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Strengthening Customer Due Diligence on a Strategic Approach to Preventing Money Laundering: A Concept Paper

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Abstract
This study escalates the threat of money laundering and presents significant challenges for financial integrity and national security worldwide. This conceptual paper explores the critical role of Customer Due Diligence (CDD) as a strategic approach to enhancing compliance with anti-money laundering (AML) regulations. Despite the establishment of comprehensive AML frameworks, compliance levels remain alarmingly low, primarily due to factors such as inadequate awareness, insufficient training, and the complex nature of money laundering schemes. To enhance and improve CDD frameworks, the strategies proposed in this concept paper are risk-based approach, financial transaction reporting and role of technology in preventing money laundering.
Keywords: Strengthening Customer Due Diligence, Strategic Approach, Preventing Money, Concept Paper

Introduction
Money laundering is a global problem that attacks financial systems, enables organized crime and destabilizes economies. Understanding money laundering equips individuals and institutions to be part of the global effort to prevent abuse of financial systems, support law enforcement, and protect economic and social stability. Money laundering by Central Bank of Malaysia (BNM) definition is "a process of converting cash, funds or property derived from criminal activities to give it a legitimate appearance. It is a process to clean 'dirty' money in order to disguise its criminal origin". By making illegal money look like legitimate income, criminals exploit weaknesses in regulatory frameworks and institutional processes. In Malaysia, the offence

of money laundering was charged under Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act (AMLATFPUAA) 2001. Section 4(1) had highlighted "any person who –

(a) engages, directly or indirectly, in a transaction that involves proceeds of an instrumentality of an offence;
(b) acquires, receives, possesses, unlawful activity disguises, or transfers, converts, exchanges, carries, disposes of or uses proceeds of an unlawful activity or instrumentalities of an offence;
(c) removes from or brings into Malaysia, proceeds of an unlawful activity or instrumentalities of an offence; or
(d) conceals, disguises or impedes the establishment of the true nature, origin, location, movement, disposition, title of, rights with respect to, or ownership of, proceeds of an unlawful activity or instrumentalities of an offence,

commits a money laundering offence and shall on conviction be liable to imprisonment for a term not exceeding fifteen years and shall also be liable to a fine of not less than five times the sum or value of the proceeds of an unlawful activity or instrumentalities of an offence at the time the offence was committed or five million ringgits, whichever is the higher."

To combat money laundering activities, CDD has become a key part of Anti-Money Laundering (AML) solutions (Yusoff et. al, 2023). BNM have defined CDD as "the process of identifying and verifying the identity of the customer. A Reporting Institution (RI) must be satisfied that the customers are who they say they are. This includes knowing:

a. the identity of the customer
b. the identity of beneficial owner i.e. people behind the transaction
c. the identity of person conducting transaction if the transaction is done on behalf of someone else or the person you dealing with is a representative appointed by a legal person
d. the purpose i.e. why the transaction is undertaken"

Reporting Institutions (RIs), which include individuals and their branches or subsidiaries engaging in activities outlined in the First Schedule of AMLATFPUAA 2001, are required to implement CDD measures in specific scenarios. This encompasses forming new business connections, suspecting money laundering activities, facing unreliable documentation, engaging in transactions that surpass regulatory limits, interacting with entities from high-risk nations, and participating in ongoing monitoring initiatives. (Yusoff et al., 2023). CDD is also a key component of the Financial Action Task Force's (FATF) 40 Recommendations. Despite its importance, current practices of CDD have faced several challenges, including inconsistent implementation, legal variations across jurisdictions, and the need to balance regulatory compliance with customer privacy.

Background of Study

AMLATFPUAA 2001 Section 16 specifically mentions requirements of RIs to conduct CDD when establishing business relationships, which involves confirming customer identities and gaining insight into their business operations. (Yusoff et. al, 2023). It highlights the importance of continuous transaction monitoring to ensure alignment with the institution's understanding of the customer and their risk profile, utilizing a risk-based strategy for AML compliance. Furthermore, institutions must keep accurate records of CDD information and report any suspicious transactions to the appropriate authorities. The section also underscores the importance of implementing effective internal policies and training programs in order to combat money laundering or terrorism financing, thereby fostering a robust compliance framework.

