The fast-paced transformation of the Compliance function in banks

How to change the relationship with the Business to meet tighter regulatory standards
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Regulatory requirements have increased tremendously in the banking industry, leading to the enhancement of the Compliance function and its progressive structuring. Sanctions imposed to a number of players, be it from the US or European regulators, have been widely published in the media: banks have paid almost $ 60 billion in fines, penalties and settlements in 2014. Banks in Europe in particular have actively launched remediation processes and raised the topics to their Executive Committee and their Board of Directors.

We are now entering a second phase of maturity for European banks, with a need to further industrialize their Compliance function and to develop new competencies, in order bring up to standard in a context of pressure on costs.
Tighter regulatory environments imply significant compliance challenges for banks.
Complying with complex requirements from different regulators

Compliance challenges are twofold: banks have to meet tighter requirements and to keep up with standards coming from a wider scope of regulators.

The complexity of requirements reaches a record high. Sanctions may target individuals, entities, countries, but also specific areas in a country and specific sectors (sectorial embargo is a new sanctions regime introduced by the US in July 2014).

As regards these sanctions, regulators can be very specific and target particular entities which prove difficult to pinpoint in banking operations, such as the American embargo on the Crimean peninsula. But regulations can also be very comprehensive. US jurisdiction applies worldwide, based on the 3 pillars: US dollar, US goods and US persons. This implies banks to keep updated and detailed records of operations that can be related, directly or indirectly, to US extraterritoriality.

Adding up to the many requirements to meet, one country may have several regulators. In France alone, a French bank has to comply with several French regulators (ACPR, AMF, CRBF, ...), with European regulators (European commission, ESMA) and with international rules (Basel committee).

For banks managing businesses across multiple jurisdictions, the number of regulations to address becomes significant:

- The regulation of the home country is a first reference;
- OFAC sanctions are unavoidable because of their extraterritorial scope;
- Then regulations from other countries apply locally in the country of business.

Facing higher sanctions

Risk of non-compliance with these tighter requirements comes with a high cost. For a few years now, regulators enforce legislation rigorously and do not hesitate to impose dissuasive sanctions.

Compliance authorities join forces to put banks under watch. The AEOI (Automatic Exchange Of Information) standard in OECD strengthens transparency. US authorities have recently focused on European banks compliance and EU authorities are following this trend and tightening their controls over their banking systems.

Sanctions from authorities can trigger tremendous losses for a bank. We can identify four consequences:

- Direct operational loss: fine amounts are skyrocketing and now amount to billions of USD
- Business loss: exclusion from some business can be a sanction (e.g. Mandatory exclusion of one bank from the dollar clearing for a year, on much of its oil and gas business, was a heavy blow)
- Indirect loss: image risk is to be considered. Newspapers and civil associations relay information and can tarnish the reputation of the bank
- Independence loss: enhanced scrutiny from regulators to implement remediation actions puts additional pressure on the bank. In 2012, the Standard Chartered Bank paid US regulators $667 million to settle charges following an anti-money laundering scandal. An independant consultant was appointed from the New York Department of Financial Services after the settlement, to overview the new compliance program of the bank. As the independant consultant discovered commitments were not met, the bank was fined an additional $300 million in August 2014.

Facing this level of sanctions, banks now consider de-risking, as the opportunity cost of exiting risky businesses may be lower than the non-compliance costs related to them, or focusing on their major clients (for instance, on Commodity Finance in a European bank, the business decided to pull out of all clients with revenues lower than 100 000 EUR as their cost of doing business had doubled when including compliance controls). For instance, certain Private Banks have decided to stop relationships with their US customers when FATCA was put in place as the adapting costs to the new legislation were exceeding the actual or expected revenues on the few clients it concerned.

The Compliance function is expected to feed the Board with reliable data and insights to support their decisions on risk appetite; the challenge for the Compliance function is to define the appropriate level of granularity for this risk assessment exercise

- Head of Compliance of a European Corporate and Investment bank.

Focusing on Financial Sanctions

The Compliance function as a whole is being disrupted by the complexity of new regulations, and so are the different stakeholders involved in the bank. Since the Compliance function is connected to other departments, challenges ripple through other transversal functions:

- Legal helps to determine the risk level associated with alerts and circumvention attempts
- Internal control: Operational Risk and Permanent Control may or may not be integrated into the Compliance function. In both cases, collaboration is key to align on procedures and tools
- Risk management shares some challenges with the Compliance department
- Internal Audit and General Inspection are likely to perform more missions on sanctions related issues, which will be analyzed by compliance teams
- However one particular Compliance domain is one at the root of most disruptions. As the level of financial sanctions described above has led Boards to review their priorities, Financial Sanctions is in banks’ sights and at the heart of the Compliance function revamping. This poses great challenges to the function:

We have doubled our team within one year, with people from all horizons, and feel we are in a startup mode, trying to develop a common culture

- Compliance head in a major European bank.
Reinventing Financial Sanctions mission and roles within Compliance
On Financial Sanctions, three major challenges can be highlighted, which Compliance has to respond to:

1. Providing the Executive Committee, the Board of Directors and Regulators with a comprehensive view of risks and mitigants
2. Facilitating decision-making to act as a real business partner
3. Increasing agility in responding to the Regulators’ requirements

Providing the Executive Committee, Board and Regulator with comprehensive views of risk, of quality of controls and associated costs: Mission Impossible?

