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Costs of Implementing KYC Compliance and Prevention of Money Laundering and Fraud Risks on Commercial Banks in Kenya

Koske Dorothy Chelangat[1], Munene Ruthwinnie [2]

[1].*Student,Jomo Kenyatta University of Agriculture and Technology,*
[2].*Lecturer, Jomo Kenyatta University of Agriculture and Technology,*

Abstract: The know your customer' (KYC) has emerged as an important strategy for a proactive war against money laundering, both nationally and internationally. Central Bank of Kenya requires all banks to be compliant with know your customer (KYC) policy, which aids the country's fight against illegal banking practice.The main objective of the study was to examine the effects of costs of KYC compliance on prevention of money laundering and fraud risks on commercial banks in Kenya.The study was based on agency and behavioural finance Theories. Descriptive survey was adopted in the study. The study targeted 172 officers who make up the AML section that. Four financial officers from each of the 43 commercial banks. The sample size was 82 respondents. Purposive sampling was used in the study to select employees working in the AML department. Statistical Package for Social Sciences (SPSS) version 25.0. The data was next be examined using statistical techniques for both inference and descriptive analysis. The results showed that the costs associated with Know Your Customer compliance and money laundering and fraud risks within a commercial bank are positively and significantly correlated (r=0.930**, P=0.000).Finally the results regression model the high R Square value (0.916) indicates that the combination of Staff Competence, Customer Characteristics, and Cost of KYC Compliance predictors explains a substantial portion of the variance in the outcome variable. This implies that 91.6% of the independent variables are used to explain the dependent variable while 8.4% is explained by other factors. It is recommended that to reduced costs banks should incorporate machine learning and artificial intelligence technologies to enhance the accuracy of monitoring systems.

Keywords: Cost of KYC compliance, customer characteristics, know your customer, money laundering

I.   INTRODUCTION

1.1 Background

As per Aketch (2020), financial institutions such as banks play a crucial role in facilitating financial transactions and permitting the flow of money throughout the economy. Therefore, it is a fundamental responsibility of financial institutions to accept monetary deposits from their clients and to facilitate cash transfers when needed. However, they have a larger danger of being used by criminals as a means of money laundering. Banks, in Kumar's opinion (2022), facilitate the concentration of money obtained from both local and foreign savings. By creating a favourable atmosphere and effectively allocating resources to investment projects, these organisations help advance investment prospects and make a significant contribution to long-term economic growth. The role of banks in a nation's economic development is crucial. These financial institutions use both domestic and international money to promote economic development. To support economic growth, these financial institutions use both domestic and international money. However, money laundering and fraud currently hamper the expansion of these financial institutions. Staff members engage in fraudulent and money-laundering operations collectively, as evidenced by the anti-money-laundering rules enacted by the relevant financial institutions. When criminals regularly use financial institutions as conduits for the laundering of stolen funds, those institutions inevitably suffer. Large sums of money can be lost due to reputational harm and damaged relationships with external parties including customers, suppliers, funders, and business partners (KMPG, 2019).

According to National Money Laundering and Terrorist Financing (ML/TF) risk assessment report (2021)The ML threat in the banking sector was assessed High with a likelihood of increasing. Banks are the most likely institutions to be abused for money laundering. The High rating for ML threat in the banking sector is attributed to the fact that the

banking sector features prominently in money laundering investigations ((KPMG,2020).The NRA report stated that in the period it reviewed (2016 – 2020), at least Ksh 1,456,000,000 (approximately USD 12,772,000) was seized or confiscated, being proceeds of foreign predicate offences brought into and laundered in Kenya (ESAAMLG ,2022).The national money laundering vulnerability was assessed as Medium High. Banking industry was assessed as the sector with the highest impact on the national ML vulnerability, largely due to the important role played by commercial banks in the economy (Financial Reporting Centre ,2021).