According to BNM, there are 17 types of RIs in Malaysia (refer to Figure 1) inclusive of Financial Institutions and Designated Non-Financial Businesses and Professions (DNFBPs) & Non-Bank Financial Institutions (NBFIs). These institutions are required to adhere to reporting requirements under BNM Policy Documents which were published on 31st December 2019 and revised version effective from February 6, 2024.

Despite the establishment of comprehensive anti-money laundering (AML) frameworks globally, many countries, including Malaysia, continue to struggle with low compliance levels among both financial and non-financial institutions. Factors contributing to this issue include a lack of awareness regarding legal obligations, insufficient training on AML practices, and the evolving nature of money laundering techniques that exploit gaps in regulation. Recent studies have highlighted that criminals are increasingly shifting their focus from traditional financial institutions to professionals who may be less regulated. This shift underscores the importance of strengthening CDD practices across all sectors to effectively combat money laundering (Yusoff et. al, 2024). The involvement of professionals in facilitating money laundering activities often without their knowledge illustrates the urgent need for enhanced compliance measures and awareness programs.

Figure 1. Summary listing of the common reporting institutions

This research seeks to provide valuable insights into the challenges and opportunities associated with strengthening CDD as a strategic approach to preventing money laundering. By addressing these issues holistically, the study aims to contribute to more effective AML frameworks that encompass a broader range of professionals and industries, ultimately supporting global efforts to mitigate money laundering risks. In other point, the strategic enhancement of Customer Due Diligence is not merely a procedural necessity but a cornerstone of an effective AML framework. The study of this topic has multidimensional value, enabling stakeholders to anticipate risks, comply with global standards, and safeguard institutional and national interests. As financial crime continues to evolve, a strategic and research-informed approach to CDD remains crucial in fortifying the global fight against money laundering.

Problem Statement

Despite the establishment of comprehensive AML frameworks in Malaysia, including the AMLATFPUAA 2001, low compliance levels persist among various sectors of RIs, particularly within designated non-financial businesses and professions (DNFBPs) Ahmad Tarmizi et. al. (2023). It was reported in the News Straits Times dated 6th May 2024 that BNM has recognized two main offenses frequently committed by financial institutions that contribute to the rise of money laundering and terrorism financing activities. These offenses pertain to the inability of financial institutions to carry out CDD and sanctions screening during the client onboarding process, both of which are mandated by BNM for RIs.

Further to this news, it was reported that since the enforcement framework and penalties were introduced in 2014, BNM has implemented 74 measures, including both punitive and corrective actions, to tackle compliance offenses and prevent breaches of the AMLATFPUAA 2001. Between January 2021 and October 2023, 15 financial institutions and related entities were fined a total of RM7 million for various infractions. In 2021, two money services businesses incurred administrative penalties totaling RM147,000. In 2022, four insurance companies and takaful operators faced administrative fines exceeding RM1 million, while seven entities not under BNM's supervision were penalized with RM5.2 million in fines. In 2023, two e-money issuers received administrative penalties amounting to RM600,000.

In other cases, BNM in a press statement dated 23rd October 2024 reported an administrative monetary penalty RM30,600 imposed on BSB Darussalam Sdn. Bhd. (BDSB) for non-compliance with CDD requirements during an on-site inspection. Notably, BDSB did not perform CDD on three customers involved in money-changing transactions exceeding RM3,000. This oversight was facilitated by intentional actions from its staff, who split the transactions into amounts below the required threshold for conducting CDD, as identified by BNM.

RIs are at the forefront of combating this issue, tasked with implementing robust CDD processes to identify, assess, and mitigate risks associated with their customers. However, many institutions still struggle with effectively integrating comprehensive CDD measures into their operations, leading to vulnerabilities that can be exploited by criminals. Key challenges include inconsistent implementation of CDD measures, which creates gaps in customer risk assessment; an evolving threat landscape that requires continuous adaptation of CDD processes; complex regulatory compliance that institutions must navigate; difficulties in integrating advanced technologies like artificial intelligence (AI), block chain and machine learning into existing systems; and cultural resistance within organizations that hampers adherence to due diligence protocols.

