Emerging trends of the compliance function in banks: Implications from a business and risk perspective

Presented by: Juan Carlos Fernandez Zara  
November 11, 2016
Setting the stage

Lehman Brothers

UBS

Merrill Lynch

HSBC

Goldman Sachs

And many others
Trends

Some trends since 2009:

- Increase in regulatory requirements and cost of regulatory fees
- Tightening of the requirements
- Increase in scope of regulatory focus
- Increase in geographical scope of regulations
Regulatory fees

**BNP Paribas**: USD 8.9 billion for continuing doing business with countries and entities on the US sanctions list (e.g. Sudan, Cuba, Iran).

**HSBC**: USD 1.3 billion

**ING**: USD 619 million

**Credit Suisse**: USD 536 million

**Lloyds TSB Bank**: USD 350 million

**Barclays**: USD 298 million

Other fines... other reasons...
Trends

Sanctions now may reach:
- Entities,
- Individuals
- Countries,
- Specific areas and sectors in a country.

Non-exhaustive list of major acts with international scope:

- July 2010 the US enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act).
- The Foreign Account Tax Compliance Act (FATCA) – 2010
- European Market Infrastructure Regulation (EMIR) – 2012
- Markets in financial instruments directive MiFID - 2007
Perspective

Singapore 1MDB scandal
Compliance related risks

Non-compliance with new requirements have potential large consequences

- Operational loss (fines, settlements, etc.)
  - Business loss
  - Reputational loss
- Independence loss (example of Standard Chartered Bank in NY, 2012)
  - Talent loss?

Source: Capgemini Consulting, The fast-paced transformation of the Compliance function in banks
Is de-risking the solution?

In response, many banks are de-risking from:

- Sectors,
- Clients,
- Countries.

How can banks do a business that is essentially related on managing risk with a de-risking approach?

Is this sustainable in the long run?
Compliance: before and now

Banks need to change the paradigm

Check-the-box approach with limited understanding of business operations and underlying risk exposures. Limits ability to impact on compliance literacy, accountability, performance incentives and risk culture.

Compliance functions moves towards a **Risk-based** approach linked to the whole strategy

Increases compliance and control costs with limited impact on risks.
Compliance: before and now

Is this sustainable and does it create a long term strategic win?

Source: PwC, fs viewpoint, Let’s make a difference: Managing compliance and operational risk in the new environment
Performance incentives (bonuses, promotions) need to be aligned with bank risk-appetite, strategy and business approach (front to back).
Compliance: before and now

Lines of defense need to be aligned front to back

BUT

Careful of complacency
There are several common archetypes for compliance organizations.

<table>
<thead>
<tr>
<th>Organization chart</th>
<th>Key features</th>
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| A. Legal-led organization: Compliance as part of legal | • Head of compliance reports to general counsel  
• Historically most common reporting structure  
• Compliance considered as a specialized unit within legal department  
• Legal and compliance staff often cover issues/cases jointly with an unclear separation of work  
• Fosters independence from business divisions  
• Facilitates synergies sharing of legal/regulatory expertise |
| B. Risk-led organization: Compliance as part of risk | • Head of compliance reports to chief risk officer  
• Compliance considered a risk similar to operational risk—generates an integrated view across all risk types  
• Facilitates business alignment established in risk function (internal control unit and first level of control)  
• Recent trend among global banks, which previously had compliance reporting to legal  
• Compliance acts as control function, while legal advises business |
| C. Stand-alone compliance function | • Head of compliance reports to CEO or COO (or directly to board of directors)  
• Positioning of compliance similar to internal audit with clear separation from business  
• Significantly raises compliance-function profile  
• Ensures independence of compliance from other support functions (but requires coordination with risk function)  
• Usually focuses on control activities |

Compliance: new technologies

Search engines such as:
World-Check (for information on individuals)
Sanctions List Tool

Automated Systems for:
- Know-your-clients (KYC)
- Know-your-transactions (KYT)
Suggested readings (not exhaustive)


• Basel Committee on Banking Supervision, *Compliance and the compliance function in banks*, April 2005
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THANK YOU
Swiss perspective. Has regulation gone too far? How Swiss banks cope with an ever demanding regulatory framework

Presented by: Juan Carlos Fernandez Zara
November 11, 2016
Swiss market share

World Swiss market share in Asset Management is approx. 25% (CHF 3.2 trillion – approx. 4.5 times Swiss GDP)