The know your customer' (KYC) has emerged as an important strategy for a proactive war against ML, both nationally and internationally. In terms of policy, financial institutions in most countries are required to identify their clients and the legitimacy of their respective financial transactions.KYC compliance in Kenya is no longer a suggestion for best practice but it has become a compliance mandate for banking in Kenya under the Proceeds of Crime and Anti-money Laundering Act (2008). Having an effective KYC program seems to be a challenge to many banks as the KYC guidelines issued by the CBK appears to be applied with varying levels of intensity dependent upon various factors determined by individual bank business ideals(Arasa and Ottichilo,2015).Byrne (2020) argued that the full implementation of all aspects of KYC programs is difficult, because it is hard to establish when a financial institution is in compliance. KYC was seen as difficult to implement because there was no obvious end-point to the information that would be useful to a bank manager in seeking to prevent ML. Banking secrecy represents a significant obstacle to anti-money laundering efforts as it shields access to bank accounts and safeguards potentially illicit funds. (Al-Nuemat, 2014).Despite the crucial role that KYC played in avoiding fraud and money laundering, both international and local researchers have not given it the attention that it merits. The prevalence of money laundering at the Commercial Bank of Pakistan was studied by Raza (2019). In Ghanaian commercial banks, the effect of KYC on operational risk was evaluated by Sarapong (2021). Mochere (2022) examined the banking industry's anti-money laundering enforcement practises. The impact of lending practises on the financial performance of Kenyan commercial banks was examined by Maina (2020). The majority of the research we analysed did concentrate on KYC as an anti-money laundering strategy. This study is therefore aims at evaluate the effects of cost of compliance on prevention of money laundering and fraud risks on commercial banks in Kenya in commercial banks in Kenya.

1.2 Specific Objective
i.   To determine the effects of costs of implementing KYC policy and prevention of money laundering and fraud risks on commercial banks in Kenya

1.3 Research Hypothesis
Ho1 There is no statistically significant effect of costs of KYC compliance on prevention of money laundering and fraud risks in commercial banks in Kenya

II.   LITERATURE REVIEW
2.2.1   Theory of Regulatory Compliance

The Theory of Regulatory Compliance (TRC) by Fienea (2016) deals with the importance and significance of complying with rules or regulations. Despite the fact that the research is coming from the human services sector, this theory has ramifications for all rule, regulatory, and standard formulation in the economic and human service sectors. Over the course of the last 40 years, the TRC has grown. Now that the necessity for either greater or less control has taken on political significance, it is especially important. The TRC's emphasis on choosing the best rules rather than having more or fewer rules and the way in which these rules are designed to considerably increase the likelihood that outcomes would be favourable just by being followed are what make it so important.(Governatori and Sadiq,2021).

According to Fienea (2020), TRC is concerned with choosing the "correct" rules and criteria that are both beneficial and have predictive validity. It admits that not all laws and regulations are the same and affect monitoring and licencing systems in various ways. The most cost-effective and successful system can be implemented by using a differentiated monitoring strategy of key indicators and risk assessment. According to the Theory of Regulatory Compliance, policy should be founded on significant compliance (i.e., less than 100%) with all regulations.

The variable cost of compliance is supported by this theory. According to the theory, abiding by all the rules is not always advantageous and does not guarantee success. Commercial banks should choose the proper regulations and standards that are both beneficial and have predictive validity. It admits that not all laws and regulations are the same

and affect monitoring and licencing systems in various ways. The most cost-effective and efficient system can be implemented by adhering to a differentiated monitoring method of key indicators and risk assessment.

2.3 Conceptual Framework

A Conceptual framework is a hypothesized model identifying the model under study and the relationship between the dependent and independent variables. The dependent variable in this study is project success while the independent Variables is the influence of resource planning,

