

# “The Compliance Function in Banks and the Need for Increasing and Strengthening its Role - Lessons Learned from Practice”

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## Abstract

The environment in which banks operate requires familiarity with a growing number of techniques and regulations, as well as increasing attention to risk management policy. The following trends have been noticeable in recent years:

diversification of business lines within large groups

increase in the range of products on offer for the various categories of customer;

growth of complex transactions;

widening of the geographical area in which institutions are operating and accepting risks;

fiercer competition among institutions, resulting in further profitability constraints.

The overall outcome has been an increase and diversification of the risks incurred by institutions, against a background of continually evolving legislation. As a consequence, institutions are required to exercise a very high degree of vigilance, so as to ensure that their operations comply with the relevant rules and standards.

This paper focuses on compliance risk. First it describe the definition of this risk and the regulatory framework in place dealing with this risk in Albania Banking System. Also are described main principles on the subject of compliance from best practices. It then looks to existing practices in banks and the role of different Bank Bodies and structures involved in governing the compliance risk. Finally in the light of these practices are identifying some moments how systems for controlling this type of risk might be improved.

*Keywords: Compliance risk; Governance of compliance risk; Organizational independence of compliance risk.*

## 1. Introduction

Compliance risk is defined by the Basel Committee as "the risk of legal or regulatory sanctions, financial loss, or loss to reputation that a bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice". According to the Basel document, this includes the conduct of banking and financial business (including conflicts of interest), privacy and data protection. And in particular, provisions on the prevention of money-laundering and terrorist financing.

So defined, compliance risk differs from the litigation risk with a counterparty as it does not deal with credit institutions' responsibility on their contractual obligations but with negative consequences of non-complying with rules of public order.

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## 1.1 Regulations on compliance risk

The main responsibility of the compliance function is to assist the senior management for effectively managing compliance risks. More specifically compliance with laws, rules and standards. The compliance risk is measured by using performance indicators (e.g. increased number of customer complaints, irregularities in payments) to enhance compliance risk. The compliance function also identify, record and assess compliance risks associated with the bank's operations, including new products and practices, proposed establishment of new types of business, customer relations, and material changes in the nature of such relations. It covered the fields such as lending, operation, deposits, transfers, etc.

Through these last years the regulation framework of the Bank of Albania dealing with compliance risk has been improved. The requirements for banks to have a specific structure/ function dealing with compliance risk is now a regulatory requirement. Also the transparency requirements for financial products and services with the clients has been improved.

Below are the regulation into force dealing with Compliance Risk in the Albania Banking System:

- **Regulation “On core management principles of banks and branches of foreign banks and criteria on the approval of their administrators”**. This regulation set out the core principles and regulations for a responsible and efficient management of banks and for an effective system of risk management, including the management of the compliance risk.
- **Regulation “On transparency for banking and financial products and services”**. The purpose of this regulation is to set out the requirements concerning the way and form of providing information to the client about banking and financial products and services offered by the subjects of this regulation with the intention to insure transparency and the customer's safeguarding.
- **Regulation “On consumer credit and mortgage credit”**. This Regulation lay down the standards on the content and way of providing pre-contractual and contractual information of consumer credit and mortgage credit to consumer.
- **Regulation “For the minimum requirements of disclosing information from banks and foreign bank branches”**. The purpose of this Regulation is to set out the minimum requirements, the methods and timelines associated with the information that needs to be published in the periodical reports of banks and foreign bank branches, with the view to enhancing transparency and promoting market discipline across the banking sector as well as to securing sustainability and credibility of the banking sector.

Regulatory compliance has undoubtedly affected banks in a variety of challenging ways, increasing the cost of service and sometimes making the delivery of great customer experiences more difficult. However, as the regulatory environment evolves, we see a major opportunity for the compliance function to get ahead of the curve by

implementing targeted changes to its operating model and processes, and thus delivering a better quality of oversight while at the same time increasing its efficiency. Banks that successfully make this shift will enjoy a distinctive source of competitive advantage in the foreseeable future, being able to deliver better service, reduce structural cost, and significantly de-risk their operations.

## **2. Chapter 2**

### **2.1 Main principles on the subject of compliance from best practices**

Even though a lot of work has been done by the industry to respond to regulatory requirements and its changes over time, the industry needs a more structural answer that will allow banks to effectively and efficiently mature their risk-and-control frameworks to make them more robust and sustainable over time. So below are presented some main principles from best practices on the subject of compliance.