Compliance Financial Sanctions is in charge of providing a global map of risks and mitigator factors, but also of evaluating the associated costs to close the gaps. The required information includes developing a granular as well as synthetic cartography with nature and localization of risks, ranking the risks, identifying mitigating controls and required actions.

This work is close to the Risk mapping performed by Operational Risks, but requires a specific know-how to define the methodology. In addition, tools need to be designed to apply and maintain the risk assessment, with the expected need to rely on Big Data in order to scan less structured information (Audit reports for instance).

“We need to use Big Data, but we do not know how to start”

- The head of Financial Security of a major continental European bank.

In parallel, this global map must be shared at various levels (business, Executive Committee, Board of Directors, Regulators) and adapted to the type of decision required. This implies providing a personalized visualization for a comprehensive understanding. It is clear that the regulator needs differ from those of the management. If part of the objectives is common, monitoring business requires a more prospective way than retrospective view of risks that should be provided by the Compliance department.

Moreover, the evaluation of costs related to Compliance need to be Incorporated into the Cost of Doing Business: It needs to cover the cost of enhanced risk assessment and control measures and the costs of Non-Compliance.

Facilitate decision-making internally:

Compliance Financial Sanctions is expected to facilitate decision-making at all levels of the bank organization, both for the compliance officers and for the business, and both at a strategic and tactical level.

The strategic facilitation requires implementing a global set-up to identify weak signals and draw lessons from the detected potential non compliance situations.

The tactical facilitation includes various dimensions such as: Faster information escalation when needed, tools to facilitate the decision-making (analysis of weak signals and estimate of potential impact for the bank).

Developing these facilitation competencies will entail the implementation of new governance, alongside processes and tools. It will help to better structure the cooperation between Compliance and Front / Middle / Back functions on the business side, to accelerate the work flow to address cases to the appropriate level of expertise and decision, to capture and historicize information alongside the investigation process and make it available to stakeholders, to enhance a fast learning process and control enhancement process leveraging on encountered cases.

Increase agility to respond to Regulators’ requirements

Last, Compliance Financial Sanctions department is on the forefront to respond to Regulators’ requests, and to act as catalysts vis-à-vis businesses and functions. This requires developing specific skills, which range from content-driven skills (conducting internal audits, training staff) to execution-driven skills (driving or checking the progress of compliance-specific projects, parallelizing projects etc.) and to business-management skills (budget and resources calibration for projects and for run activities).

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Fig 1: ambition and reference model at Board level

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Tackling short-term remediation actions and a full-fledged transformation in parallel
To respond to these challenges, we see two priorities for Compliance Financial Sanctions: launch a full-fledged transformation and develop the appropriate governance vis-à-vis business, organization, operating model, industrialization, tooling and culture, while driving in parallel short-term remediation actions.

These competencies are usually rare within the function, given its recent history and the capabilities required from it so far. So, how can Compliance Financial Sanctions make such a change in a constrained time frame and budget?

**Governance**: becoming a business enabler while maintaining segregation of duties

We see four priorities in this field: adapt the chain of command, crystallize the segregation of duties, implement a robust and swift arbitration process while developing a proactive stance towards businesses.

- **Change the chain of command**, adopting hierarchical or “strong functional” reporting (for subsidiaries) with Group Compliance to maintain distance from the business and allow the escalation of cases up to the Board level when needed.
- **Crystallize segregation of duties** between Risk management, Internal control, Compliance departments on topics such as control & risk assessment. Various segregations can take place, leading to different governances and organizations. For instance, some banks delegated the compliance risk assessment to Operational Risks while others created a dedicated team within Compliance Financial Sanctions.
- **Implement a robust and swift arbitration process** in the Compliance function, to prioritize resource allocation in order to address in parallel the immediate remediation actions and lead the Compliance function transformation.
- **Develop a business partnership approach with the businesses**, providing proactively information, insight and advice. For instance, in reviewing and reorganizing the operations filtering process, Compliance Departments should closely associate the business. Compliance is also the key partner in educating the businesses on regulatory evolutions and in providing rapid access to expertise on encountered deviant cases.

**Organizational structure and Operating model inside the Compliance function**: towards more horizontal and collaborative models

Organizing or reorganizing is an important step to deliver new missions, with however the risk to build up costs. In particular, the new organization principles, which require more proximity to Regulators requirements, to local Compliance and to business needs could lead to complexity and costs. In that context, a number of organizational solutions can be used:

- Organize into centers of competence or sub sections of Financial Sanctions departments around major regulators (i.e. US, UE, bank country of origin)
- Create horizontal communities in the Compliance function, across businesses and geographies, to embark and take advantage of the expertise of local Compliance officers, and extend those communities to other related Group functions such as Legal or Risks

**Fig 2: Organization challenges**

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<td>Compliance expertise related to a business domain</td>
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1. **Change chain of command with Business Compliances** Set up horizontal communities, closer to Local
2. **Develop a partnership approach with business**
3. **Segregate duties**
4. **Set up competency centers around major regulators & major businesses**
5. **Align procedures, IT tools, risk mappings and indicators among Compliance domains**
6. **Review Compliance Talent management**
7. **Develop smart tools**
– Enhance the Project management competencies, to have a strong capacity to lead operational transformations in the Compliance activities and teams, submitted to committing deadlines fixed by the regulators and requiring to cooperate with the business, IT and operational teams.