INDEPENDENT VARIABLE   **DEPENDENT VARIABLE**

Costs of KYC Compliance
- Training Costs
- Reporting Costs
- Monitoring Costs

Prevention of Money Laundering and Fraud Risks
- Number of detected and reported ML and fraud incidences
- Effective suspicious activity reporting
- Strong compliance culture
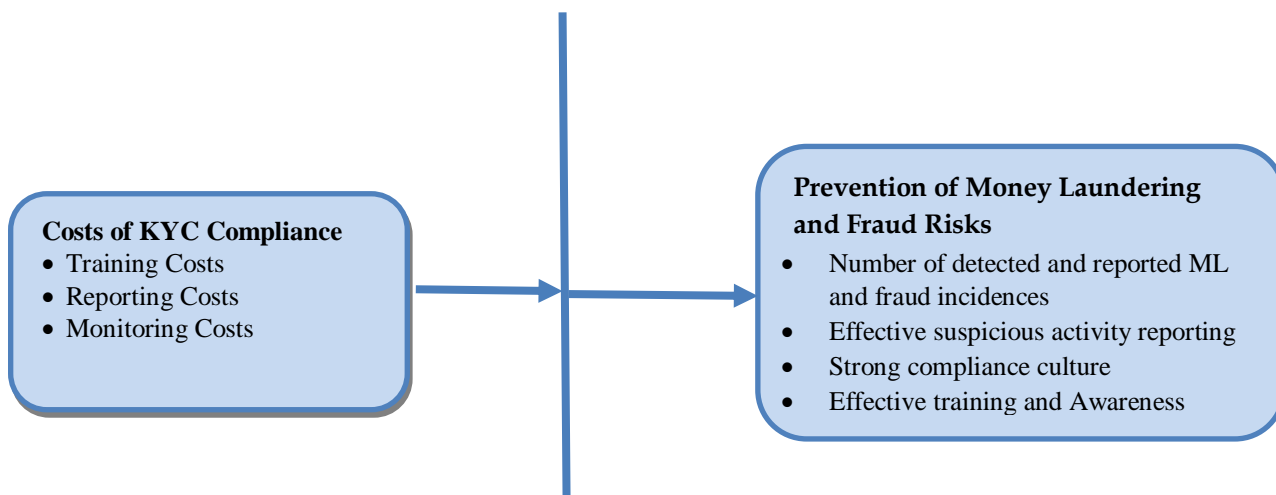- Effective training and Awareness

Fig 2.1: Conceptual Framework

2.4 Empirical review

In their study Abu Salma, Al Zoabi, and Mohammad (2020) investigated the effect of banking secrecy on anti-money laundering in Jordanian commercial banks. They claimed that commercial banks and other financial institutions had to spend more money due to the implementation of anti-money laundering programmes and policies because of things like compliance costs, monitoring costs, and the need to train and equip employees and staff with the skills and techniques necessary to implement the programmes and policies..

AML legislation implementation's impact on the financial outcomes reported by Kenyan commercial banks was investigated in a study by Murithi (2020). A descriptive research approach was adopted for the investigation. According to the results, commercial banks' profitability was hurt by the introduction of AML since it raised operating expenses. Commercial banks have to employ and train staff members in the recognition and reporting of suspicious transactions. After the AML protocols were put in place, however, the level of ML had decreased. Because people couldn't steal from the government and flee the country with their plunder, the introduction of ML processes served to lower the degree of capital flight from the nation.

Michugu (2020) used Chase Bank as a case study to investigate how Anti-Money Laundering laws affected commercial banks in Kenya. The primary goals of the research were to ascertain the impact of AML on financial institutions, the costs of complying to AML rules, and the benefits to financial institution performance. The research design was descriptive, and the sample of Bank employees was selected using stratified sampling. The findings reveal that compliance with AML regulations increased running costs for Chase Bank. As a consequence of reporting expenses (FRC), more reports were filed with the Financial Reporting Centre and the Central Bank of Kenya. The benefits included, but were not limited to, better due diligence thanks to streamlined account setup and monitoring, and more effective fraud detection and prevention training for staff.

In a study, Sainah (2020) looked at the impact of anti-money laundering risk assessment on the performance outcomes of Kenyan commercial banks. All 43 of Kenya's licenced and active banks as of December 2014 were used in the investigation, which employed a descriptive study approach. The results showed that there was only a tenuous connection between ROA performance and AML risk assessment.

III.   RESEARCH METHODOLOGY

3.1 Research Design

Research design, according to Cooper and Schindler (2020), relates to how data collection and analysis are organised in order to efficiently achieve the research objectives through empirical evidence. The used descriptive survey research design, this study. Descriptive survey is an effort to gather information from members of a population in order to ascertain the population's current state with regard to one or more variables. The design examines the degree, difficulties, and impact of supply chain performance and compliance with public procurement regulations in public enterprises. The study targeted the 4 employee in the AML department in the 43 commercial banks totalling to 172 respondents

3.2 Sampling size and Sampling technique

The number of individuals or observations included in a study is referred to as the sample size. The ideal sample size, in terms of subject availability, should be both large enough to serve as sufficient representations of the population and small enough to be picked cheaply, according to Best and Kaln (2020). The Nassiuma (2000) formula was used to establish the sampling size for this investigation

$$n = NC^2 / (C^2 + (N-1) e^2)$$

Where: n = Sample size,

N = Population,

C = Coefficient of variation,

e = Standard error.

