COMPLIANCE AFTER THE GLOBAL CRISIS

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1. Introduction

The financial turmoil that originated with the sub-prime crisis in the United States and spread globally over the last two years left no economy or financial institution unaffected. The resultant cost to the global economy is staggering and is being measured in trillions of dollars. According to Bloomberg, losses in global equity values in 2008 reached USD 31 trillion, while write downs and debt losses in major financial institutions exceeded USD 1 trillion. Unlike previous recent crises that were experienced in the recent past such as the dotcom bubble in the US, the asset price bubble of Japan and the East Asian crisis, which were mostly regional in nature, the recent turbulence was global in nature. The crisis, the reasons that contributed to its origination, as well as lessons learnt, post crisis reactions and measures to tide over the crisis have been the main theme for discussion at almost all the financial forums of recent times.

A variety of reasons have been identified as having contributed to the current crisis, inter alia, developments (or deficiencies) in the regulation and supervision as well as global macroeconomic imbalances. At a micro level, deficiencies in risk management, corporate governance and incentive structures have contributed to the financial instability. Overall, deficiencies in macro-prudential supervision in un-regulated, systemically important, shadow entities and ignoring the systemic warnings have also contributed to this situation. Although non-compliance with rules and regulations has not been cited as a main reason for the crisis, regulatory arbitrage by banks has been one of the contributory factors. Thus, it is evident that failures in compliance controls did not just occur within individual corporates or markets, but were global in nature and transcended regulatory models.

Regulatory arbitrage arose with the unprecedented explosive growth of securitized credit intermediation. The underlying assumption was that this constituted a mechanism whereby the risk was transferred out of the bank balance sheets, thereby reducing capital requirements for individual banks.

The 2008 Annual Report of the Bank for International Settlements (BIS) points out that weaknesses in regulation have also contributed to the crisis. Financial institutions found it relatively easy to move activities outside the regulatory perimeter, avoiding regulatory capital charges thereby engaging in regulatory arbitrage.

Post crisis, the call for increased regulatory coverage and tightening of the hitherto lax regulatory framework has commenced already. This indicates that the significance of the role of compliance after the crisis has increased considerably.

What the banks that have been affected by the financial crisis have suffered mostly, apart from the devastating financial losses leading to bankruptcy, is loss of reputation, which is hard to quantify, but has added to the financial losses. Therefore, the role of compliance in safeguarding the reputation of banks increases in significance.

Thus it can be expected that the regulatory landscape will see many changes in the near future. The Sarbanes-Oxley Act of 2002 is the US response to the corporate scandals and breakdowns such as the Enron case that erupted in the USA in 2001, which highlighted the need for stronger regulations for publicly listed companies. In addressing the sub-prime crisis, the Credit Card Accountability, Responsibility and Disclosure Act has been enacted in the USA as a measure of addressing the lacuna in regulations relating to credit card operations. In the UK, the Banking Act 2009 has been enacted while the Turner Review and the Walker Review of corporate governance of UK banking industry have reviewed the regulatory aspects and corporate governance aspects, respectively. The Bank for International Settlements (BIS) has included a unit in its office in Basel for monitoring the financial stability of insurance companies. Several central banks, whose objectives hitherto were mainly the maintenance of price stability, have now expanded their objectives to include financial stability. The BCBS has recently issued amendments to the Basel II framework to introduce measures to strengthen the regulation of the banking sector. These are some of the changes to the regulatory landscape that are taking place as a result of the crisis. The increased complexity of regulations will no doubt require effective compliance frameworks to be in place in individual banks to meet the expanded regulatory requirements.

This article examines the significance of the role of the compliance function in banks after the global financial crisis and how an effective compliance function can help maintain the soundness of a banking institution.

2. Definition of Compliance/Compliance Risk

The Basel Committee on Banking Supervision (BCBS), the international standard setter with regard to banking supervision has defined compliance risk as 'the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to banking activities.

The Wikepedia refers to compliance (with regard to regulation) as 'the act of adhering to, and demonstrating adherence to, a standard or regulation'.

The compliance universe generally consists of laws, rules and standards as well as internal codes of conduct, and typically includes areas such as prevention of money laundering and terrorist financing. Matters such as observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, fall within the ambit of the compliance function.

As generally known, banks are highly regulated entities, due to the nature of their activities and there are a host of laws and prudential regulations applicable to them. Banking supervisors regularly supervise and maintain an oversight over banks in order to ensure that the laws and prudential requirements are being adhered to by the banks, in the interest of ensuring the soundness of each bank. Thus, it is imperative to establish a control function within banks that ensures that the bank meets these requirements.

The BCBS paper titled 'Compliance and the Compliance function in banks' issued in 2005 sets out the international best practices with regard to an effective compliance programme. An effective compliance function will safeguard the banking institution from adverse regulatory sanctions for non-compliance with regulations, prevent financial losses by way of penalties and protect the reputation of banks.

