

Characteristics of Compliance Risk in Banking

Emil Asenov*

Summary:

This paper examines the characteristics of the "risk of discrepancy" known as "risk of non-compliance with regulatory requirements" or "compliance risk" in the activities of financial institutions. Practice shows that this risk can be a source of serious losses for those of them who consciously perform practices and transactions with the purpose of avoiding regulatory requirements. In order to avert the risk of discrepancy financial institutions establish and maintain in their activities a function of observance of legal requirements ("compliance function"). The implementation of this function suggests building a system for risk management, a special status of the persons who are assigned to exercise control over the risk and a systematic implementation of programs for risk prevention. The risk of non-compliance with regulatory requirements is also present in the Bulgarian banking practice. Bulgaria's accession to the European Banking Union requires that new European regulations, supervisory procedures, and other legal

norms be embraced. This will test the institutional capacity of Bulgarian regulators and the ability of financial institutions to operate in a more complex regulatory environment.

Key words: compliance risk, compliance function, legal risk, normative acts

JEL Classification: G21, G28

Along with the term 'compliance risk'¹, there are other similar terms in use in the financial practice such as 'risk of non-compliance with regulatory requirements', 'legislative risk', 'legal risk', and other types of risk. They define the risk associated with legal and regulatory sanctions, significant financial losses² or loss of reputation as a result of failure to comply with laws, regulations, internal rules and standards, codes of business conduct applicable to the banking sector.

Compliance with laws, rules and standards encompasses a wide range of issues regarding the monitoring of the standards of responsible market conduct, managing conflicts of interests, providing equal treatment of clients by supplying relevant appropriate information³.

* Associate professor, Ph.D., Department of Financial Control, University of National and World Economy, e-mail: control_asenov@abv.bg

¹ Derived from English compliance, meaning obey, consider.

² Since 2009 the big banks in the US and Europe have paid \$230 billion to cover legal costs. Source www.capital.bg/.../2453905-evropeiskite_banki_sa_izpraveni_pred_globi_z_a_oshte_52/

³ For example, a message from the Commission for Consumer Protection /CCP/ states that it has drawn up nine law infringement statements for advertising consumer credit against banks and credit institutions. Some of them, included in their advertising messages interest rate or other figures related to the cost of credit, but they did not inform users about the annual percentage rate cost for the credit / APR /. Source: http://www.kzp.bg/index.php?mode=viewd&group_id=1&document_id=343

Laws, rules and standards are legal means to achieve their underlying objectives. Legislative texts in the financial sector usually relate to specific areas such as the prevention of money laundering and financing of terrorism. Their scope may also include tax laws that are related to structuring of banking products or customer advice. Practical experience shows that financial institutions that deliberately engage in customer transactions in order to avoid regulatory requirements, tax liabilities or facilitate illegitimate governments may be running a significant risk of non-compliance with regulatory requirements.⁴

The occurrence of the risk of non-compliance is determined by the action of two types of factors that can be both internal and external to the credit institutions. The internal factors may be:

- a) inability of credit institutions to comply with activity requirements of the current legislation;
- b) disparity between internal documents of credit institutions and legislative texts, as well as the inability of credit institutions to promptly adjust their activities and internal documents to changes in that legislation;
- c) inefficient organization of legal activity in credit institutions, which leads to errors resulting from actions of employees or management bodies;
- d) breach of existing contracts to which credit institutions are a party;
- e) lack of legal inquiry by credit institutions on matters regarding the development and implementation of new technologies and conditions for carrying out banking operations, financial innovation and technology.

External factors that may cause the occurrence of the risk of non-compliance

with regulatory requirements most often relate to:

- a) the imperfection of the legal system of the relevant country (absence of legal regulation, contradictory legal decisions, excessive dynamics and changes in regulation, imperfect methods of state regulation and (or) supervision, incorrect application of the law of the foreign country and (or) international law), inability to resolve certain issues through negotiations, which leads to the appeal of legislative and administrative decisions by the credit institutions in court;
- b) breach of contracts by clients and counterparties of credit institutions;
- c) the credit institution, its branches, subsidiaries, and their partners, and customers are under the jurisdiction of different countries.

