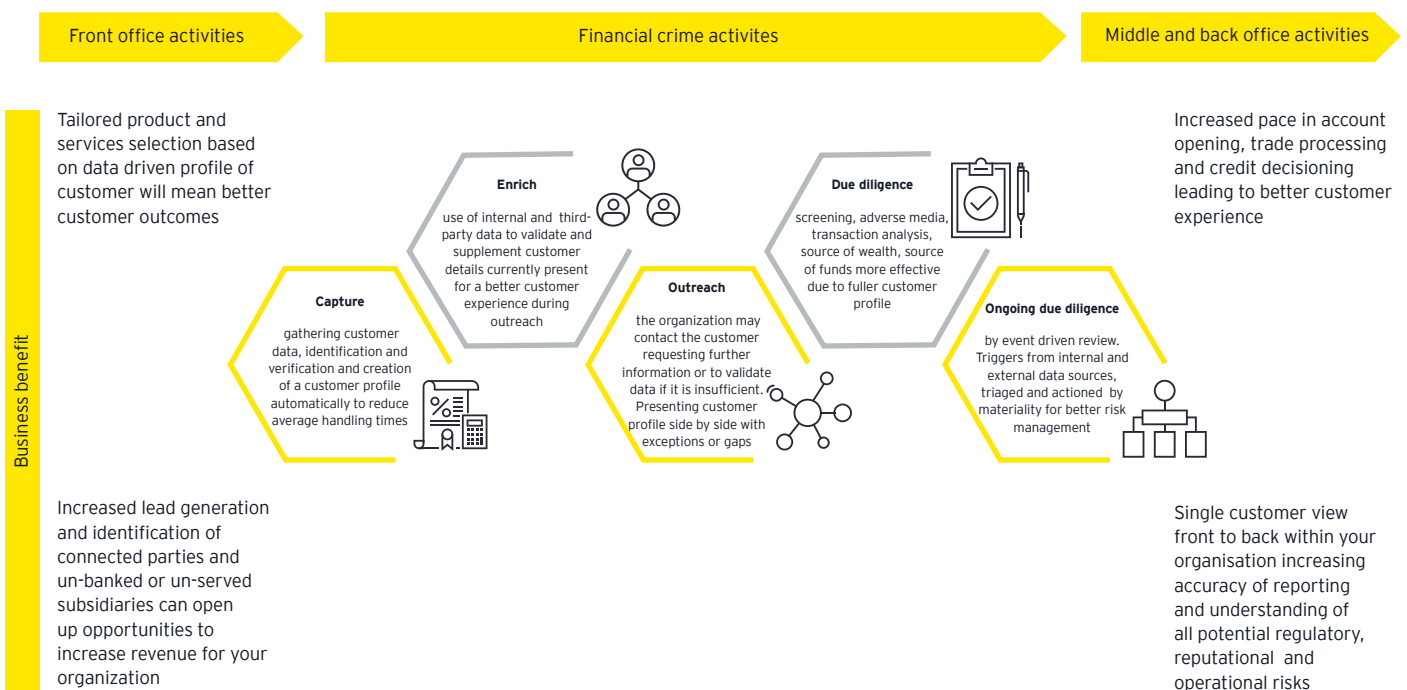
CDD is a compelling use case for introducing or enhancing premium third-party data. But business sponsors and process owners should also consider leveraging this powerful data asset across the rest of the firm. Other valuable applications for the same data asset, covering the organization's whole value chain, can often be identified. Examples include:

▸ Supporting prospecting activities by analyzing subsidiaries without an established business relationship

▸ Pre-filling customer onboarding forms to simplify the customer journey

▸ Improving product distribution across global accounts, enhancing the attribution of revenues or Returns on Risk Weighted Assets

▸ Reviewing the credit risk exposure against the value chain to determine if addition lines of credit are within limits, as opposed to only looking at a single entity

Leveraging premium third-party data sets with leading technology capabilities such as network analytics and machine learning capabilities can help unlock insight and actionable intelligence. In short, the effective use of premium third-party data can not only supercharge CDD outcomes, but also create value across numerous business functions.

There are five high level benefits of partnering with a premium data service provider on financial crime, and numerous other benefits across front, middle and back office activities

Front office activities	Financial crime activites	Middle and back office activities

Tailored product and services selection based on data driven profile of customer will mean better customer outcomes

Enrich
use of internal and third-party data to validate and supplement customer details currently present for a better customer experience during outreach

Capture
gathering customer data, identification and verification and creation of a customer profile automatically to reduce average handling times

Outreach
the organization may contact the customer requesting further information or to validate data if it is insufficient. Presenting customer profile side by side with exceptions or gaps

Due diligence
screening, adverse media, transaction analysis, source of wealth, source of funds more effective due to fuller customer profile

Ongoing due diligence
by event driven review. Triggers from internal and external data sources, triaged and actioned by materiality for better risk management

Increased pace in account opening, trade processing and credit decisioning leading to better customer experience

Business benefit

Increased lead generation and identification of connected parties and un-banked or un-served subsidiaries can open up opportunities to increase revenue for your organization

Single customer view front to back within your organisation increasing accuracy of reporting and understanding of all potential regulatory, reputational and operational risks

Conclusion

Premium third-party data is a core component of supercharging CDD processes. It's vital to select the right data sets for each organization's customer universe, aligning data attributes with the organization's data model and using unique identifiers to maintain data lineage and implement triggers for event-driven review.

The business case for change often takes two paths, depending upon an organization's starting point:

1. Organizations yet to use any premium third-party data, that are looking to build confidence and internal data in processes such as CDD.

    ‣ This often starts with a proof of value or single operational gain, such as automating a process or accelerating the customer review cycle. The CDD process is a great place to start, given the benefits it can create by establishing an accurate, cross-validated customer base.

2. Organizations with numerous premium third-party data providers, but where individual contracts limit volume, geography or permitted use cases.

    ‣ Consolidating contracts under fewer providers allows multiple use cases to be supported with far fewer constraints. Increasing the consistency of data, managing it centrally and making it available to front, middle and back offices will drive cost efficiency and create opportunities for revenue generation, for example by improving account penetration, product distribution and value proposition design.

Achieving the benefits that third-party data can bring to CDD relies on breaking down silos and ensuring that IT, master data management, source systems and financial crime operations are working together across the firm.

The whole CDD capability must also come together to maximize the benefits of a data-driven approach. People need comprehensive training and embedded quality control to maintain continuous improvement. Processes must be optimized to reduce waste. Technology needs to support people and processes with the right tooling.

CDD is a compelling use case for automating and enriching the customer profile with premium third-party data. The wider business benefits that flow from a data-driven approach will not only enhance operational and risk activities, but also commercial results and customer experiences.

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