Effective Compliance in Banks: Regulatory Expectations

1. Introduction

Additional Director, Centre for Advanced Financial Research and Learning (CAFRAL), Smt. Indrani Banerjee and team CAFRAL, Chief Compliance Officers (CCOs) and other participants from supervised entities, Good morning to all.

It is my pleasure to interact with you today on a critical aspect of compliance in financial institutions. In the recent past, the Reserve Bank has been continuously focussing on enhancing the effectiveness of compliance function within the financial institutions under its regulatory ambit. I am glad that the CAFRAL has organised this conference for CCOs, which will go long way to strengthen compliance culture in our regulated institutions.

2. Three Lines of Defense Model

As we all understand, compliance is defined as the act of following laws, rules, regulations, and codes of conduct. While most of the compliance requirements are exogenous, following the organization's own internal rules, policies, and procedures and to act in accordance with ethical practices are equally important. As such, the Compliance risk is the risk of legal or regulatory sanctions, material financial loss or loss to reputation an entity may suffer as a result of its failure to comply with laws, regulations, or codes of conduct.

So where does the compliance as an activity stands in the overall functions of any entity? I am sure that you are well conversant with the three lines of defence, which have been developed in 2013 by the Institute of Internal Auditors and have been revised and updated very recently. Under the three lines of defence model, an entity is fortified by its own defence system. The revenue-generating business units are referred to as the **first line of defence**. The intention of the model is to assign the basic control and risk management responsibilities to this first line of defence (i.e., staff and managers working in those revenue generating units). With the introduction of automated controls, it has become possible to make control activities comprehensive as well as detailed (i.e., to capture all relevant data), given that only exceptional situations are highlighted by a system requiring immediate management review.

The second line of defence mainly constituted of Risk Management and Compliance functions. If the control systems outlined in the first line of defence becomes ineffective, or are absent, the second line of defence becomes very critical. As such, the second line of defence of which compliance is an integral part, defines preventive and detective control.

The third line of defence, which represents the next level of control, comprises the internal audit function. Over the years, the practice has developed such that it provides independent assurance to senior management and the board on a broad range of objectives. For the function to be effective, it needs to be based on the highest level of independence and objectivity. Organisational independence, implementation of a direct reporting line for the chief audit executive and unrestricted access to senior management and the board can make third line of defence effective.

Beyond these internal three lines of defence exist additional external levels of controls, i.e., External auditors and Regulators/ Supervisors, that complement these layers.

3. Compliance Management

As I have mentioned earlier, compliance requires following organization's internal rules, policies, and procedures. In most cases supervised entities need to transform the role of their compliance departments from that of an adviser to the one that puts emphasis on active risk management and monitoring. In practice it translates beyond offering advice on rules, regulations, and laws and instead they become an active co-owner of risks. Consequently, compliance function can exercise an independent oversight of the control framework. Compliance risks are driven by the same underlying factors that drive other financial risks, but their stakes are higher in the case of adverse outcomes. For example, regulatory actions that can result in restriction of business activities and large fines. Therefore, it's only fitting that a modern compliance framework needs to be fully integrated with the supervised entity's operational-risk view of the world.

A **good compliance management can benefit** financial institutions in many ways, for example,

- It lowers organizational and individual risk,
- It improves transparency which enables better decisions,
- It enhances relationships with regulators and other stakeholders,
- It lowers reputational risk,
- It enhances enterprise valuation,

On the other hand, **the cost of poor compliance** can be enormous. Inadequate compliance focus leads to heightened compliance risk to the entity, which includes risk of legal or regulatory sanctions, business restrictions, material financial loss, or loss of its reputation. Since Global Financial Crisis (GFC), amounts involved in penalties and fines imposed on financial institutions by regulators, write-down of their losses and erosion of profits have reached mammoth proportions. Several too-big-to-fail and very famous institutions have either failed or have been rescued by a huge burden on the exchequer. In the Indian context, you would have noticed that few large fines the Reserve Bank has imposed recently as well as business restrictions imposed on supervised entities due to their failure to comply with regulations.