The sources of risk of non-compliance with the regulatory requirements can be identified on a broader global scale. The internationalisation of banks increases the efficiency of both domestic and global markets, but can also create difficulties for the regulatory and supervisory process. This would be the case if cross-border transactions and deals were used to conceal the actual problems of the bank, thus remaining out of reach and not attracting the attention of national supervisors. For instance, the activities of subsidiaries in countries with less regulation and supervision could lead to losses and could reduce the capital of an international bank, and these facts could thus remain hidden from the supervisory authority in the country where it is headquartered. Hence the risk of non-compliance could be a result of the asymmetry and differences in terms of regulation of the banking business

⁴ Even Wegelin & Co, Switzerland's oldest bank, founded in 1741 announced that it would close down due to systematic infringement of the laws. The investigation shows that for nearly ten years the bank helped US citizens to hide taxes: a sum total of 1.2 billion dollars. The bank agreed to pay US authorities compensations and fines amounting to 57.8 million dollars.. Source: Mediapool.bg.-04.01.2012<http://www.mediapool.bg/nai-starata-shveitsarska-banka-obyavi-che-prekratyava-deinost-news201303.html>

in different countries and the insufficient coordination between them. Sources of that risk may be as follows:

- a) inconsistent or contradictory approach to regulation and supervision towards the different types of financial institutions;
- b) scarcity and inconsistency in determining the risks that different types of financial institutions face;
- c) the differences regarding the criteria and parameters of regulation of the activities of the various categories of financial institutions;
- d) lack of coordination between the regulatory bodies and the supervisory bodies in the financial sector.
- e) hence the conditions for regulation and supervision need better coordination in different countries, so as to ensure adequate environment for the banking business.

Of course, there may be other views on the sources of 'compliance risk'. For example, 'Operational Risk: Regulation, Analysis and Management' refers to three main groups of sources (Hadjiemmanuil, C., 2003, p.74-100):

- 1) violation of the rights of the bank, its employees and contractors;
- 2) uncertainty regarding the requirements of legislation and the consequences of non-compliance;
- 3) the relative inefficiency of the legal system⁵. It is possible to classify the risk as legal after conducting an initial general assessment of the nature of these sources, especially if taking into account the fact that the potential liability of credit institutions in case of risk events is primarily legal. However, it should be borne in mind that banks operate in a far more complex social environment, which requires

compliance with a diverse and broad set of regulations, laws, rules and standards.

The legal framework within which credit institutions operate is built on a foundation of different sources – 'basic legislation, rules and standards established by the legislator and supervisory authority, marketing agreements, best practices issued by the banking industry, internal codes of business conduct applicable to bank employees. For these reasons, the function of regulatory compliance covers not only formal statutory provisions, but also broader standards of professional ethics and code of ethics (Basel Committee on Banking Supervision, April 2005). These circumstances require the adoption of a broader framework of the sources of potential risk, which is beyond the scope of usual sources of legal regulation. In this case we can assume that legal risk is an element of the compliance risk. Legal risk is an important, fundamental part of the compliance risk, but still has a narrow framework that mainly relates to one (albeit the most important) part of the tools to regulate financial and banking practices. The risk of inconsistency has a much wider range of potential sources whose number will inevitably increase in the future.

The increasing variety of regulatory instruments, the respective new terminology that they introduce and the quality evaluation criteria, however, create another border area in risk assessment. It arises as a consequence of the process of increasingly wider reception of ethical principles and values, acting as a tool for regulation. They suggest the establishment and maintenance of a corporate culture in banks that emphasizes standards of honesty and integrity⁶. In carrying out their business,

⁵ Regarding other classifications of the sources of risk see- Shyamala Gopinath :Changing Dynamics of Legal Risks in the Financial Sector // <http://www.bis.org/review/>

⁶ Since 2009 until now, European banks have paid fines amounting to 102 billion dollars. According to Morgan Stanley 52 billion dollars are still required to be released, mainly for the payment of fines and compensation for infringement in international currency trading and misleading customers during sale of US mortgage-backed securities that triggered the financial meltdown of 2008. These costs may limit the payment of dividends by banks in the following years. Source: <http://www.capital.bg/biznes/kompanii/2015/01/14/2453905>

banks must maintain high standards at all times and seek to comply with both the spirit and the 'rule of law'. Underappreciating the potential impact of these standards on the motivation of shareholders, customers, employees and the market could lead to significantly damaging the reputation of banks, even when the law has not been formally violated. Therefore, this risk is sometimes defined as a risk of 'honesty' (or integrity), since the bank's reputation is closely related to the principles of decency and fairness in its activities. This is one reason why there is no clear and fully terminological distinction between the risk of non-compliance with legal requirements, on the one hand and the risk of reputation, on the other.

