

## Arnold Schilder: Banks and the compliance challenge

Speech by Professor Arnold Schilder, Chairman of the BCBS Accounting Task Force and Executive Director of the Governing Board of the Netherlands Bank, at the Asian Banker Summit, Bangkok, 16 March 2006.

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Compliance risk is becoming one of the major risks banks are facing. The increasing globalization, issues with the corporate governance of complex institutions, changing laws and regulations, the understanding of what constitutes sound risk management, and the continuous evolution of financial products create complex situations for banks that operate on a cross border basis. One may wonder whether the compliance framework in place is robust enough to effectively manage these rapidly changing factors. Creating a “best in class” compliance framework seems to be the best way forward. The development and implementation of such framework might well be a challenge equal to the implementation of Basel II.

### Introduction

The subject of my speech is the challenges that banks face today with respect to compliance. You may wonder - why?

The main reason for delivering a speech about this topic is that we have all recently seen banks involved in compliance related problems. Riggs Bank acts as a well known example of such problems. In July 2004, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs published a report on Riggs Bank. The evidence reviewed by the Subcommittee staff establishes that, since at least 1997, Riggs Bank had disregarded its anti-money laundering obligations, maintained a dysfunctional anti-money laundering programs and allowed or, at times, actively facilitated suspicious financial activity<sup>1</sup>. In a more recent case De Nederlandsche Bank, together with the relevant regulators in the United States, issued a Cease and Desist order with respect to ABN AMRO Bank. The reason for ordering this Order had to do with compliance issues. The problems ABN AMRO was faced with, albeit less far-reaching than those at Riggs Bank, act as another example of compliance related deficiencies.

Another reason for this speech can be found in the publication of the paper ‘Compliance and the compliance function in banks’ published by the Basel Committee on Banking Supervision (BCBS) in April 2005. In the related Press Release of 29 April 2005, BCBS Chairman Caruana said: “Compliance has emerged as a distinct branch of risk management within the banking system<sup>2</sup>.” So it is fully appropriate and timely to address this important topic in this Conference’s broader context of sound risk management in banks. Compliance risk is quickly becoming one of the major risks banks are facing. So the efforts banks should undertake concerning compliance, may become comparable in size and importance to the endeavours of banks in relation to the implementation of the new Basel II Capital Accord.

However, unlike the various risks discussed by the new Capital Accord, holding additional capital to ‘cover’ compliance risks will not act as a mitigating factor. Other efforts are needed.

During the first part of this speech I will briefly discuss what should be understood under compliance. Then I will go more in depth on the nature of the compliance related problems that not only banks, but the entire financial world is encountering. Subsequently, a closer look at what compliance really implies and what the international standard-setting bodies perceive as compliance. I will then discuss some issues involved in the ABN AMRO case and lessons learned. I will conclude with some broader perspectives on how to approach the challenges ahead.

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<sup>1</sup> Case study involving Riggs Bank, United States Senate, Permanent Subcommittee on Investigations, Committee on Governmental Affairs, released on 15 July 2004, page 2.

<sup>2</sup> Press release of 29 April 2005, [www.bis.org/press/p050429.htm](http://www.bis.org/press/p050429.htm)

## Scope and definition of compliance

The notion of 'compliance' literally means 'obedience' or 'dutifulness'. It has a broad scope. As such it is known to have various interpretations. To avoid any misunderstandings during my speech, I will provide you with the definition used by the Basel Committee.

In its Compliance function paper, the Committee has defined compliance risk as being "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 its banking activities"<sup>3</sup>. Hence, compliance generally covers matters such as observing proper standards of market conduct, managing conflicts of interest and treating customers fairly. Also, compliance typically includes specific areas such as the prevention of money laundering and terrorist financing, and may extend to tax laws that are relevant to the structuring of banking products or customer advice<sup>4</sup>. In my opinion, the compliance function should protect the institution against unlawful behaviour and strengthen its ethical consciousness.