- The Board of Directors must oversee management of compliance risk. It must approve the bank's strategy. It must be informed at least once a year of the bank's compliance policy and the arrangements for its implementation.
- Senior management must establish a compliance policy, ensuring that it is observed and reporting to the board of directors on its ongoing implementation.
- Senior management must establish a permanent and effective compliance function.
- The compliance function must be given formal status through a charter or other document approved by the board of directors that sets out the function's standing, authority and its position in the hierarchical structure.
- It must be independent of the operational side.
- Its role should be to identify, assess and monitor the compliance risks faced by the bank and advise and report to the senior management about these risks.
- The head of compliance is responsible for the day-to-day management of the activities of the compliance function. The supervisor of the bank must be informed when the head of compliance leaves that position.
- Staff exercising compliance responsibilities must have the necessary qualifications, experience and professional and personal qualities to enable them to carry out their duties effectively.
- The compliance function must ensure that institutions engaged in international business are able to satisfactorily manage compliance risk in accordance with local rules.
- The activities of the compliance function must be included within the scope of the bank's internal auditing.

### **2.2 Measure taken from banks to reduce compliance risk**

For a number of years, banks have been improving their regulatory monitoring arrangements, so as to make their staff more familiar with the legislation and to place their regulatory or statutory compliance procedures on a more formal footing. The

compliance risk management function at banks is now both more formalized and more visible. Mostly all banks have already appointed a compliance officer.

The definition of compliance risk is extended to cover the monitoring of compliance with current laws, regulations, codes of conduct and standards of good practice and with the guidelines laid down by the board of directors or senior management. This means, in particular, that a manager in charge of monitoring compliance risk is systematically consulted on each significant new transaction. These institutions have drawn up also procedures detailing how this risk is to be monitored.

### **3. Chapter 3**

#### **3.1 The roles and responsibilities of the Bank Bodies and specific structures involved in the governance of compliance risk**

An independent compliance function is a key component of the bank's second line of defence. The key responsibilities related to compliance are assigned as follows:

##### **Board of Directors**

With reference to compliance activities, the Board of Directors is responsible for overall supervision of the system for managing the risk of non-compliance with the rules of the Bank of Albania and Responsible Authority at the Ministry of Finance regarding Anti Money Laundering. It is responsible, by assigning to the Chief Executive Officer of the Bank specific competences, to efficiently manage this risk. Specifically the Board of Directors, is supported by the Audit Committee to enhance board effectiveness.

##### **Senior Management**

Senior management across the organization is responsible for communicating and reinforcing the compliance culture established by the board, and for implementing measures to promote the culture. Senior management also should implement and enforce the compliance policies and compliance risk management standards that have been approved by the board. Senior management of the corporate compliance function should establish, support, and oversee the organization's compliance risk management program. The corporate compliance function should report to the board, or a committee thereof, on significant compliance matters and the effectiveness of the compliance risk management program.

##### **Compliance Department or Unit**

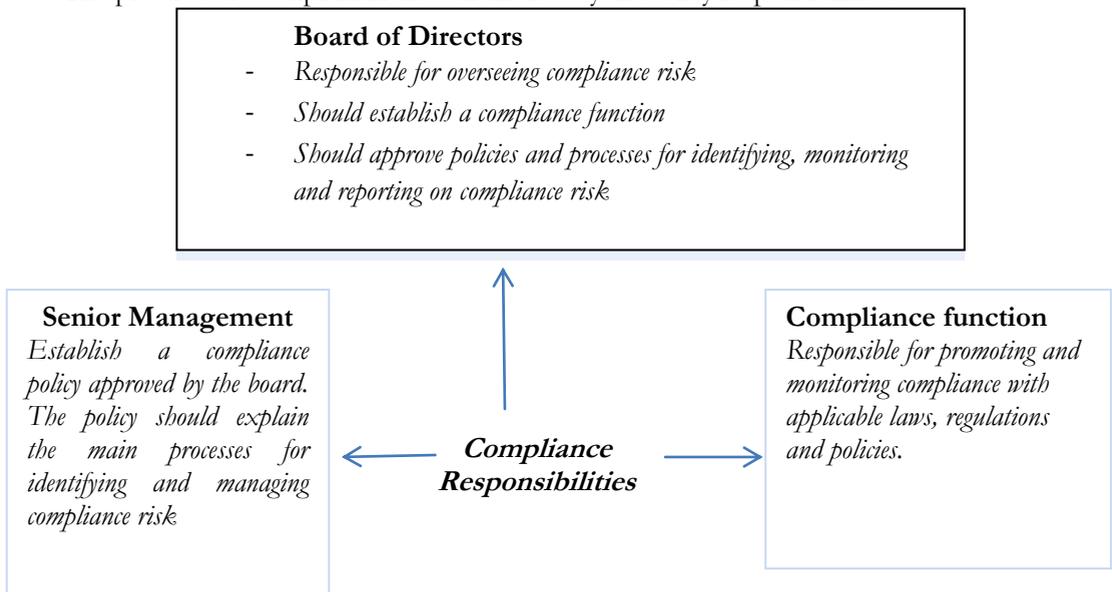
In some banks the structure deals with compliance function is organized in the form of Department reported directly to the CEO, or in some others it is organized as a unit inside or outside the Risk Department.