4. RBI instructions on Compliance functions

Reserve Bank of India had introduced a system of "Compliance Officer" in banks way back in August 1992, based on recommendations by the Committee on Frauds and Malpractices in Banks (Ghosh Committee). The role of compliance officers came into sharper focus since 1995 when the General Manager in charge of Audit and Inspection was made responsible for the compliance functions, with a requirement for periodic reporting or certification on compliance functions directly to the CMD. However, it was gradually recognized that the circumference of compliance functions in banks needed to be clearly defined and enlarged.

In the very recent past, in September 2020, Reserve Bank issued revised guidelines for compliance function in banks and role of Chief Compliance Officers, to bring uniformity in approaches followed by banks and to align the supervisory expectations from CCOs with global best practices. Emphasizing the critical role played by compliance function in overall structure of corporate governance and keeping in view the principles of proportionality, similar guidelines were prescribed for a segment of NBFCs in April 2022 under the scale-based regulation and for a segment of Urban Co-operative Banks in September 2022. The guidelines gave main thrust in Policy, Independence, Stature, Authority and Resources of the compliance function. Some of the key aspects of the instructions are-

Policy:

- Board of Directors should approve and put in place policies governing compliance in the bank.
- Policy should document the purpose, authority, and responsibility of the compliance function.
- Policy should be consistent with the size, nature, and complexity of the entity, and should be reviewed periodically.

Independence:

- Compliance function should be independent of risk-taking functions.
- Compliance, risk management and internal audit functions should be independent of each other.
- The head of compliance should have fixed tenor, can be removed only with Board approval, there shouldn't be dual hatting for CCO, and his/her compensation should not be linked to the business performance of the entity

Stature & Authority:

- The CCO should have the same stature as that of heads of business verticals & should directly report to either the ACB/Board/ and/or MD & CEO.
- It should have complete access (staff, documents, systems etc.) of the business/risk functions.
- The Compliance function should have the ability to influence and change business operations if they are not compliant with the various regulatory and supervisory guidelines / expectations.

Resources:

- Compliance function should comprise sufficient number of adequately qualified employees.
- Infrastructure and resources allocated to compliance should keep pace with changes in the bank's profile, the external landscape and industry practices.

Competence & Training:

- Employees posted to the compliance function should possess requisite experience and qualifications.
- Should have access to regular training and upgrades.

5. Compliance Culture

It is well understood that regulatory guidelines focus on 'Compliance as a function'. However, experience tells that presence of compliance as a function is necessary but not a sufficient condition to achieve sustainable compliance. Therefore, let me delve a little deeper from the 'letter' to the 'spirit' or rather 'philosophy' of compliance. And for that I want to draw your attention toward the issue of 'compliance culture', which to my mind has not yet received due attention within the industry. I have touched upon the benefits of compliance and cost of poor compliance. Compliance helps fulfill the fiduciary duties of a Financial Institution and having an enduring compliance culture ensures that the entity keeps misconduct in check and enjoys high degree of trust which is the foundation to build not only a successful business but also to ensure resilience and stability of financial system.

For a resilient entity with a focus to achieve sustainable growth, the compliance must get reflected in its culture, should essentially become part of the DNA and reflect in its organizational ethos. Often the non-sustenance of compliance has its root in an inadequate compliance culture in the organisation. Compliance culture of an entity is defined as the entity's norms, attitudes and behaviours of individuals and groups, that determine the way in which they understand, discuss and act on all aspects relating to compliance. An entity's culture influences all aspects of its business from its attitude to risk-taking, both financial and non-financial, to its treatment of its customers and the development, sale and review of its products and services. Hence, building a desirable culture within an organization is a core function of the Board and Senior Management. One must be mindful of the signs of poor compliance culture, such as Focusing on short-term profitability with little or no consideration for long term interest of the entity; Dominance of individuals in decision making process; Adherence to the letter of law and regulation, but not in spirit, Treating internal controls/risk management framework as an irritant, etc.

Establishing and sustaining a culture of compliance requires continuous vigilance, resources, and time to influence widespread change. It requires unwavering commitment and belief starting 'from the top' and percolating at all levels that truly sustainable growth can come only through following rules/regulations.