## Drivers of compliance related problems

As supervisors we provide frameworks and guidance for the financial sector to facilitate the functioning of the financial world - although I am aware that our efforts may not always be perceived as such by the industry. In the end, however, the industry and supervisors serve the same goal, which is to create a stable and prosperous financial industry worldwide. It is essential that clients are confident in the solidity of financial institutions and that they are assured that their salaries paid into their bank accounts are safe. So, the industry as well as standard-setting bodies should always reflect on irregularities and consider whether the current risk control framework in place is still adequate and warrants stability. By adequate I mean that the framework should be effective for the industry as well as for the supervisory community. It is therefore essential to consider the possible underlying drivers of recent compliance related irregularities.

If we look at the financial world of today, one of the greatest challenges is the rapid globalization of the world economy. New economies such as China and India are emerging, and are rapidly attracting investors and financial institutions. This globalization does not only take place in a traditional way, i.e. through businesses' presence in the countries concerned.

What I personally find fascinating is the current trend with regard to outsourcing, offshoring and 'smart sourcing'. Not too long ago, I myself observed how service providers in India even play along with the different time zones their customers are located in by tailoring work shifts of their employees to these time zones.

A first complication that globally operating financial institutions are facing as a consequence of the globalization, relates to corporate governance, and especially head office oversight. Of course, a board of directors should approve and oversee the bank's strategic objectives, and set a desired compliance culture. Also, the board should ensure the institution has adequate policies and procedures to ensure head office oversight of the activities carried out by the various business lines. However, given the increasing complexity of 'cross border' institutions, this sounds easier than it is. The board should ensure that adequate controls are in place to oversee the decisions made by its senior management, and to ensure that the entire organisation acts in line with the set objectives, and the desired compliance culture. This raises all kinds of organisational and managerial questions, varying from the amount of autonomy that the business lines should have, to issues with regard to control frameworks and reporting lines. There is no easy answer.

Secondly, financial institutions have to make sure that they comply with applicable laws and regulations in the jurisdictions where they operate. As a result of the increasing globalization, financial institutions nowadays have to make sure that they are compliant with laws that have extraterritorial effects. These different legal requirements pose a challenge for institutions operating cross border.

Another challenge is that our understanding of what constitutes sound operational management is continuously changing. What we all understood to be sound operational management five years ago

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<sup>3</sup> Compliance and the compliance function in banks, Basel Committee on Banking Supervision, April 2005, paragraph 3.

<sup>4</sup> Compliance and the compliance function in banks, Basel Committee on Banking Supervision, April 2005, paragraph 4.

no longer applies. The recent best practices papers produced by the Basel Committee sustain the view that the understanding of adequate operational management is rapidly changing<sup>5</sup>. The number of standards and regulations that banks have to adhere to, is tremendous and not by definition in accordance with how banks in practice have been conducting their businesses.

The development of new products and the increasing complexity of the products being offered by financial institutions, are making life even more difficult. The specific risks of these complex products and their global distribution, should be analyzed by banks and be included in their global risk management framework. Given the ongoing evolution of the financial markets in Asia, it is essential for your institutions, like ours, to analyze the compliance risks that relate to the financial products sold by them, especially since these products will continue to evolve.

The increasing globalization, issues with the corporate governance of complex institutions, the continuously changing understanding of what constitutes sound operational management, changing laws and regulations, as well as the ongoing evolution of products - combined with a determination with governments and regulators to fight money laundering, terrorist financing and other illegal financial transactions - all create complex situations for banks that operate cross border. The unavoidable conclusion is that banks need to address these compliance challenges in their risk management programs on a global basis, and that the most stringent requirement quickly becomes the benchmark.

When reflecting on these challenges, one may wonder whether the compliance framework in place is robust enough to effectively manage the challenges and risks that financial institutions face. What, then, are the latest developments concerning such compliance framework?