Compliance risk already has strong presence in the banking practice. In a study conducted by "The Economist Intelligence Unit" in 2006 among the 175 largest banks in North America, Europe and Asia indicates that over a third of them have to work in accordance with the statutory requirements imposed by ten or more national regulators. More than three quarters of the banks in the study indicate the need for compliance with the regulations that apply to four or more national regulators. The case of Deutsche Bank is especially prominent, as the bank operates in 73 countries, and the result should solve more than 350 regulatory cases per year.⁷

Factors determining the occurrence of the risk of non-compliance demonstrate a trend of steady growth. Most of the banks surveyed indicated that they expect the regulation of the banking business in the coming years to become more complicated and cumbersome. According to them it will be characterized by a broader range

of regulations, with more complexity and severe consequences from non-compliance with provisions. The results show that 92% of banks foresee a growing complexity of future provisions, and some 91% expect regulatory bodies to extend the scope of regulation to new areas. At the same time 81% of banks expect sanctions for non-compliance with the statutory requirements to become more severe.⁸

In order to prevent compliance risk, each financial institution is required to establish a function to comply with regulatory requirements. According to the recommendations of the Basel Committee on Banking Supervision, the function of regulatory compliance is the responsibility of the board of directors of commercial banks, which should clearly define the compliance policy of the banks, including via an official document, which would create a permanent and effective compliance function. At least once a year the board should assess the extent to which credit institutions effectively manage their compliance risk. Banks can manage their risk more effectively if they have established a compliance function, which adheres to the compliance function principles.

Significant disparities can be observed in the practical organization of the compliance function. In larger banks employees involved with compliance may be involved in other operational activities of the bank, while international banks may have employees who oversee the compliance on a group basis in the respective locations. In smaller banks employees who perform this function can be positioned in one unit. Some banks have established separate units for specific areas such as protection of banking information and prevention against money laundering and terrorist financing.

⁷ From 2012 to 2014 Deutsche Bank spent 7 billion. euro for fines and outside legal agreement. Source .. <http://bnr.bg/finance/post/100478477/>

⁸ Source: Economist Intelligence Unit survey, 2006 - :<http://www.acegroup.com/se-en/assets/cro-risk-report.pdf>

Banks organize the function of compliance with regulatory requirements by establishing priorities managing the risk of non-compliance, so that this feature is consistent with its strategy for and structure of risk management. For instance, some banks may organize their compliance function within the operational risk function, as there are close links between the risk of non-compliance and certain aspects of operational risk. Other banks prefer to have separate functions for the risk of non-compliance and the operational risk, but they establish mechanisms of close interaction between the two functions.

Regardless of the practical means by which a bank goes about complying with regulatory provisions, it should be independent and dispose of sufficient resources. Its responsibilities should be clearly defined and its actions - subject to regular and independent 'internal audit'.

1. Purposes, requirements and stages of the activity of the system managing the risk of non-compliance

The purpose of the system managing the risk of non-compliance and bank management shall be to exercise control over the risk level and prevention against the occurrence of risk events that could adversely affect the interests of the Bank. The main priority is to ensure the safety of assets and equity by reducing (exclusion) of possible losses, including cash payments based on court decisions, which may lead to unexpected losses. Managing the risk of non compliance may have the following specific purposes:

- a) identification, measurement and determination of the acceptable level of risk of non-compliance;
- b) continuous monitoring of the risk of non-compliance with the regulatory requirements;

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- c) measures to maintain the risk of non-compliance at a level that is not a threat to the financial stability of the Bank and the interests of shareholders, creditors and depositors;
- d) compliance with the internal acts and bank regulations on behalf of all employees;
- e) the bank or its employees do not participate in illegal activities, including legalization of money from crime and terrorist financing.

Management of the risk of non-compliance in the banks has the following stages:

1. identifying the risk of non-compliance with regulatory requirements;
2. assessing the risk of non-compliance with regulatory requirements;
3. monitoring the risk of non-compliance with regulatory requirements;
4. controlling and minimizing the risk of non-compliance with regulatory requirements.

The aims and objectives of the management of risk of non-compliance can be achieved while respecting the mentioned basic requirements, by using the following instruments:

- a) Establishing a "risk profile" of the bank;
- b) Using a card system for results assessment;
- c) System of decision-making powers in the Bank;
- d) Monitoring operational risk indicators;
- e) Information System;
- f) Control System.