Strengthening CDD is not merely a regulatory requirement but a strategic approach for RIs aiming to protect themselves from legal repercussions and reputational damage associated with money laundering. By addressing these challenges through enhanced training, technology adoption, and a commitment to continuous improvement in due diligence practices, institutions can foster a more secure financial environment that deters criminal activity.

Research Gap

A notable research gap in the area of CDD and AML practices lies in the integration of risk-based approach, financial transaction reporting and emerging technologies with their effectiveness in enhancing CDD processes to prevent ML. While existing literature emphasizes the importance of robust CDD measures, there is limited exploration of how risk-based approach, financial transaction planning and roles of technologies can be systematically implemented to improve risk assessment and customer verification during the onboarding process and ongoing monitoring phases. Therefore, investigating these aspects could provide valuable insights into developing more effective CDD strategies that not only comply with regulatory standards but also adapt to the evolving landscape of financial crime in preventing ML in Malaysia.

Literature Review

Preventing Money Laundering

A series of studies have been conducted to investigate a variety of issues concerning money laundering compliance measures and how money is laundered (Latif and Abdul-Rahman, 2018). Normah et al. (2015) looked into Malaysian accountants' awareness, perceived impacts, and views on Anti-Money Laundering/Counter Financing of Terrorism (AML/CFT) requirements, especially among non-financial businesses and professions (DNFBPs). Their findings revealed that most respondents were aware of anti-money laundering regulations and felt there should be enhanced information sharing among reporting entities, emphasizing that law enforcement is key in effectively preventing and detecting money laundering (Normah et al. 2015). Additionally, Aspalella (2015) highlighted the crucial role of corporate governance in bolstering AML efforts. This study centered on the responsibilities of senior management and boards of directors in banking institutions, ensuring that relevant and effective anti-money laundering methods are in place to secure safe banking operations. A solid AML strategy backed by good governance can significantly lower the incidence of money laundering activities (Aspalella, 2015).

Moreover, Nadim et al. (2016) accentuated the need for tailored AML approaches for Islamic Banking due to the lack of a unified understanding of money laundering and terrorism financing in the context of Islamic finance. Latif and Abdul-Rahman (2018) urged that the FATF, Islamic finance standard setters, and national regulators take the time to fully grasp the distinctive money laundering and terrorism financing risks inherent in Islamic finance before formulating a suitable AML framework. They noted that while Islamic financial services adopt a standardized regulatory framework, their compliance and risk management systems differ significantly from those of traditional financial institutions when addressing AML/CFT risks (Latif and Abdul-Rahman, 2018).

Risk-Based Approach

One of the key policies from Bank Negara Malaysia (BNM) is that reporting institutions must adopt a risk-based approach to identifying, assessing, and understanding their money laundering and terrorism financing (ML/TF) risks. This approach puts an extra responsibility on these institutions to evaluate and mitigate those risks (Concept Paper 1: Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) - Money Services Business Sector—Bank Negara Malaysia, 2013). As pointed out by Yusoff et al. (2023), financial institutions are encouraged to implement risk-based strategies regarding Environmental, Social, and Governance (ESG) factors during their due diligence processes. Certain clients might carry specific risks tied to their occupation or expected transaction behaviors (Esoimeme, 2020). At this stage of the risk assessment, it's essential to apply sound judgment rather than categorizing all individuals within a specific group as carrying the same risk level (AML/CTF Rules | AUSTRAC, 2024). Reporting institutions will assess which due diligence measures are necessary, which can include:

- A standard level of due diligence applicable to all customers (AML/CTF Rules | AUSTRAC, 2024).
- An enhanced level of due diligence for those customers flagged as high-risk, which could be due to their business operations, ownership structure, anticipated or actual transaction volume, or the nature of their business activities—especially those linked to higher-risk countries or otherwise classified by relevant laws or regulations as high risk (AML/CTF Rules | AUSTRAC, 2024).