– Set up hubs of Compliance experts, equipped with “phygital” tools (physical+digital) allowing to share information and escalate in close relation with the businesses. For instance, regional hubs may provide Compliance competencies in a certain geographical area, being capable of analyzing business requests, answering quickly and precisely, on the same time schedule, and if needed to escalate.

**Industrialize the Compliance function to gain consistency:**

Industrialization is a prerequisite at two levels: Program management and Processes. The former requires the hiring/training of Program management experts and the implementation of the required tools.

The latter cover the following priorities:

– **Standardization of procedures and IT tools group wide**, in order to allow uniform implementation across businesses and geographies and monitoring of all entities (based on comparable data)

– **Normalization of risk mappings and indicators** to deliver a consistent view at Group level allowing to spot higher risk areas and prioritize remediation plans accordingly

– **Shared understanding of the drivers of costs and of resources allocation versus Compliance costs.** This understanding should facilitate cost controls.

– **Use offshoring/outsourcing to control costs.** A number of banks have tested and deployed remote centers, starting with the more repetitive back office or IT tasks, within KYC for instance, and support in seasonal peaks. External providers such as BPO servicers or SWIFT have started providing third party services for banks. Natural centers are emerging such as India, Singapore, Canada, Portugal, and Eastern Europe around Poland.

**Change the culture, from policy enforcer and operational validator to operational business supervisor**

Becoming an Operational Business supervisor requires to adapt the culture, in a context of a significant hiring of resources. Such cultural changes must embed a deep review of the Compliance Talent management strategy. This requires working on the following levers:

– **Determine the target career paths** offered to the Compliance officers (sourcing, development, training) within Compliance as well as within the Bank. Some banks envision including a position in Compliance in the career path of their Talents for instance.

– **Enhance the training offer** to maintain and develop the necessary skills, with two focuses :
  - Certification with content trainings
  - Project management and soft skills for better interaction within the Bank

– **Enhance the communication** on the risk exposure, the control framework key features and the key role of Compliance to raise awareness at all levels of the bank organization.

**Develop the appropriate tool-kit**

Many of the Regulatory requirements entail the use of more robust and state-of-the-art tools:

– **Screening tools:** Centralized, standardized and common tools in order to share best practices and common watch lists

– **Compliance function tools:** Such as Actimize, SAS, Fircosoft, Metricstream, SWIFT,... but also community management tools through Enterprise Social Networks (Jive, Tibbr, Yammer…)

– **Smart analytics tools,** going as far as the creation of Big data centers of expertise within Compliance Financial Sanctions – a number of banks have already created such centers, hiring over 50 data scientists

– **Risk mapping tools** providing group wide visualization of risk cartographies

– **Training tools**: with the creation of MOOCs, e-learnings, webinars to target the training per categories of staff in relation with their risk exposure

**Drawing a parallel with the Finance function: similar challenges but high stakes regarding the pace of transformation**

A parallel can be drawn with the transformation of the Finance function a decade ago, in order to increase control quality and efficiency while developing a partnership model with businesses. The Finance heads focused on three major priorities: reorganize to create specialized domains leveraging synergies among competencies beyond the business and geographical hierarchical organization in place, switch from policy enforcer to business partner and develop strong ties with the Risk organization.

The parallel is not full however, as the Compliance function is experiencing higher time constraints to transform and will have to resort to more drastic approaches to reach its goals in a cost effective manner such as mutualization of resources, creation of shared centers of expertise or developing Big data centers.
Will Big data transform Compliance? What value does it bring? And what is its relationship with the existing screening tools that exist on the market?

**Building a complementary approach to traditional analytics for a second line of defense**

Big data provides the ability to manage high-volume and complex, multi-dimensional data (transaction, account and customer levers for instance), Class Imbalance (very few occurrences), Concept-drift (dynamic patterns continuously evolving), Class overlap (illegal transactions looking as normal as possible) and Class mislabeling (in a number of cases, reported cases such as in AML are not tagged in the systems).

**Providing 3 core values:**

- Further Insight, based on information not screened so far, or on information already screened through tools such as SAS, Actimize, Fircosoft … but also emerging players such as SWIFT

- Improved cost/speed ratio, with the ability to automate repetitive tasks (e.g. checking information on PEPs)

- Visualization, with much more powerful presentation tools.

**Applying Big data to AML and KYC**

- AML: many banks are upgrading their tools, with built-in pre-identified risk patterns; Big Data can go further, building on those upgrades.

- Similarly, Correspondent banking becomes an area where Big Data can enrich analyses, in particular thanks to its powerful presentation tools.
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