To allow the identification and assessment of the risk of non-compliance, banks shall build the necessary set of specific indicators. The main purpose of this system of indicators is to ensure the adoption of the right management decisions regarding the activities of the bank in order to reduce the impact of risk on the bank in general. Banks can use the following indicators:

- a) increase (decrease) in the number of complaints and claims to the bank;

- b) increase (decrease) of the cases that involve violations of the law, including advertising legislation, banking secrecy and limitation of monopolistic activity;
- c) increase (decrease) in the number and size of cash payments by the Bank as a result of court orders,
- d) decisions of State authorities and management, as well as the ratio of the number and amount of the legal actions for which payments are made by the bank or to the bank;
- e) imposing sanctions and enforcing measures against the Bank by regulatory and supervisory authorities, and dynamics of these interventions.

The system for management and control of the risk of non-compliance is similar to the control of other bank risks. Providing the necessary capacity of the system and financing its activities in some aspects can be very expensive: for example bank staff training. However, losses in the case of neglect of that risk can have sometimes simply disastrous outcomes.

That is why the management of each bank should periodically initiates internal assessments of the systems used to control the risk of non-compliance with regulatory requirements (with their own practices or to work with external experts on different issues), by using the statutory requirements of the regulatory authorities. The Basel Committee on Banking Supervision also recommends regular checks of departments (services) to control the risk of non-compliance with the regulatory requirements. The audits cover the study of the following issues:

- 1. Experience of staff from various departments;
- 2. Organization and degree of completion of the services themselves to control the risk of non-compliance with the regulatory requirements;
- 3. Transactions volume;

- 4. Products complexity;
- 5. Quantity and type of customer complaints;
- 6. Number and type of subsidiaries;
- 7. Size of the bank;
- 8. Organizational structure of the bank;
- 9. Level of detail of control procedures.

2. Status and role of the persons in charge of the control of the risk of non-compliance with regulatory requirements

The description of the job requirements and competences of the employees who are responsible for the control of the risk of non-compliance with regulatory requirements, make it possible to obtain greater perception of the particularities of that risk. New technological development creates new risks for financial institutions, but they also contribute to create new instruments for risk control. Methods of bank fraud alerts and errors also change. Authorized persons in the bank shall study all law requirements, regulations, bank procedures and policies in order to reduce the risk and to prevent the occurrence of property and bank reputation damage.

The Head of Non-Compliance Risk Management and Control Department shall be directly responsible to the Board of Directors of the Bank regarding the analysis of the regulatory requirements in terms of functional areas of the activity, analysis of the Banking Regulatory Authorities reports, the answers to these reports, general issues of non-compliance and risk management. For example, in the current practice of US banks such employees shall be responsible for:

- 1. Maintaining the necessary knowledge about the relevant regulatory requirements for bank activities and their interpretation;
- 2. Bank policies and procedures formulation are updated in line with the

responsibilities arising from the banking regulations and their interpretation;

3. Coordination and training of Bank staff regarding bank policies and procedures to control the risk of non-compliance with regulatory requirements;
4. Monitoring and control of customer complaints, which relate to the normative regulation;
5. Implementation of permanent programs for analysis of Bank systems compliance in accordance with the relevant applicable laws and regulatory acts.

An important task of the departments that manage the risk of non-compliance is associated with the coordination of relationship with banking supervision and regulation institutions, which is realized through:

1. External audits coordination and accountability;
2. Coordination of the regular meetings with local regulators and preparation for bank presentations;
3. Responsibility in terms of corrective actions, coordination and accountability of regulators regarding the outcome of their inspections;
4. Coordination between the legal departments and various business divisions of the bank regarding new projects, initiatives, advantages to provide equivalence in line with the banking regulations requirements;
5. Cooperative activities with the services for internal control and coordination of activities necessary to ensure effective internal audit;
6. Supervision of compliance with the legislative and normative acts that regulate the Bank activity;
7. Supervision of services (functions) that are responsible for quality control of bank lending.