### **Closer look at compliance**

During the last couple of years, various international standard-setting bodies have published papers on compliance related issues. For instance, as a response to the increasingly sophisticated money-laundering techniques the Financial Action Task Force has revised its recommendations in 2003. Also, the Basel Committee on Banking Supervision published a paper on customer due diligence in 2001 and the Consolidated Know Your Customer paper in 2004<sup>6</sup>. The cause for these papers was that supervisors around the world were increasingly recognizing the importance for banks to have adequate controls and procedures in place so that they know the customers who they are dealing with. Also, the Basel Committee published a paper on the compliance organization and the compliance function in 2005. This paper provides guidance on embedding a compliance organization within credit institutions.

The compliance definition used by the Basel Committee considers the sanctions, or loss to reputation, that an institution may suffer as a result of failure to comply with laws, regulations and standards. As the laws, regulations and standards are continuously changing, compliance becomes a moving target. The question that arises from this observation is that one should continuously ask oneself: "how can I be sure that my organization is compliant"? The changes occur at such a high-speed that one may well be "compliant" today but no longer so tomorrow. Today's challenges are tomorrow's history.

The Compliance function paper emphasizes that compliance starts at the top. Compliance will be most effective - if not, will only be effective - in a corporate culture that emphasizes standards of honesty and integrity. The board of directors and senior management should lead by example. The tone at the top is vital for a culture of awareness. The board of directors is responsible for overseeing the management of the bank's compliance risk. To this end, the board or a committee of the board should at least once a year assess the extent to which the bank is managing its compliance risk effectively<sup>7</sup>. Having said this, compliance requires continuous attention of the board of directors and senior management; its responsibilities are not limited to the yearly assessment. Compliance implies a great

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<sup>5</sup> E.g. papers published by the Basel Committee on the internal audit function, compliance function, operational risk and (very recently) corporate governance.

<sup>6</sup> Customer due diligence for banks, Basel Committee on Banking Supervision, October 2001, Consolidated KYC Risk Management, Basel Committee on Banking Supervision, October 2004.

<sup>7</sup> Compliance and the compliance function in banks, Basel Committee on Banking Supervision, April 2005, paragraph 14 et seq.

involvement of the board of directors, especially since it is widely accepted that the board is ultimately responsible for the operations and soundness of a bank<sup>8</sup>.

Without disclaiming the ultimate responsibilities of the board of directors, the responsibility for the effective management of the bank's compliance risk resides with the bank's senior management. One of the most important responsibilities of senior management with regard to compliance is to make sure that the main compliance risk issues an institution is facing, are identified and assessed on an annual basis. Subsequently, senior management - with the assistance of the compliance function - has to ensure that plans are prepared to manage these risks. Such plans should address any shortfalls (policy, procedures, implementation or execution) related to how effectively existing compliance risks have been managed, as well as the need for any additional policies or procedures do deal with new compliance risks identified as a result of the annual compliance risk assessment<sup>9</sup>. This risk assessment, together with the subsequent introduction of improvements to the control framework, form an essential step in the ongoing process to ensure adequate control of the risks banks are faced with.

Aside from the responsibilities of the board of directors and senior management, the paper also mentions principles concerning the status and responsibilities of the compliance function. It is essential that the compliance function has a formal status within a bank. This in order to give the compliance function the appropriate standing, authority, and independence<sup>10</sup>. The responsibilities of the compliance function should be to assist senior management in managing effectively the compliance risks faced by the bank. Specifically this means that the compliance function should:

- advise senior management;
- provide guidance and education to employees on compliance issues;
- identify, measure and assess compliance risks; and
- monitor and test compliance and report the findings through the reporting line in accordance with the bank's internal risk management procedures.