The main functions of the Compliance Department or Unit are as described below:

➤ provides the compliance risk management guidelines and policies, for submission to the Chief Executive Officer, Board of Directors and to the Audit Committee of the Bank;

- provides the periodical reports regarding the adequacy of compliance governance, for submission to the Chief Executive Officer, Audit Committee, including identification and assessment of the principal compliance risks to which the bank is exposed and the scheduling of the related management interventions concerning both any shortcomings (in terms of policy, procedure, implementation or execution) that have emerged during bank operations, and the need to deal with possible new compliance risks identified following the annual risk assessment;
- it notifies the Audit Committee, Chief Executive Officer of the Bank regarding the compliance issues and violations considered to be particularly significant;
- it supports the Risk Management Department (in cases where it is a separate department not part of Risk Department), and other departments, in the preparation of reports for the Bank Bodies such as to enable an integrated picture of all operational and reputational risks, both compliance-related and otherwise, the related governances and corrective interventions initiated, at organisational structure and process level.

The picture below explain in the schematic way these key responsibilities:



Also the other structure in the Bank contributes to compliance are Legal Department, Risk Management Department and Audit Committee or internal audit.

### Legal Department

The Legal Department contributes to the compliance risk management, through the governance of the legal risk. In particular:

- it helps the Compliance Department to identify on an ongoing basis the applicable rules, monitoring their evolution and guaranteeing their interpretation;

- it supports the Compliance Department as regards the aspects requiring interpretation of regulations for the definition of organisational and procedural changes designed to ensure an adequate governance of compliance risks;
- it provides interpretations of the rule required by the Compliance Department to enable its preventive assessment of compliance as regards innovative projects, transactions and new products and services to be launched on the market;
- it cooperates with the Compliance Department in order to manage relations with the Regulatory Authorities in connection with compliance matters and to manage non-compliance events, reviewing the legal aspects of issues and participating, with regard to such aspects, in the preparation of responses.

### **Risk Management Department**

As regards compliance activities, the Risk Management Department:

- cooperates with the Compliance Department in order to define the compliance risk assessment methodologies, encouraging synergies with the tools and methods adopted by Operational Risk Management;
- supports the Compliance Department in the annual assessment of compliance risks;
- supports the Compliance Department in assessing the compliance with the legislation in force of transactions and new products and services to be launched on the market, both on request and through a structured Clearing process, cooperating in order to identify potential risks for the Bank and Customers and providing, where applicable, quantitative.

### **Audit Committee**

The competences of the Audit Committee are as described in the Articles of Association of the Bank and in the rules which govern its operation. More specifically, in reference to compliance risk, the Audit Committee supervises the compliance with Law, regulations, rules and code of conduct of the Bank. Audit Committee controls the compliance of the Bank activity with the legal and sub-legal acts and informs the Board of Directors of the Bank. It analyses the activity of the Compliance Department of the Bank regarding exercise of its duties and functions.

The interrelationship among the risk management (RM), internal audit and compliance risk assessment are summarized below.

	ERM	Internal Audit	Compliance
Objective	Identify, prioritize and assign accountability for managing strategic, operational, financial and reputational risk.	Determine and prioritize risks to aid in developing the internal audit plan, helping to provide the board and executive team with assurances related to risk management efforts and other compliance activities	Identify, prioritize and assign accountability for managing existing or potential threats related to legal or policy noncompliance - or ethical misconduct - that could lead to fines or penalties, reputational damage, or the inability to operate in key markets.
Scope	Any risk significantly impacting the organization's ability to achieve its strategic objectives	Financial statement and internal control risks, as well as some operational and compliance risk that are likely to materially impact the performance of the enterprise or financial statements.	Laws and regulations with which the organization is required to comply in all jurisdictions where it conducts business, as well as critical organizational policies - whether or not those policies are based on legal requirements.
Typical Owner	Chief Risk Officer	Chief Audit Executive	Chief Compliance Officer

## 4. Chapter 4

### Lessons learned from practice

#### 4.1 Independence needs to be guaranteed

The compliance risk management and control function needs to be independent of the operational side of the bank. As suggested from Basel Committee, it seems desirable for a member of the senior management to take responsibility at the highest level for compliance. Whether or not the compliance officer is a member of the management committee, he or she must have a direct reporting line to the bank's senior management, in order to be able to inform it of any irregularities that have been identified.