There are **some essential basic elements at organizational level** to establish this sustainable and enduring culture of compliance,

a. Organisational ethos - Creating a cultural capital of compliance means embedding ethical behaviors at all levels of the bank- right from the top to the bottom of the hierarchy. It means helping employees to make better decisions in the business while following rules, regulations, and policies.

b. Incentives – It is rightly said that ‘corporate culture reflects what is being rewarded’. Let me quote a practical advice given by a former Director of Enforcement, Mr Stephen Cutle from Securities and Exchange Commission of US which may go a long way to fortify a culture of compliance in financial institutions.

“*Make integrity, ethics and compliance part of the promotion, compensation, and evaluation process as well. For, at the end of the day, the most effective way to communicate that “doing the right thing” is a priority, is to reward it”*.

c. Awareness of regulatory expectations – Financial institutions need to put resources to keep employees abreast of new regulatory developments, meet deadlines and understand complex rules in a timely manner to make well-informed decisions.

d. Communication – Effective dissemination of information and messaging from the top are essential for shaping sustainable compliance culture.

e. Education – Ensuring that all employees are educated through diverse learning approaches, on an organization’s internal policies and external regulations in a regular and influential way is essential.

f. Incident Reporting and Case Management – Tracking and addressing any misconduct is critical to complete the feedback loop and create a sustainable system.

6. Compliance Culture Assessment by RBI:

Reserve Bank has put in place structured framework to measure the compliance culture of supervised entities. In assessing compliance culture focus is not only on structural and procedural part but also on softer elements such as organizational dynamics of an entity, and the Reserve Bank, inter alia, looks at the following elements:

- **Tone from the top**: Basel Committee on Banking Supervision principles of compliance, 2005 state that 'Compliance starts at the top'. The Board and senior management are the starting point for setting the entity's core values and expectations for the culture of the entity, and their behaviour must reflect the values being advocated. Compliance management will be most effective in a corporate culture that emphasizes standards of honesty and integrity. Non-compliance observed is promptly escalated, and in which the board of directors and senior management lead by example.
- **Accountability framework:** Behavioural research indicates that employees are motivated to think in a critical manner when the organization promotes responsible decision making. In broader terms, accountability serves as an effective tool for ensuring a desired outcome. In the context of compliance culture, an effective accountability framework ensures that relevant employees at all levels - understand the core values of the entity and its approach to compliance.
- **Open communication:** A sound compliance culture promotes an environment of open communication and constructive engagement. The main indicators of effective communication are how dissent is handled within an entity and the stature accorded to compliance function.

- **<u>Ex-ante and Forward Looking:</u>** The focus here should be preventive. Sound compliance culture encourages ex-ante assessment of the activities of the entity and is forward looking. It prevents non-compliant activities from taking place.

7. Role of Chief Compliance Officer

As CCOs/compliance officers you have a unique role and a vantage point, which enables as well as requires you to work across functions and look at the breadth of compliance risks facing your organization. CCOs should see that role of compliance is seen in the broader context, that it becomes part of the culture of the organisation and not just remain the responsibility of specialist compliance staff. While RBI guidelines lay emphasis on structural part of independence and stature of CCOs, it is very essential that you exercise that independence and utilize access and channel of communications within and outside the organization. If compliance leaders conduct assessments in silos or focus on specific regulations, with limited data aggregation then enterprise-wide, systemic risks and risks across regulations may not become apparent. For that reason, it is vitally important that CCOs have processes in place for aggregating quantitative and qualitative enterprise-wide data and to identify compliance risk across the organization.

8. Conclusion:

To conclude, compliance management may be less popular function amongst other functions within a supervised entity, but its sustainable future can only be ensured by acknowledging and giving due importance to this in overall scheme of things. Role of ethos-centric compliance culture is garnering attention across the globe, and it has been acknowledged by the central banks and bankers alike that compliance warrants considerable attention. Regulators, supervisors, and international standard setters have become increasingly cognizant of the fact that merely enacting rules and regulations is a futile exercise unless these are complied with, both in letter and spirit. As a supervisor, Reserve Bank has keen interest in making sure that supervised entities put in place a sound compliance management framework. While there has been a substantial progress on structural and functional aspects of compliance, but significant improvement is needed in compliance culture across supervised entities. I hope you will carry this message and work towards instilling these cultural elements of compliance for lasting improvements in your entities.

Thank you.