Once more, I would like to stress the importance of timely identification, measurement and assessment of compliance risks. Citing the Compliance function paper "the compliance function should, on a pro-active basis, identify, document and assess the compliance risks associated with the bank's business activities, including the development of new products and business practices, the proposed establishment of new types of business or customer relationship, or material changed in the nature of such relationships". The paper continues by stating that the compliance function should consider ways to measure compliance risk (e.g. by using performance indicators) and use such measurements to enhance compliance risk assessment. It should assess the appropriateness of the bank's compliance procedures and guidelines, promptly follow up any identified deficiencies and formulate proposals for amendments<sup>11</sup>. Institutions are expected to tailor their control measures to the risk classification of both their clients, and their products and to implement specific control measures for the nature and severity of the compliance risks posed by each category.

Therefore, the question that each one of you will need to answer for his or her organisation is: "how can I be sure that my organisation is compliant?"

### **The ABN AMRO case<sup>12</sup>**

Recently, the importance of an adequate compliance function was illustrated by events that took place within ABN AMRO, one of the largest credit institutions headquartered in the Netherlands, and one of the large internationally operating banks worldwide.

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<sup>8</sup> Enhancing corporate governance for banking organisations, Basel Committee on Banking Supervision, February 2006, paragraph 17.

<sup>9</sup> Compliance and the compliance function in banks, Basel Committee on Banking Supervision, April 2005, paragraph 18.

<sup>10</sup> Compliance and the compliance function in banks, Basel Committee on Banking Supervision, April 2005, paragraph 22.

<sup>11</sup> Compliance and the compliance function in banks, Basel Committee on Banking Supervision, April 2005, paragraph 37 et seq.

<sup>12</sup> This section is based on publicly available information, [www.dnb.nl](http://www.dnb.nl), [www.federalreserve.org](http://www.federalreserve.org), [www.abnamro.com](http://www.abnamro.com).

Those of you who have read ABN AMRO's press release of 19 December 2005, the related website publications of the regulators in The Netherlands and the United States, or subsequent press publications, may already be familiar with this case. However, for those of you that are not, I'll provide a brief overview.

In July 2004, ABN AMRO signed a so-called Written Agreement with US banking regulators concerning compliance-related deficiencies, identified by the regulators at the US dollar clearing activities of ABN AMRO in New York. These deficiencies were related to cases of non-compliance with the United States' Bank Secrecy Act and OFAC regulations (the United States' sanction regime). This Written Agreement, that addressed ABN AMRO's anti-money laundering policies, procedures and practices, was designed to correct these deficiencies. In response to this Written Agreement, ABN AMRO strengthened its compliance function and its anti-money laundering programme in New York. Many measures were taken to achieve a best-in-class compliance programme. These measures varied from a centralisation and increase of its compliance function to the implementation of new IT-support systems.

Nevertheless, during the remediation process ABN AMRO itself identified other shortcomings in one of its overseas offices. Investigations from its audit department revealed that certain employees of the branch, without the enforcement or knowledge of anyone outside the branch, were not observing the bank's policies and standards in relation to certain US dollar payment instructions sent to the bank's US dollar clearing centre in New York on behalf of Libyan and Iranian clients. Under EU legislation, ABN AMRO was allowed to have dealings with said counterparties. Nonetheless, the United States' OFAC regime imposed certain limitations. Further investigations by the bank made it clear that these procedures were aimed at not including certain client-specific information from the relevant payment instructions. As such, it was ensured that the payments would pass through the New Yorkbranch' OFAC filter without being detected and blocked.

Having been informed by ABN AMRO about these procedures, the United States bank regulators and De Nederlandsche Bank concluded that this constituted a pattern of unsafe and unsound practices warranting further enforcement action<sup>13</sup>.

On 19 December 2005, an "Order to Cease and Desist" was issued by the joint regulators, requiring ABN AMRO to undertake comprehensive additional measures - in addition to the measures it had already undertaken in response to the Written Agreement. Amongst others, these additional measures related to:

- the submission of a U.S. Law Compliance Programme, ensuring continuous compliance with state and federal laws of the United States;
- the improvement of Head Office oversight to ensure effective control over and supervision of its foreign branches; and
- the completion of a written plan to improve the effectiveness of the management oversight in the United States.