Financial Transaction Reporting

From identifying the customer to transaction monitoring, what the overall objective of this exercise is supposed to be, is to identify and report suspicious incidents of money laundering, terrorist financing to the FIU (Viritha, Mariappan and Haq 2015). Filing information like this helps law enforcement (Reuter and Truman 2004). Thus, STR/Suspicious Activity Report (SAR) is one of the AML/CFT implementation indicators (Viritha, Mariappan and Haq, 2015). The quantitative and of suspicious transactions reports make it appear how good or bad a country has in operation, with respect to increase, decrease in number given (Viritha, Mariappan and Haq 2015).

To avoid legal liability, banks must be able to meet the reporting obligations (Financial Services Authority, 2003) therefore reporting only to avoid such exposures would fail as well as not remove the banks' moral and social responsibility to implement a state-of-the-art national AML/CFT regime (Viritha, Mariappan and Haq 2015). It creates a defensive reporting burden to law enforcement leading, in even the most justified cases, to mere visibility and distraction (Johnston & Carrington 2006).

Role of Technology

Regulatory Technology (RegTech) is an important aspect of an effective AML-CFT system as it can enable the safe, affordable and robust regulatory solutions for the utilization of digital technology, and even though the FinTech also (Karsha and Abufaraa, 2020; Zabelina et al., 2018). Money laundering and terrorist financing can be prevented by monitoring of transactions to verify customers identities using RegTech, which essentially means by Zabelina et al.,2018. When banks use RegTech it allows them to examine data coming from suspicious transactions in real time (Zabelina et al., 2018). Fraud symptoms are identified with a system that authenticates the customer documents and checks, and credit card (on RegTech inspection) from the customer (Zabelina et al, 2018). RegTech is a computing technology that can assist businesses manage regulatory and compliance needs, manage and mitigate risks as per finance or non-finance, reports of compliance (Butler and O'Brien, 2019).

A study on experimental aspects of AML-CFT related to charitable fundraising indicated that artificial intelligence, RegTech and Charity Tech have the potential to assist charity with compliance issues, reduce the risk of crime (including money laundering and terrorist financing), Singh and Lin (2020). In a study examining the Bahrain banking sector, another study was conducted to find a statistical association on money laundering prevention and identify the role of RegTech using TM and CTE (Turki et al., 2020). The government suggested that the Indonesian banking sector should create a balanced digital economic and financial ecosystem in which consumer protection, consumer rights, integrity and stability are maintained with the spirit of healthy competition in business using KYC, AML-CFT and data disclosure to oversee RegTech and Supervisory Technology (SupTech) in reporting, regulatory, and supervisory obligations (Bank Indonesia, 2019).

Conceptual Framework

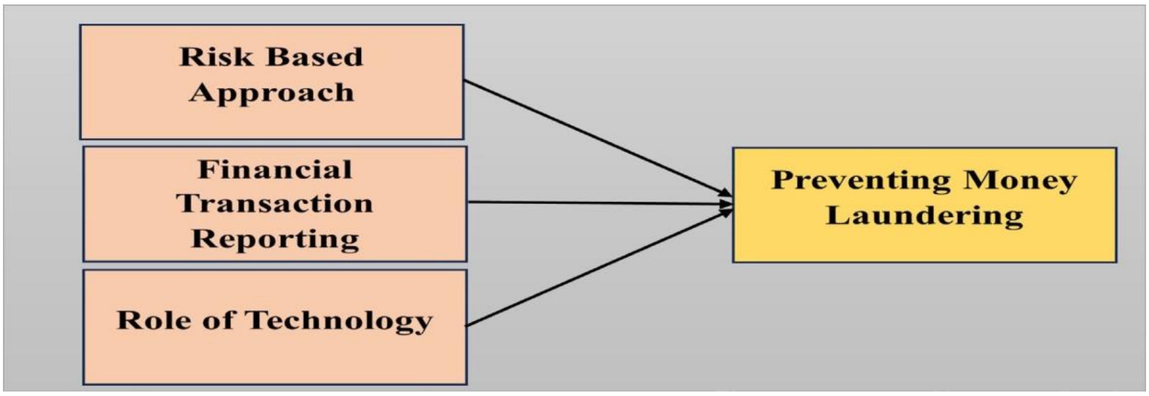

Figure 2. The Proposed Conceptual Framework for the Strengthening Customer Due Diligence: A Strategic Approach to Preventing Money Laundering: A Concept Paper