Hong Kong and Singapore together represent 18%

Total # of banks in Switzerland (2015): 266
Hierarchy of the framework

L’Assemblée fédérale — Le Parlement suisse

Laws for banks and banking industry

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Conseil Fédéral

Regulations for implementation of laws

finma

Eidgenössische Finanzmarktaufsicht - FNMFA
Autorité fédérale de surveillance des marchés financiers - FNMFA
Autorità federale di vigilanza sui mercati finanziari - FNMFA
Swiss Financial Market Supervisory Authority - FNMFA

Specific directives for banks and banking industry

SwissBanking

Swiss Bankers Association

Self-regulation (some have mandatory application)

Self-regulation
Proportion of Compliance costs

Source: Association de Banques Suisses Commerciales et de Gestion, Le cout de la mise en conformite pour le Private Banking en Suisse (July 2012)
Trend in banking sector

Evolution du nombre de banques en Suisse

- 2015: la baisse du nombre de banques se poursuit.
- Tendance persistante à la consolidation au niveau des établissements

Source: SwissBanking, Barometre Bancaire 2016, Conference de Presse, Septembre 2016
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THANK YOU
The Compliance Function within the Regulatory Environment in Mauritius

Presented by:
Mrs Sudha Hurrymun, Assistant Director – Supervision and Mrs Rajshri Jutton-Gopy, Chief-Legal Services Division

11 November 2016
Overview of the Presentation

1. Compliance risk and the Compliance function in banks
2. The domestic regulatory framework
3. Special focus on AML/CFT
4. Personal Liabilities
1. Compliance Risk and the Compliance Function
**BIS Definition of Compliance Risk:**
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 its banking activities (together, “compliance laws, rules and standards”)
Why a Compliance function?

To manage the compliance risks more effectively!

However,

Compliance is not solely the responsibility of specialist compliance staff, it must be part of the culture of the organization.
Importance of the Compliance Function

Increasing attention of decision-makers and legislators to the issue of compliance with regulations, laws, guidelines, especially after the global financial crisis

Key component of banks’ second line of defence
Better performance of financial institutions
Avoidance of risks and enhancing success
Maintains reputation and credibility
Protection against regulatory sanctions
Protection of the interests of shareholders and depositors
2. The Domestic Regulatory Framework
The Compliance Function

**Regulatory requirements (BIS Standards & BOM requirements)**

- Compliance Function should have adequate authority, resources, independence & stature
- Responsibility of *board* to oversee management of compliance risk
- Responsibility of *senior management* for effective management of compliance risk, establish compliance policy
- Compliance function should report directly to the *board* or a *board committee* and have an easy access
- Compliance should be ingrained in the culture of the organization
Regulatory requirements (Guidance Notes on AML/CFT):

- Financial institutions to appoint a Compliance Officer at Management level with responsibility to verify, on a regular basis, compliance with AML/CFT policies, procedures and controls. *(Appointment of Compliance Officer (senior officer) requires prior approval of Bank of Mauritius)*
- Regular KYC compliance reviews and ongoing monitoring of transactions *(e.g. through sample testing and alerts/exception reports)*
- Independent evaluation of financial institution’s own policies and procedures, including legal and regulatory requirements
- Compliance should alert senior management and Board in case of non adherence to procedures
### Some weaknesses in Compliance of banks

- Compliance function not sufficiently resourced
- No separation between operational function and compliance function (*e.g.*, *Account Opening Process, customer risk categorization process, dual hatting by Head of Compliance*)
- Compliance risk audit not included in internal audit coverage
- AML/CFT Compliance monitoring for detection of suspicious transactions is not system-based
- Missing KYC documentation and information in some cases (*e.g.*, *business plans, financial statements, declaration of customer on ultimate beneficial owner, information on source of wealth and source of funds*)
The Compliance Function

Some weaknesses in Compliance of banks

- Where there are trigger systems, assessment of triggers is not carried out by Compliance & Internal Audit
- Parameters set in monitoring software may not be adequately calibrated
- Closing of alerts, a compliance monitoring exercise, is relegated to business units
- No updates and no audit trail for Sanctions Screening listings
- No policy for compliance monitoring (*Basis for customer risk categorization and frequency of KYC reviews/updates*)
- Customer risk categorization not accurate and not subject to frequent reviews (*should be a dynamic process*)
Some weaknesses in Compliance of banks