On top of the "Cease and Desist Order", the USbank regulators imposed a fine amounting to US dollar 75 million, and a voluntary endowment of US dollar 5 million to the Illinois Bank Examiners' Education Foundation.

### **Lessons learned**

It goes without saying that ABN AMRO's Supervisory Board and its Managing Board respectively, have ordered detailed analyses of the compliance-related incidents, to ensure the lessons learned would be beneficial in the future. In addition to the institutions themselves, the regulatory community must learn from such incidents as well.

Given the severe impact of such incidents, it is important that the regulatory community and financial institutions reflect on whether the so-called "principle based" approach is adequate in this area. The reality is that appropriate compliance means adhering to many rules in various jurisdictions. So even if supervisors apply a principle based approach, at least the financial institutions themselves need to

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<sup>13</sup> Page 3 of the Order to Cease and Desist Issued upon Consent issued by De Nederlandsche Bank and the US Regulators.

couple this with rule based instructions. Some banks have introduced a mix of risk-based and rule-based compliance programs. My point is that both supervisors and the industry need to reflect on their paradigms. It is not either principles or rules, but rather an intelligent combination of principles and rules.

Another issue that warrants further consideration is that of “awareness cultivation”. It is widely believed that compliance should always be at the forefront of the employees’ thinking. Nevertheless, the modification of US dollar payment instructions acts as an example of deliberate attempts of employees to dodge internal and external regulations. Clearly, these employees lacked the desired mindset. Training and counsel remain very important tools to create the desired mindset: it helps employees to better understand not only the requirements and regulations itself, but also the “why” of such requirements.

Unfortunately, training alone will not always suffice to get the message through. It remains difficult to deal with this issue, but alternative solutions are not inconceivable. You, as senior management of supervised institutions, continue to have, of course, an exemplary role within your own organisation. This enables you to influence your staffs’ behaviour by acting as shining examples.

In addition, an interesting approach that you as senior management might want to consider, relates to annual appraisals of staff members. In addition to the traditional commercial objectives that usually dominate the appraisal process, one might consider including compliance-related objectives. Such objectives, of course, remain difficult to measure and, therefore, require careful consideration; the proverb “haste makes waste” is certainly applicable here. However, the growing usage of such performance objectives by banks like ABN AMRO as a tool to further influence employees’ behaviour, illustrates that - if properly applied - they have their merits. I am convinced that the importance of such factors will continue to grow, in the Netherlands but also in Asia.

In the end however, whereas the aforementioned factors undoubtedly contribute to the observance of internal and external requirements and regulations, it is my belief that the tool ‘par excellence’ to achieve compliance remains the combination of control and enforcement. “Control” to increase the possibility of being caught, either by internal control bodies like the audit- and the compliance function or by external authorities like the banking regulators. And “enforcement” to exact compliance with rules, regulations and other requirements.

## **Parallel with Basel II**

In the beginning of my speech I made a brief comparison between compliance and the new Basel Capital Accord. I can imagine that you may wonder what the afore-mentioned has to do with the new Basel Capital Accord. And yes, there seems to be little convergence between the capital requirements laid down in the Accord, and today’s challenges with regard to compliance. There are, however, some interesting links that I would like to highlight.

“Compliance risk” is swiftly becoming one of the most important risk drivers that credit institutions are facing. Firstly, not having adequate controls to prevent, for example, money laundering or terrorist financing will be unacceptable for regulators, who - as illustrated by the fines levied against ABN AMRO in the United States- will not hesitate to take formal measures against your institutions. Secondly, and perhaps even more importantly, involvement in serious compliance related incidents can lead to reputational damage, the impact of which may be even larger than that of regulatory interference. As confidence remains one of the financial sector’s cornerstones, a substantial impairment of an institution’s reputation could very well lead to its collapse. Nevertheless, whereas the Basel Accord, of course, requires institutions to set aside capital to cover credit-, market and operational risk, “compliance risk” is not covered.