Avoiding reputation-damaging incidents can deliver financial rewards as well, including higher margins, lower perceived risk and cheaper capital. A banking institution without compliance problems attract customers and shareholders who prefer a more trustworthy brand, which can lead to low cost deposits.

Historically, there has been greater emphasis on risk management in the areas of credit, market, operational and liquidity. Due to the growing complexity of banking operations and the regulatory frameworks the emphasis on the banks' ability to measure and manage the compliance risk is now receiving increased attention of bank management and regulators along with risk management.

Compliance function is expected throughout the organization structure and is not only limited to a particular department. The board of directors and senior management of banks are expected to lead by example. It is also expected to be part of the culture of the bank and is to be viewed as an integral part of the bank's business activities. In meeting the regulatory expectations with regard to compliance, banks are expected to observe the spirit of regulations as well as the letter of law.

Compliance risk cannot be mitigated by holding a capital 'cover' and thus the role played by compliance cannot be undermined.

In response to the global crisis, the emerging regulatory regime is expected to be broader in scope and complexity, while rules will extend to new areas. As a result, compliance will become a core stand alone function with a Chief Compliance Officer reporting to the board.

While the structure of the compliance function is expected to vary from bank to bank depending on the areas of operation, complexity of products etc., an effective compliance function consisting of an appropriate compliance programme has been recommended by the BCBS.

3. Implementation of a Compliance Structure

Results of a survey published in August 2008 by the BCBS with regard to implementation of the compliance principles issued previously by it indicated that ' in a substantial majority of respondent jurisdictions, banks manage and supervise the compliance function as an important risk management control function'. Whilst this is encouraging, the recognition and prominence given to the control function by the boards of banks may need improvement, especially in the wake of the crisis. For, during a boom, if what they are doing is profitable, it is going to be difficult to get the top management and directors to listen to the compliance officer.

A study carried out by the Economist Intelligence Unit on the bank compliance functions in relation to controlling risk and improving effectiveness revealed that despite the differences among various banks and regulators, all were focused on a handful of common themes:

* **Compliance is playing a more prominent role –** Examples of banks that have suffered enormous damage as a result of compliance failures are many. The risk of non-compliance is increasingly one that banks cannot get wrong.

* **More deliberate measurement and management of compliance risk is needed –** It can help to anticipate where compliance missteps are most likely to surface. How well are compliance processes working? Knowing the level of enterprise-wide compliance risk helps to gauge the effectiveness of compliance.

* **Performance appraisal (in relation to compliance) is nascent but will no doubt develop** – Few banks explicitly measure the return on compliance investment. Most use qualitative and quantitative measures based on tools such as surverys, regulatory feedback, benchmarking and score cards. But in oirder to comply efficiently (and slow the growth of compliance spending), it will be necessary to measure performance on a more consistent and accurate basis.

* **Integration across the enterprise is crucial – risks in banking are both complex and often inter-related –** credit can be accompanied by interest rate risk, market risk could aggravate liquidity risk, and compliance risk could overlap with other types of risk, especially operational risk. To ensure that risk is managed thoughtfully across the enterprise, compliance must work closely and communicate well with all risk areas and businesses.

* **A culture of compliance is crucial –** compliance must be visibly embraced by senior management and built into the hiring and training process. Ideally, it should be linked to the remuneration and promotion process as well. Moreover, the right metrics can make the culture of compliance concrete. It is important to address issues such as: who delivers the compliance message – line or staff? How senior are the messengers? How often do they address compliance issues? Culture, like other aspects of compliance processes, can be managed and measured over time.

The BCBS has made the following recommendations with regard to setting up an effective compliance function:

1. The responsibility for overseeing the management of the bank's compliance risk is with the board of directors. The Board should approve the bank's compliance policy and review the effectiveness of the compliance function at least annually.

2. The effective management of the compliance risk is with senior management of the bank

3. The senior management should be responsible for establishing and communicating a compliance policy, for ensuring that it is observed, and for reporting to the board on the management of the bank's compliance risk

4. The senior management should establish a permanent and effective compliance function within the bank as part of the bank's compliance policy.

5. The compliance function should be independent – this requires a formal status for compliance within the bank; appointing a group compliance officer/head of compliance; avoiding conflicts of interest between the compliance function and any other function of the compliance staff; access to information and staffing to carry out their responsibilities

6. Sufficient and appropriate resources to carry out the compliance responsibilities effectively

7. The responsibility of the bank's compliance function should be to assist the senior management in managing effectively the compliance risk faced by the bank.

8. Compliance function should be subject to periodic review by the internal audit function

9. Banks should comply with the relevant laws of all jurisdictions in which it operates

10. Compliance should be regarded as core risk management activity within the bank.

4. Compliance issues that have surfaced due to the financial turmoil

Several compliance issues have surfaced as a result of the financial turmoil such as adequacy or inadequacy of financial guidelines, rules and regulations, observance of operational rules and appropriate codes of behavior.

