COMPLIANCE FUNCTION

IN FINANCIAL INSTITUTIONS

WHO IS ULTIMATELY RESPONSIBLE FOR COMPLIANCE IN A FINANCIAL INSTITUTION?
AND WHAT DOES A COMPLIANCE DEPARTMENT DO?
THIS ARTICLE SHEDS LIGHT ON THESE QUESTIONS.

COMPLIANCE IN FINANCIAL INSTITUTIONS is increasingly sophisticated. With growing regulatory demands, major financial institutions such as banks are devoting substantial resources into compliance functions.

Surprisingly, there is a lack of intellectual resources on compliance in Asia. This article aims to bridge that gap. We hope to contribute a resource, increase awareness in compliance issues, stimulate interaction amongst financial and compliance professionals, and ultimately enhance compliance standards in the financial industry.

Who is Responsible?

Compliance officers seem to be the obvious candidates to take responsibility if things go wrong. But does the buck really stop there?
The prime responsibility to ensure that the business complies with regulations rests with the board of directors, or with the owners or the most senior executive management group where there is no board. The board, owners or senior management will usually delegate compliance activities, but...
their personal responsibilities cannot be delegated away.

Given that the laws and regulations permeate most activities of a financial business at every level, management has two choices. The first is to appoint compliance officers to perform quality control of each designated function at the operational level ("System A"). The second is to make every individual in the business responsible for compliance with all regulations relevant to their jobs ("System B"). It is the author’s view that System B yields greater benefits to the firm in the long term.

In System B, employees are trained and relied upon to do their jobs in a compliant way, just like other job requirements. Once trained in their regulatory obligations, the employees take complete responsibility to follow compliance procedures. In practice, each employee’s performance appraisal (which affects their remuneration, increment, promotion, benefits etc) will be positively co-related to his compliance performance. He thus has a vested interest to comply. Over time, this promotes a compliance culture in the firm.

On the other hand, firms adopting System A needs to keep adding compliance headcount in order to control as many processes as possible. Apart from escalating costs, it is hard for such firms to inculcate a compliance culture.

The Role of the Compliance Department

Broadly speaking, the roles of the Compliance Department are as follows:

(1) FACILITATE THE DEVELOPMENT AND MAINTENANCE OF THE RIGHT CULTURE
A healthy, positive compliance culture within the firm minimizes the risk of regulatory failure and the resultant sanctions and damage to its reputation.

(2) DELIVER COMPLIANCE TRAINING
Training is essential to ensure that the employee is able to perform his job in a compliant way. Compliance training is more effective if it is integrated into the training that the employee receives on his core job functions (e.g. operations, IT, finance etc). On this basis, Compliance’s role is to train the trainer and ensure that the compliance element of the training is properly incorporated, updated and adequate.

(3) ADVISE ON REGULATORY ISSUES
Advising on relevant regulatory issues concerning the firm’s business is a fundamental responsibility of Compliance. For instance, compliance advice may be required when a new business line or product is launched, when a procedure is changed, or when new regulations are promulgated which may impact the business.

(4) MONITORING
The compliance department is commonly associated with this task. Good monitoring by compliance provides a source of timely and focused feedback to other departments on how well they are fulfilling their regulatory obligations. But, excessive monitoring can overkill and cause an unnecessary burden to the business. It may also create a moral hazard for other staff to relax their diligence knowing that the compliance function "will pick up any errors".

(5) COMMUNICATING
Compliance is an important interface between regulators and regulations on one hand, and business on the other. In this connection, Compliance will communicate any new rules or guidance issued by regulators to the relevant departments. It must also provide the regulators with any information they request and notify both senior management and the regulators of any significant issues that arise.

(6) HANDLING ISSUES
Regulators expect all regulatory issues to be resolved promptly and thoroughly. Compliance can advise the investigating manager (usually a supervisor within the department from which the issue emerged) on the substantive issues and the process to resolve the issues.

(7) BALANCING COMPLIANCE COSTS AGAINST REGULATORY BENEFITS
As a cost centre, Compliance needs to justify the costs of compliance against regulatory obligations, devise ways of keeping implementation costs low, and maximizing the benefits of the compliance function.

The role of Compliance is summarized in Figure 1.

Risk-Based Compliance Approach

(1) RATIONALE
It is recommended that Compliance adopts a risk-based approach which recognizes that different areas of the business and different regulatory issues carry different levels of regulatory risk. There are two main benefits. First, the firm’s resources can be prioritized and allocated to most-needed areas, fostering greater productivity. Second, the compliance function and management can talk a common language based on an agreed notion of risk. This promotes mutual understanding and greater objectivity.