Is this a missed opportunity? Should the drafting panels of the new Capital Accord have spent time on a concept like “compliance capital”?

In my opinion, requiring institutions to set aside capital to cover losses from compliance incidents is not the issue. I believe that it is justified that the Basel Committee has not included compliance risk in its Capital Accord. Whereas (potential) credit losses can be financially compensated by holding additional capital, compliance incidents will not be mitigated by financial means. After all, compliance incidents will impact the reputation of a credit institution, which cannot be measured in financial terms. Compliance is not a financial matter, but a matter of principle. Nevertheless, the question about the position of compliance continues to intrigue me.

You will undoubtedly be aware that Pillar II (the so-called Supervisory Review Process) of the new Capital Accord deals (amongst others) with the treatment of risks that are not fully covered by the requirements under Pillar I<sup>14</sup>. Under Pillar II, the Accord requires banks to address all material risks faced in the capital assessment process, even those risks that cannot be measured or quantified precisely<sup>15</sup>. Banks are expected to further develop techniques for managing unquantifiable risks like reputational risk<sup>16</sup>. Although the language in the Capital Accord gives the impression that 'something' needs to be done, it also implies that holding additional capital for unquantifiable risks is not the solution. So, what then is the solution?

I would argue that, whereas it remains necessary to mitigate compliance risks, a more structured and coherent approach is necessary. As previously discussed, banks are faced with challenges like the increasing globalization, issues with the corporate governance of complex institutions, the continuously changing understanding of what constitutes sound operational management, changing laws and the ongoing evolution of products. At the same time, the requirements and best practices imposed by legislators, supervisors and international standard setting-bodies are not necessarily attuned to each other.

Those of you who work for an internationally active bank will recognize the difficulties that this brings to day-to-day practice. One important step towards solving these difficulties will be to bring these requirements and best practices together. This entails monitoring the implications of these requirements and best practices and putting effort in finding workable solutions and where possible to improve the consistency of standards already available. In my mind, this will be one of the bigger challenges for the supervisory and legislative community for the upcoming years. But you know that we are working hard here, amongst others through the BCBS Accord Implementation Group and the Core Principles Liaison Group.

In the end such effort will as a result also entail new challenges for the banks themselves. It is widely realised that implementing the new Basel Accord is a huge burden on financial institutions, not only because of the complexity of the materials, but also because of the sheer size of the implementation project.

The development and implementation of a consistent international compliance framework, might well be a challenge of equal size. New policies have to be written, approved and implemented, procedures have to be developed, IT-systems (e.g. automated systems to facilitate transaction filtering and -monitoring) have to be installed, staff members have to be trained and control measures have to be put in place to detect and correct deficiencies. The amount of work done by ABN AMRO in response to the Cease and Desist Order resulted in comprehensive and extensive plans. This is illustrative of the effort that might well be the desired benchmark for the entire financial industry.

## **Closing remarks**

I have highlighted the challenges that banks are facing today with respect to compliance and the compliance function amidst the ongoing increasing globalization, issues with the corporate governance of complex institutions, the continuously changing understanding of what constitutes sound risk management, changing laws and regulations, a continuous evolution of financial products, and a determination of governments and regulators to fight money laundering, terrorist financing and other illegal financial transactions. Therefore I expect that the importance of "compliance" will continue to grow exponentially. At this moment, multiple requirements and best practices with regard to compliance have already been issued. Nevertheless, it is my view that creating a "best in class" compliance framework by integrating these requirements and best practices should become a main priority, both for regulators and the industry. I realize that this will not be easy, but I am convinced that this is the best way forward.

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<sup>14</sup> Par. 724 of the new Capital Accord.

<sup>15</sup> Par. 732 of the new Capital Accord.

<sup>16</sup> Par. 742 of the new Capital Accord.