The framework illustrated in Figure 2 offers a clear conceptual overview for strengthening customer due diligence as a strategic approach to preventing money laundering. There is a factor to analyze the effectiveness of Customer Due Diligence (CDD) in combating money laundering that needs to be appropriately addressed and implemented (Yusoff et al., 2023). Thus, this conceptual paper emphasizes the need of strategies such as Risk Based Approach (prioritizing high-risk entities), Financial Transaction Reporting (detecting anomalies through patterns) and the Role of Technology (compliance on technology advancement) to mitigate the risks associated with money laundering. This research provides fresh insights into the challenges and opportunities faced by Reporting Entities by examining how effective Customer Due Diligence (CDD) is at preventing money laundering, as noted by Yusoff et al. (2023).

Data Collection

Using a qualitative desk research method, the study explores the connections between different strategies such as Risk Based Approach, Financial Transaction Reporting, Role of Technology and Money Laundering prevention. The methodology in this research is to analyze the existing literature review and identify the gaps, challenges and impacts on the mentioned strategies in preventing money laundering. The time period for literature review between 2010 – 2024.

Data for this study was collected from the following sources such as academic research from a journal or articles published in Google Scholar using keywords like customer due diligence, CDD, money laundering, concept paper. Besides that, the issues on the problem statement were found in an online newspaper. Other than that, information was also cited to publication by organizations such FATF and also policy documents published by the Central Bank of Malaysia (BNM). All sources in this research are properly cited to ensure intellectual integrity. Objectivity was maintained by avoiding over-reliance on sources with potential conflict of interest. Results reported as below:

No	Source	Google Scholar	Scopus	Researchgate
1.	Risk Based Approach	122	58	107
2	Financial Transaction Reporting on fraud	183	61	74
	Role of Technology on preventive of fraud	221	109	208
3	Money Laundering prevention	302	142	289

Policy Implications and Recommendations

To enhance and improve CDD frameworks, several strategies can be implemented focusing on regulatory alignment and standardization, leveraging technology for real-time monitoring and strengthening information sharing networks. The strategies such as: -

Enhancing Regulatory Alignment and Standardization - Risk Based Approach

RIs especially Financial Institutions should implement a risk-based approach to CDD that prioritizes resources toward higher risk customers while simplifying processes for lower risk clients. This ensures compliance without overburdening lower risk entities. CDD works within the larger context of AML practices, concentrating on the prevention of money laundering and other financial crimes (Zarraluqui, 2024). While Know Your Customer (KYC) validates the customer's identification, CDD is always on the lookout, keeping a close eye on behavior and transactions to spot any unusual activity that might hint at money laundering or the financing of terrorism (Ibitola, 2023). The rules that guide CDD, KYC, and AML practices form a thorough set of guidelines and laws aimed at maintaining the integrity and security of the global financial system (Ibitola, 2023). These regulations include requirements for identifying customers, procedures for verifying their information, methods for assessing risk, and rules for reporting any suspicious transactions (Zarraluqui, 2024). Additionally, the framework requires ongoing monitoring of customer relationships, regular reviews, and the application of appropriate measures based on the assessed risk levels.

Establishing standardized CDD procedures that are in accordance with international regulations can, in fact, promote more seamless compliance across borders. This process includes harmonizing (or aligning) definitions of critical terms and risk categories; it aims to mitigate confusion and enhance cooperation among various regulatory bodies. However, achieving this can be challenging because of differing national interpretations. Although the intention is to create a unified approach, implementation may vary significantly (Zarraluqui, 2024 & Ibitola, 2023). It's really important to regularly assess and update Customer Due Diligence (CDD) policies to keep them in line with the latest regulatory changes. This approach allows organizations to adhere to both local and international regulations, however, it also necessitates adjustments in response to emerging risks. Because of this, organizations must remain vigilant, although the process can be complex and time-consuming (Zarraluqui, 2024).

Strengthening Information Sharing Networks - Financial Transaction Reporting

Strengthening information-sharing networks is crucial for enhancing financial transaction reporting and combating financial crimes such as money laundering and terrorist financing. Fostering collaborations between regulators and the financial institutions lead to significantly enhancing the effectiveness of CDD measures. Joint initiatives can, however, lead to a more comprehensive understanding of risks and more coordinated responses to activities deemed suspicious (Zarraluqui, 2024).