4.1 Adequacy/inadequacy of regulatory background

Compliance and appropriate regulation must go hand in hand. Thus the rules and regulations applicable to the institutions in the financial system must be relevant and effective. The global regulatory environment to date, in relation to financial services has been a paradox. Some institutions were subject to relatively strict regulations, such as deposit taking institutions, while others operated almost entirely outside a regulated environment, such as hedge funds managing billions of dollars in assets. Perhaps most ironic about the regulatory environment is that a certain institution may be highly regulated with regard to traditional products in most jurisdictions, but totally unregulated in relation to innovative instruments. The financial failures clearly illustrate the need for a wider coverage of the financial sector beyond commercial banks and for stricter coverage of the financial entities that were actually regulated.

The existing model in the USA relied heavily on self-regulation, while in Europe, principle-based models provided guidelines on compliance objectives. The theory of supremacy of the self-correcting mechanisms of the market finds itself being increasingly challenged today. As the scope and coverage of regulations are expanded to encompass hitherto unregulated areas, it is reasonable to assume that the complexity of policies, volume and scope of compliance will also increase correspondingly. With this increase will come a dynamic focus, not just on improved transparency, but on vastly improved enforcement.

The crisis indicated that the existing capital criteria for banks were inadequate. As a result of the financial meltdown many banks had to be recapitalized by the Governments and by the private sector. Yet many of the impact studies of Basel II guidelines would have led to lower capital requirements for most banks. Conversely, results of stress tests conducted on banks in the USA indicated that the capital levels of most banks have to be increased – significantly in some cases. Despite acceptance of this, there is also increasing acceptance of the fact that capital levels cannot save a bank when a crisis hits. Operational probity is more important in preventing its occurrence.

4.2 Implementation of Risk Management/Prudential Guidelines

It is generally agreed that one of the most important considerations in ensuring good financial management is adherence to or effective implementation of applicable risk management and prudential guidelines. The warning signals indicated by the rapid growth in the sub-prime market and the manner in which risks were assumed, should have alerted policy makers as to the dangers looming ahead. Many of the warnings turned out to be accurate, but were obviously issued in vain. Ensuring the effective implementation of rules and regulations is a primary task of compliance.

4.3 Appropriate codes of behaviour

Whilst it is impossible for regulations to cover all aspects of operations of banking institutions extending to minute details, each banking institution should adopt their own codes of behaviour and best practices. Such codes of conduct would be important but minute detail may be impossible. For example, should such codes specify that it is inappropriate for a lender to require from a borrower, monthly payments which exceeded the monthly income of that borrower? This is what was happening in the sub prime mortgage market before the eruption of the crisis. This was influenced by the fact that the lenders' compensation was based on the volumes rather than the quality of credit. It would seem that general codes of behaviour rather than explicit rules would be important since one cannot anticipate every situation, nor can rules be devised to cover every possible eventuality.

5. Changes to the compliance function in view of the Global Crisis

The global crisis revealed the extent to which global economies are interconnected. Perhaps no greater example is required than the near collapse of Iceland's financial system, which was heavily reliant on leveraged instruments backed by assets thousands of miles away. As countries and economies strive to emerge from the depths of the crisis, and regulatory systems are developed to cover the loopholes that existed, the compliance challenge increases to meet the emerging new financial architecture.

5.1 Cross-jurisdiction cooperation and Compliance requirements

Given the global impact of the financial crisis, regulators have significantly increased cooperation with their counterparts in other jurisdictions. At some level, more consistent compliance programmes may be needed to meet ease the burden of global financial institutions. Global cooperation among regulators will present a more dynamic environment and increase the potential risk of compliance failures or likely success of their enforcement actions.

As a result of increased global cooperation, financial institutions will need to manage two primary sets of obligations: the ability to comply with regulations across multiple jurisdictions, and the ability to respond to inquires from all regulatory authorities. More importantly, issues that may be of particular concern in one geography may not hold the same priority as another. This increases the compliance challenge in meeting the diverse requirements of different regulators.

5.2 Aligning legal and compliance requirements

Compliance covers a wide spectrum of issues. It may be necessary to adhere to different laws, regulations or codes of conduct with respect to one area of operations. Understanding the diverse requirements will be required in order to respond effectively to the diverse compliance needs.

6. Conclusion

As countries and economies emerge from the devastating effects of the financial crisis which spread across the globe, and as a result of the many changes that are taking place and will be made with regard to the global financial architecture, the compliance function of banks will have a significant role to play. In the post crisis scenario, a dynamic and an effective compliance function will not merely be yet another fixed cost, but definitely an indispensable risk management tool in safeguarding the reputation and stature of individual institution. Further, an effective compliance function will help steer organizations, and as a result financial systems from the deep waters of the financial crisis towards safer shores of a safe and sound global financial system.

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