C=25% is acceptable according to Nassiuma (2000), e = 0.02 and N= 172

$n = 172 \times 0.25^2 / 0.25^2 + (172 - 1) 0.02^2$

$n = 10.75 / 0.1309$

$n = 82$

Thus, the sample size was 83 respondents

 Purposive sampling was used in the study to select employees working in the AML department

3.3 Data analysis and presentation.

 Before being coded and submitted to additional analysis, the data acquired from the questionires were first be cleaned and altered using the computer programme Statistical Package for Social Sciences (SPSS) version 25.0. The data was next be examined using statistical techniques for both inference and descriptive analysis. Means and standard deviations were used in descriptive analysis to define the population's fundamental features. To ascertain the nature of the link between the variables, inferential statistics involves the use of Pearson's Product Moment Correlation and multiple regression model;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where;

Y = Prevention of Money Laundering and Fraud Risks at Commercial banks

β_0 = Constant

X_1 = Staff competence

X2 = Customer Characteristics

X3 = Cost of KYC Compliance

β1 to β4, are the coefficients of the variables to be determined by the model

ε = the estimated error of the regression model

IV.   RESEARCH FINDINGS AND DISCUSSION

4.1 Response Rate

The 82 questionnaires issued out to respondents, 70 were successfully filled and returned for analysis thus giving the study an 85 % response rate. This response rate was considered sufficient for the purpose of the study. A 50% response rate is adequate, 60% good and above 70% rated very well (Mugenda and Mugenda, 2019)

4.2   Descriptive Analysis

The study further evaluated the views of the respondents on the KYC strategy adoption on prevention of Money Laundering and Fraud Risks at commercial banks in Kenya In this section, the data collected and analyzed was on a 5-point Likert scale ranging from strongly agrees to strongly disagree.

4.2.1 Cost of KYC Compliance

The reseacher sought to examine the effect ofcost of compliance and Prevention of Money Laundering and Fraud Risks at commercial bank. The relevant findings are as shown in Table 4.1

Table 4. 1: Cost of Compliance and Prevention of Money Laundering and Fraud Risks at Commercial Banks

Statement	N	SA (%)	A (%)	N (%)	D (%)	SD (%)	Mean	Std. Dev
The cost of KYC monitoring has increased for the Bank	70	(57)	(36)	(0)	(1)	(6)	4.37	1.01
Compliance with Anti-Money Laundering and Countering Financing of Terrorism regulations has driven up expenses for banks over the last five years	70	(50)	(37)	(0)	(9)	(4)	4.02	1.098
For the past five years, our bank has seen an increase in the cost of staff training	70	(30)	(60)	(0)	(4)	(6)	4.04	0.934
The cost of money laundering reports has been rising in our bank	70	(19)	(71)	(0)	(4)	(6)	3.93	0.937

Because of the use of transaction monitoring technologies, our banks' operating costs are increasing	70	(10)	(71)	(0)	(0)	(19)	3.54	1.259

Looking at the results in Table 4.7, it is evident that most respondents (94%) agreed that the cost of KYC monitoring has increased for the Bank (Mean = 4.33 ;Std=1.10).From the findings 87% of the respondents agreed that Banks' expenses have risen in the last five years due to compliance (Mean = 4.02; Std. Dev.=1.098).

Most(90%) of the respondents agreed that Over the past five years, their bank has witnessed rising costs associated with staff training. (Mean = 4.04; Std. Dev. =0.999). These findings, however, were also consistent with those . Likewise, 90% of the respondents agreed that the cost of money laundering reports has been rising in our bank (Mean = 4.00; Std. Dev.=0.952).

From the findings, it was revealed that 81% of the respondents disagreed that because of the use of transaction monitoring technologies operating costs are increasing (Mean = 4.13; Std. Dev.=0.998).The findings correspondent with previous study by Swift (2023) that inferred that the despite the challenges, developments in technology could make transaction monitoring and screening programmes much more effective and less costly.

The results show that the cost of compliance has risen for the majority of financial institutions.Muhammud (2017) also found that the cost of AML measures had increased gradually following the adoption of AML law, therefore these results are consistent with his.Michugu's (2019) results that banks' expenses went up after the introduction of AML laws and regulations are consistent with our own.