Establishing clear guidelines regarding how data should be shared among institutions is crucial where this will promote consistency and trust in collaborative efforts to combat money laundering and terrorist financing (Zarraluqui, 2024). Furthermore, creating secure platforms for information shared with financial institutions, regulators and law enforcement enhances collective efforts in the fight against financial crimes. These platforms should facilitate the exchange of insights on suspicious activities and emerging threats, although challenges may persist (Zarraluqui, 2024).

According to Bank Negara Malaysia, by establishing a unified framework for data exchange, institutions can (in fact) collaborate more effectively when identifying patterns of suspicious activity. This collaboration leads to more accurate and comprehensive reports. However, strengthening information- sharing networks through these strategies directly enhances the effectiveness of financial transaction reporting. It does so by improving collaboration, standardization and knowledge sharing among all stakeholders involved in combating financial crime. Although there are challenges, the potential benefits are significant because they can lead to a more coordinated response to illicit activities.

Leveraging Technology for Real Time Monitoring - Role of Technology

The incorporation of sophisticated technologies such as AI, machine learning, blockchain, big data analytics and RegTech into CDD frameworks significantly augments the capacity of financial institutions to prevent money laundering. By harnessing these technologies for real-time monitoring, organizations can not only enhance their detection capabilities but also streamline compliance processes and foster collaboration among stakeholders in the battle against financial crime (Yusoff et al., 2023).

Utilizing artificial intelligence (AI) and machine learning (ML) can greatly improve the efficiency of CDD processes. These technologies can automate identity verification, monitor transactions in real-time and flag suspicious activities promptly. Developing robust data management systems that facilitate the efficient collection, storage and analysis of customer data is essential (Yusoff et al., 2023). This includes ensuring data integrity and security to protect sensitive information while allowing timely access for compliance checks. Implementing automated tools for generating compliance reports can save time and reduce human error; however, such tools also provide regulators with up-to-date information about customer activities and risk assessments (Yusoff et al., 2023).

Conclusion and Future Directions

Compliance with AML frameworks continues to be persistently low among reporting institutions. This is largely due to a lack of awareness, inadequate training and the inherent complexity of money laundering schemes. However, this situation indicates a pressing need for enhanced educational initiatives and training programs designed to improve understanding and adherence to AML regulations. Furthermore, the implementation of CDD measures encounters significant challenges; these include inconsistent application across institutions and evolving threats posed by sophisticated money laundering techniques. Although these obstacles are considerable, they underscore the necessity for a more standardized approach to CDD that can adapt to emerging risks. Additionally, the importance of adopting a risk-based approach was emphasized, due it enables institutions to allocate resources more effectively while focusing on higher-risk customers while streamlining processes for those deemed lower risk. This strategic prioritization is not only essential for improving overall compliance but also crucial for enhancing efficiency.

Moreover, there exists a significant gap in the integration of emerging technologies (such as AI and blockchain) that could potentially enhance CDD processes. Current practices often lack systematic technological support, which could improve risk assessment and customer verification. This suggests that investment in advanced technologies is crucial. Through the implementation of these strategies, financial institutions can markedly enhance their CDD frameworks. This ensures better compliance with regulations; however, it also improves their capacity to detect and mitigate risks that are associated with financial crimes. Although these measures are essential, they must be executed diligently because the stakes are high in the realm of financial security.

Future directions for CDD and tackling money laundering involve establishing standardized regulatory frameworks; utilizing advanced technologies (such as AI), machine learning and blockchain; enhancing training initiatives; adopting continuous monitoring systems; and promoting collaboration across various sectors. These strategies seek to bolster compliance with anti-money laundering regulations and prioritize customers who present higher risks. However, they also underscore the significance of ongoing monitoring and evaluation (as these processes allow for the adaptation of strategies according to emerging trends). Although these measures are comprehensive, they require commitment and resources because their effectiveness relies on consistent implementation and collaboration. This multi-faceted approach is crucial for the successful realization of CDD objectives.

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