#### 4.2 Accessibility to all staff

While it is essential that the compliance function should be independent in order to enable it to operate effectively, it also needs to be easily accessible to all staff. Banks might consider introducing ways of protecting staff who wish to report a possible irregularity or abuse to a compliance officer (protection of whistleblowers).

#### 4.3 An expanded role of compliance and active ownership of the risk-and-control framework

In most cases banks need to transform the role of their compliance departments from that of an adviser to one that puts more emphasis on active risk management and monitoring. In practice it means expanding beyond offering advice on statutory rules, regulations, and laws and becoming an active co-owner of risks to provide an independent oversight of the control framework.

#### **4.4 The compliance function will need to be adapted to suit each institution**

Although the Basel Committee's proposals for creating a compliance function may have been seen to apply more particularly to large international banks, the issue of compliance is no less relevant to smaller institutions. In some cases it is an even more pressing problem, insofar as small institutions find it harder to ensure an effective separation of functions and to gather all the expertise needed to gain a full understanding of the legislation and subsequent amendments.

The actual structure can vary from one institution to another. At some the function is extremely decentralized, whereas others have installed a centralized team with highly developed functions. Whatever form of organization is chosen, it must guarantee the independence of the compliance staff. Nonetheless, in order for the teams to be equally effective in all the business lines and at all the establishments of a banking group and to ensure uniformity of approach, coordination will be necessary.

#### **4.5 Integration with the overall risk-management governance, regulatory affairs, and issue-management process**

Compliance risks are driven by the same underlying factors that drive other banking risks, but their stakes are higher in the case of adverse outcomes (for example, regulatory actions that can result in restriction of business activities and large fines). Therefore, it's only fitting that a modern compliance framework needs to be fully integrated with the bank's operational-risk view of the world.

Integrating the management of these risks offers tangible benefits. First, it ensures the enterprise has a truly comprehensive view of its portfolio of risks and visibility into any systemic issues (for example, cross-product, cross-process), and that no material risk is left unattended.

Second, it lessens the burden on the business (for example, no duplicative risk assessments and remediation activities) as well as on the control functions (for example, no separate or duplicative reporting, training, and communication activities).

Third, it facilitates a risk-based allocation of enterprise resources and management actions on risk remediation and investment in cross-cutting controls.

#### **4.6 The compliance function must have sufficient resources**

It is important that the resources which a bank assigns to the compliance function should enable it to ensure that compliance risk is adequately covered at all its establishments. In order to form a credible team, the staff in charge of compliance must have all the necessary skills for understanding the transactions that they will be examining. For this reason, it is an advantage if the teams include staff who have in the past worked on the operational side or, more generally, whose careers have given them a variety of professional experience. Credit institutions are evidently trying to recruit people with complementary skills and experience for their compliance teams. These include staff with a legal training, former internal or external auditors and former operational staff.

Much, however, still remains to be done in terms of allocating adequate resources to the compliance function, so as to ensure that all establishments and business lines are properly catered for.

#### **4.7 An “auditable” function**

Internal auditing has an essential role to play in compliance risk management at banks. One of its particular tasks is to check that the internal control arrangements are working properly.

It is therefore considered essential that the compliance function should, like a bank's other activities, be "auditable". In order to be certain that the auditors (or inspectors) are able to form an independent opinion on the effectiveness of compliance arrangements (e.g. ensuring that the compliance officer is making an effective contribution towards encouraging the spread of a compliance culture) and the adequacy of the resources allocated, it would seem desirable if the functions of audit manager and compliance manager were segregated.

### **Conclusions**

The debate on compliance risk management is already well under way, both at international level among the banking regulators (Basel Committee) and at national level among the banks themselves. In the light of the changing activities of the banks and given their commitment to step up their efforts and move closer into line with international best practice, a number of points seem worth highlighting at the present stage:

- if the compliance function is to be independent and run the entire gamut of compliance risk to which an institution is exposed, there can be no single formula for deciding how it should be organized, because this will depend, above all, on the activities and size of the institution concerned;
- the compliance function is set to play an increasingly important role at the regulated institutions when new business is being decided on and at other stages in an institution's life at both the national and internal levels; this implies the need for training and information procedures, the issuing of internal guidelines and ongoing controls;
- involvement of the senior management and board of directors is essential;
- compliance must form an important part of the corporate culture, and continuous efforts therefore need to be made to ensure that this is the case.

As a result of recent investments in the area of credit and market risk management, the banks are better able to identify and measure these risks. Similar efforts are now needed

to deal with compliance risk, which is growing at the global level. These efforts will enable the banks to manage this risk even more effectively than they do today, thus helping Banks and banking system to maintain its reputation.

Finally, it must form part of the more general moves under way in all economic sectors to improve corporate governance.

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