According to the results of this research, the number of transactions subject to bank scrutiny has increased because of anti-money-laundering policies and guidelines. As a result, the bank will have to spend more on surveillance in an effort to identify and stop money laundering. As the bank has expanded the number and frequency of reports, it has also raised the expenses associated with reporting. The survey also found that the expenses involved with educating banks personnel to identify, report, and prevent money-laundering situations have grown because of the introduction of anti-money laundering rules

4.3 Inferential Statistical Findings

This section discusses the inferential statistical findings analyzed from the data collected in respect of the influence of KYC strategy adoption on prevention of Money Laundering and Fraud Risks at commercial banks in Kenya.

4.3.1 Cost of Compliance and Prevention of Money Laundering and Fraud Risks at commercial bank

The study further sought to establish the nature of the relationship Cost of Compliance, Prevention of Money Laundering, and Fraud Risks at commercial bank as shown in Table 4.2

Table 4. 2: Correlation between Cost of Compliance and Prevention of Money Laundering and Fraud Risks at commercial bank

Variable		Project Performance
Cost of Compliance	Pearson Correlation	.947**
	Sig. (2-tailed)	0.000
	N	70

**. Correlation is significant at the 0.01 level (2-tailed).

From the correlation analysis findings shown in Table 4.1, there is a substantial, significant, and positive association between the cost of KYC compliance and the prevention of money laundering and fraud risks at commercial banks (r=0.947**, P=0.000). The efficiency of reducing money laundering and fraud risks and the cost of compliance are highly correlated, as shown by the Pearson correlation value of.947**. The corresponding p-value (Sig. =.000) emphasizes the correlation's statistical importance.

These findings imply a strong correlation between increased compliance costs and more effective money laundering and fraud risk reduction .Based on the analysis of the findings, since p-value (p=0.000) is less than α value (α=0.01), we reject the null hypothesis and concluded that cost of compliance influences prevention of money laundering and fraud risks at commercial bank.

4.4 Regression Analysis

Table 4.3 shows the Model Summary provides insights into the strength of the model and its ability to explain the variability in the outcome variable

Table 4. 3: Model Summary

Model Summary

					Change Statistics				
Model R	R Square	Adjusted Square	RStd. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change	
.957a	.916	.912	.23213	.916	238.404	3	66	.000	

a. Predictors: (Constant), Staff_Competence , Customer_Characteristics ,Cost_of_KYC_ compliance

The high R Square value (0.916) indicates that the combination of Staff Competence, Customer Characteristics, and Cost of KYC Compliance predictors explains a substantial portion of the variance in the outcome variable. This implies that 91.6% of the independent variables are used to explain the dependent variable while 8.4% is explained by other factors

V.   CONCLUSION

From the study, it was concluded that the cost of KYC monitoring has increased for the Bank. The costs related to banks complying with AML and CBK regulations have gone up over the last five years. The price of employee training has increased over the last five years at their bank. Additionally, the cost of money laundering reports at the bank has been increasing. The cost of running banks has not gone up as a result of the deployment of transaction monitoring systems. There exist a strong, positive and significant relationship between the cost of KYC compliance and prevention of money laundering and Fraud Risks at commercial bank .The costs of KYC compliance has an significant effect on prevention of money laundering and fraud risks in commercial banks in Kenya.

The independent variables in the model (Staff Competence, Customer Characteristics, and Cost of KYC Compliance) are highly relevant to explaining the variation in the dependent variable. These predictors likely have a meaningful impact on the outcome you are studying.

VI.   RECOMMEDATIONS

It is recommended that banks should incorporate machine learning and artificial intelligence technologies to enhance the accuracy of monitoring systems. These technologies can adapt to evolving threats and reduce false positives. They should also utilize data analytics to identify patterns and trends that may require further investigation. This proactive approach can help prioritize cases and reduce the need for exhaustive monitoring. To exchange best practises and collaboratively handle shared compliance concerns, banks should work with other banks and financial organisations. Knowledge exchange and cost-effective solutions may arise from this. This would lower the expenses incurred by banks in complying with Central Bank of Kenya (CBK) and anti-money laundering (AML) regulations. The bank should implement a targeted training strategy by determining which particular responsibilities inside the bank need in-depth AML training and then modify the training material appropriately. Not every employee need the same amount of training.

The study sought to evaluate the KYC strategy adoption on prevention of Money Laundering and Fraud Risks at commercial banks in Kenya. Further studies should consider other financial institutions such as SACCOs and MFIs.Also a study should be done to explore the role of technology in KYC strategy adoption. Investigate how the integration of biometric authentication, artificial intelligence, machine learning, and block chain affects the efficiency and accuracy of KYC procedures.

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