- Inadequate Suspicious Transactions Monitoring
- Problems in reporting line of Compliance Function (sometimes MLRO reporting to Compliance Officer)
- Reliance on Eligible Introducers for KYC documentation (Accountability relies on banks – Banks expected to keep KYC documentation for high risk customers)
- Lack of audit trail in the opening, progress (awaiting additional information) and/or closure of alerts
3. Special Focus on AML-CFT
Emerging Global AML/CFT risks

Post financial crisis regulatory environment and strengthened requirements related to economic sanctions, AML/CFT, and tax compliance

Decisive factors in global banks’ withdrawal from correspondent banking (de-risking strategy)
Emerging Risks – Correspondent Banking

- Large fines issued to banks in the USA for failings in anti-money laundering procedures covering correspondent banking
- New risk-based eligibility criteria for customers adopted by many banks around the globe resulting in decision for FIs to stop doing business with the remittance sector
- Rising costs of compliance in face of uncertainty about how far should the Customer Due Diligence process go (i.e. to what extent banks need to know their customers’ customers – KYCC) – KYCC is not a FATF requirement
Emerging Risks – Correspondent Banking

• International community increasingly concerned about *de-risking*, i.e. FIs terminate or restrict business customer relationships to avoid rather than manage risks in line with FATF recommendations

• World Bank 2015 Survey: 15% of large global banks withdrawing from correspondent banking relationships to reduce compliance costs and regulatory risk

• Banks in Mauritius have not lost any correspondent banking services. However, they had to engage in de-risking in order for them not to lose their correspondent banking relationship.
Emerging Risks – Correspondent Banking

Consequences of Degradation of Correspondent Banking:
• Potential to hamper global trade – correspondent accounts crucial for trade finance, especially in Africa
• Money transfer operators and small banks most affected
• AML/CFT laws can have unintentional and costly consequences, in particular for people in poor countries

Remedial Measures
• Investment in supervisory capacity crucial to ensure compliance with FATF recommendations and Basel Core Principles for Effective Banking Supervision – AML/CFT risks to be effectively mitigated in the financial sector
• FATF encouraging FIs to simplify due diligence procedures
Correspondent Banking relationships and AML/CFT regime in Mauritius:

- Guidance Notes AML/CFT regularly updated by the Bank of Mauritius
- Financial Sector AML/CFT risks supervised in the light of existing regulation
- Regular meetings between BOM and Compliance Officers of FIs to discuss Compliance matters
4. Personal Liabilities
Role of Supervisors

*Basel Committee on Banking Supervision:*

Banking supervisors must be satisfied that effective compliance policies and procedures are followed and that Management takes appropriate corrective action when compliance failures are identified.

*Compliance and Compliance functions in banks April 2005*
Duty to ensure compliance with banking laws

Section 18(8) of the Banking Act - Limitations on management and remuneration

Every director or senior officer of a financial institution shall comply with the banking laws, guidelines and instructions issued by the central bank and the financial institution’s constitution and by-laws.

Applies to former director or senior officer of a financial institution.

No relief from compliance with section 18(8) and from liability for breach thereof permissible in contract, constitution of the company or any resolution of the company.
Personal Liability

Section 97(21)(c) of the Banking Act – Offences and Penalties

Any director, chief executive officer, manager, officer, employee or agent of a financial institution who fails to take all reasonable steps to ensure compliance by the financial institution with the Banking Act shall commit an offence. [Criminal Offence]

Penalty on conviction –
(I) fine not exceeding one million rupees; and
(II) imprisonment for a term not exceeding 5 years.
Compounding of Offence

Section 97(21) is a compoundable offence

(Banking Compoundable Offences)(Amendment) Regulations 2016)

A penalty, not exceeding the maximum penalty specified for the offence, may be imposed on the defaulting Director or Senior Officer, with the consent of the DPP and agreement of the person.
Conclusion - It’s a tall order!

- The Compliance function is a dynamic function.
- It must understand the business – the challenges the bank faces today and those it could in the near future.
- It must not only seek to avoid risk, but make the whole institution aware of its risks.
- The success of the Compliance function depends on the authority it is given over its main areas of responsibility, its independence, and access to the Senior Management and Board of Directors.
Thank You!