(2) HOW TO MEASURE REGULATORY RISK?
Risk can be measured against two dimensions: the
probability of a particular problem occurring and the magnitude or potential impact if it occurs. Be objective when assessing risk. A practical way is to analyze other real examples, where available, of that risk being realized.

Objective criteria for assessing the probability of a process failure could include the number of such failures experienced during the course of a particular time period such as six months or one year. All risks should be assessed over the same period for comparability. Sources of information on the failures include the breach and complaint logs, regulatory visits reports, internal and external audit reports.

One way of expressing the magnitude of regulatory risks to the firm is the potential financial risk of compensation in the event of breach. For instance, a breach of investment powers may result in compensation of the cost of selling the offending security and reinstating the fund to pre-purchase position. A breach of client money bank account regulations could result in the loss of all client money held outside a correctly designated client account.

(3) IMPACT OF THE RISK-BASED COMPLIANCE APPROACH
Implementing the risk-based approach will change the way Compliance and other departments do their jobs. Management and employees will gradually be ingrained to understand and talk in a common language of risk. Risk would be an agenda item in regular team meetings held among employees anywhere, at any level, of the firm. As the different risks are identified, ways can be explored of managing them.

Some firms have also organized dedicated risk workshops to discuss all manner of risks faced by the business, including reputational and financial risk, in addition to regulatory risk. This is possible where the firm has a cross-functional team of experts looking at risks on a business-wide basis.

Organization of the Compliance Team
Regulators emphasize that the compliance function must have direct reporting lines to senior management. Adequate resources must be available for Compliance to do its job effectively. Compliance staff must be sufficiently independent of the operations which they are monitoring to be able to perform their duties objectively.

Delivering Good Service to Business
(1) Delivering good service does not necessarily mean saying “yes” to everything that the business wants to do. Compliance team members need to think thoroughly about the firm’s issues and the risks involved in order to derive pragmatic and compliant solutions.

(2) THE COMPLIANCE SWOT
As a starting point, Compliance needs to conduct a SWOT (Strengths, Weaknesses, Opportunities, Threats) analysis based around discussions with the departments to which Compliance provides services. In particular:
- What feedback or concerns do they have about Compliance?
- In which areas do they feel that Compliance is currently strong or weak?
- What improvements would they like to see in the services provided by Compliance?
- What do Compliance or other departments see as obstacles to Compliance providing a better service?

Examples of issues which may be drawn out through such discussions include:
- “The regulatory goalposts keep changing.”
- “Rules are not implemented in a way that is at all sympathetic to our overall objectives.”
- “Compliance is poor at communicating the message originating from the regulators.”
- “Compliance concentrates on imposing controls, rather than collaborating with us in the search for solutions that fulfill both our purposes and those of the regulators.”
- “Compliance takes up too much time if done properly.”
- “Compliance comes up with ambiguous interpretations of the rules, and is inconsistent in its application of the rules.”
- “We never know precisely how well we are complying with the rules, or whether our section is better than the others.”
- “I never go near Compliance if I can help it.”
- “Compliance always becomes part of the problem, never part of the solution.”

If discussions with the different department managers reveal any of the above sentiments towards the compliance function, Compliance can take positive steps to change this perception and improve.

(3) COMPLIANCE PLANNING
The compliance planning process is crucial. Planning gives an opportunity for the compliance team to review what has taken place over previous planning periods and learn from its mistakes and successes. The compliance team can also develop a shared understanding and learning of how the approach taken by the regulators is changing.

During the planning process, consider:
- The plans of the business, the risks and the demands for Compliance’s time and expertise;
- How best to meet the training, advice and monitoring needs of the business;
Ways to address any concerns expressed about the service delivered by Compliance, and to reinforce any positive aspects of the service;

- Whether the compliance team is adequately resourced in terms of skills and manpower. (What gaps can be filled through staff development?);
- What activities can be pursued without striking an imbalance between the costs of delivery and the regulatory benefits in terms of risk reduction;
- How can the performance of the compliance function be measured and tracked, both in terms of service levels and in terms of the degree to which it has focused on areas representing the greatest regulatory risk?

### Summary: The Challenge for Compliance

1. To work closely with the business to understand and anticipate the needs of the business for compliant solutions that can take the business further.

2. To maintain sufficient independence and objectivity in performing its role of reducing regulatory risks to the firm. In this regard, it is recognized that where necessary, the immediate desires of the business will be overridden in the interest of compliance.

    Although getting close to the business is integral to the delivery of good service, it can also become an obstacle to the achievement of objectivity which the compliance professional needs when dealing with significant issues. Managing this paradox is perhaps the greatest challenge facing the compliance professional today.

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