In general, bank employees, responsible for the management and control of the

risk of non-compliance should be highly qualifies and meet high experience requirements. For example, a professional standard is introduced in the USA - „Certified Regulatory Compliance Manager" (CRCM) - Certified "Manager to monitor the compliance with the regulations". This exam is conducted and supported by the American Bankers Association. According to the Federal Deposit Insurance Corporation in the USA (FDIC), the responsible officer shall have knowledge and understanding of all regulations that in one way or another relate to the Bank's activities. He shall be familiar with the nature of the activities and operations carried out by the Bank and shall interact with all its subsidiaries and branches. He shall monitor the emergence of new regulations and innovations that may require risk management actions. The main responsibilities of the employee who is responsible for managing the risk of non-compliance with regulatory requirements relate to:

1. Elaborate policies and procedures for monitoring the risk of non-compliance with regulatory requirements;
2. Train Bank managers and staff to ensure the protection of client rights and regulation;
3. Analyse Bank policies and procedures for risk control in accordance with the laws and regulations, the established policy of the Bank;
4. The Bank shall provide the relative corrective action.

3. Non-compliance risk prevention programme in commercial banks

Non-compliance risk prevention programme and the process of ensuring compliance with regulatory requirements in banks include: policies and procedures, training, monitoring, responding to customer complaints. The Office of the Comptroller of the Currency (OCC) in the USA issued

their own guidelines (in December 2002) regarding the requirements of these programs (with corresponding British Abbreviation - SMAART). They must be specific for each individual Bank.

Bank policies (or events plan) must be presented in writing and accepted by

way that identifies, warns and as a result, minimizes the potential hazards and problems.

The risk of inconsistency in commercial banks is undoubtedly present in the Bulgarian banking practice. In principle, Bulgarian banking institutions operate in a

Table 1. Components of the Non-compliance risk prevention programme (smaat)

(S) Systems	Implementation of procedures and internal control to ensure transactions accountability in accordance with the respective regulations and client's requirements.
(M) Monitoring	Supervision process on daily basis in connection with the operation of the Bank control system to ensure real-time performance of the system in accordance with the Bank program standards.
(A) Assessment	Periodic analysis of summarized records and operations to display operation violation and program disadvantage.
(A) Accountability	Allocation of responsibilities, authority and accountability to direct the staff to implement policies in order to comply with the Bank regulations and notify the Bank management and the Board of Directors about the program results.
(R) Response	Processing customer complaints, overcoming violations of the regular requirements, control procedures modification, corrections of deficiencies in the internal supervision and implementation of policies, procedures, their revision or renewal.
(T) Training	Communication in the relationships of compliance with policy, procedures, directives, regulators requirements, information on products and services, including staff training and information.

the Bank's management. Regarding their structure and shape, they are specific for each bank and are determined by factors such as the bank's size, the number of branches and the organizational structure; bank's overall business strategy; type of products; bank's subsidiaries; geography of business.

To prepare the program it is necessary to:

1. draw up a comprehensive inventory of the normative acts with comments which are applicable to the particular bank;
2. compare the emerging issues, parameters and standards hypotheses which relate to them;
3. review the programs to control the risk of non-compliance within the overall integrated program for risk control.

Each program shall be designed in a

regulatory environment that complies with the European standards and practices. The BNB Act, the Credit Institutions Act (CIA) and the related regulatory acts form a large and diverse legal framework which defines the objectives and instruments of banking regulation as well as the rules governing the activities of credit institutions.

The Bulgarian banking system has shown its flexibility and efficiency throughout the global financial crisis and the decline in economic activity. Over the years, stable foundations were laid down, along with buffers accumulated in the form of capital and provisions which enabled the banking system to face the negative effects of the crisis and keep good financial health and stability.

The bankruptcy of Corporate Commercial Bank and the bad practices of distributing the bank's assets showed that the risk of non-compliance with regulatory requirements is one of the most dangerous and relevant risks in the Bulgarian banking practice. For a long time there has been trust in the 'self-sufficiency of national banking and financial supervision, which knew what it was doing and could handle itself without outside supervisory help'⁹. Therefore, Bulgaria's accession to the European banking union was a step in the right direction, although it meant increasing to a certain extent the administrative burden associated with the implementation of new regulatory requirements.

It should be pointed out that in 2014 the Bulgarian legislation brought in new acts – the Capital Requirements Directive and the Capital Requirements Regulation, adopted by the European Parliament and the EU Council. Regulation 575/2013 of the European Union ("Basel III") define the new capital adequacy rules and new capital buffers. This regulation is the first step towards the introduction of the so-called "Single Supervisory Handbook" (Single rulebook), which refers to the supervision of the activities of 8 300 banks in the Union.

The future adoption of European regulatory decisions will not be devoid of difficulties and no doubt will test the institutional capacity of Bulgarian regulators and the ability of credit institutions to operate in a complex regulatory environment and effectively function in compliance with legal requirements.

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