White Paper

Compliance by Design: Banking's Unmissable Opportunity

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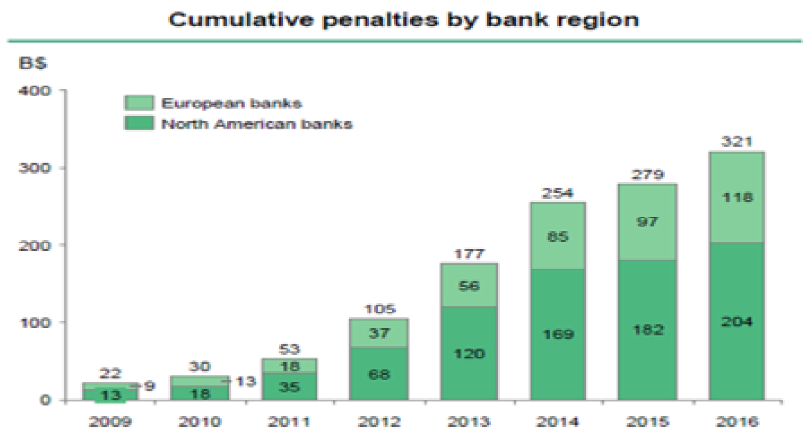
Financial institutions face a rising tide of compliance regulation requiring them to fight financial crime and ensure proper employee conduct. They must take steps to combat money laundering and terrorist financing, as well as bribery and corruption, and ensure good conduct with respect to clients and markets. Given regulatory fines of around $320 billion in the seven years to 2016, most financial market participants need to raise their game (See Exhibit 1). There is significant potential upside in doing so; an effective compliance function ensures that banks stay in line with regulation, helps them operate more efficiently, and enhances the client experience.

Exhibit 1: Regulatory fines have continued to rise



Source: Staying the Course in Banking, BCG, March 2017

Enduring Areas of Weakness

In response to punitive regulatory fines in recent years, many financial institutions chose expediency, opting for additional controls and sometimes knee-jerk hiring. In many cases those efforts evolved into recalibrated compliance target operating models and the assignment of new roles and responsibilities across the first, second, and third lines of defense (the ultimate risk owner, independent reviewers of controls, and internal auditors). The result has been a reduction in non-compliance, but at the cost of operational inefficiency and a more difficult customer experience.

One consistent weakness across financial institutions is the relationship between lines of defense, which often lacks clear reporting lines and responsibilities. In particular, the interface between compliance (in the second line of defense) and risk owner (in the first line) can be ambiguous, with firms struggling to translate regulatory requirements into business processes. For example, the compliance function may regularly update global and local regulatory requirements for onboarding, but the changes are only implemented after a delay, inconsistently, or not at all. This disconnect may be attributable to a lack of business know-how in the compliance function, or sometimes to a deficit of compliance expertise in the business itself. Inadequate resources are another perennial challenge. The inevitable result is additional risk for the institution (and sometimes for individual employees—for example under the approved persons regime in the UK), a low level of operational efficiency, and a poor service for clients.[1]

SIDEBAR: Regulatory Requirements Pose Challenges

Compliance regulation varies significantly by jurisdiction, creating an operational challenge in codifying rules on a group-wide level. Financial institutions operating in the financial hubs of London, New York, and Frankfurt, for example, must comply with a range of idiosyncratic requirements, including Joint Money Laundering Steering Group Guidance in the UK, the Bank Secrecy Act and Anti-Money Laundering Examination Manual in the U.S., and the Money Laundering Act and related supervisory circulars in Germany. Individual regulations must also be constantly monitored as they undergo revisions and modifications. Recent significant changes include the implementation of the EU's Fourth Anti-Money Laundering Directive into UK and German law in 2017. On

[1] See Code of Practice for Approved Persons; UK Financial Conduct Authority.

the basis of the requirements of each jurisdiction, banks must ensure a globally harmonized but locally calibrated framework for compliance activities.

Compliance by Design Offers a Solution

History shows that poor compliance leads to punitive outcomes. Effective compliance, on the other hand, can reduce liabilities, increase operational efficiency, and improve the customer experience. Financial institutions can ensure that they obtain the advantages of the latter by reforming compliance processes, ideally through a strategic approach, or "compliance by design."

Compliance by design means applying a systematic approach to integrating regulatory requirements into manual and automated tasks and processes (See the sidebar A Global KYC Standard). By creating a bespoke compliance function, banks increase the likelihood of aligning themselves with global and local rules (in some cases fulfilling regulatory requirements and completing documentation in parallel), reduce error rates, and boost efficiency through a reduction of unit costs and processing time.

SIDEBAR: A Global KYC Standard

In codifying onboarding or client-review requirements (know-your-customer, or KYC), the conventional approach is for the compliance function to establish a group-wide policy, which it disseminates to units in individual geographies for customization in line with local regulations. However, that system is wrought with problems and often leads to overlapping records based on iterations of the same client information. There is also a significant risk that new regulatory requirements are inefficiently incorporated into sales units' handbooks.

The essential elements of onboarding are client identification and verification, which are required by regulation and help banks meet reporting requirements and build a better understanding of customers. Until recently, banking organizations performed many onboarding steps manually, because collecting information from—and checking—diverse sources required significant human intervention. Most banks also did not have integrated workflow tools to help manage and monitor tasks.

As technology has evolved, new solutions have emerged to help ensure that key data elements are consistently recorded and effectively actioned. Banks now have an opportunity to use those elements to move to a gold standard for KYC — codifying tasks, data fields, and documentation, and processing many steps automatically. Banks that take up the opportunities are likely to make significant progress in designing a compliance function that operates to its potential.

Making the Switch

Effective implementation of compliance by design should be based on a detailed and structured analysis of regulatory requirements, followed by translation of rules into compliance processes and increasingly by the use of smart technologies and workflow tools to hardwire processes into bank systems.2 In making the switch, a three-stage approach may be appropriate:

- Identify and assess regulatory requirements for the three lines of defense.
- Analyze how the rules apply to individual processes in each line of defense.
- Design and implement a roadmap and ramp up technology.

Financial institutions are especially challenged by the first step, which requires transposition of regulatory requirements into detailed processes, data fields, and documentation. This can be a complex and demanding task. (See the sidebar Regulatory Requirements Pose Challenges), due to the high number of requirements in individual

[2] Technologies include optical character recognition, voice and speech recognition, data mining and robotic process automation.

jurisdictions and the variation between jurisdictions, the rules of which must be married with global requirements in some cases.

The second step is to define compliance processes in accordance with regulatory requirements. A critical review should include an appraisal of the frequency and structure of tasks, leading to categorization and prioritization of needs. Banks must make a thorough assessment of requirements to be embedded into daily processes, ensuring that they marshal the requisite data, documentation, and information for each customer segment, product type, and legal entity.

The third and final step is to create a roadmap for implementation and bring technology into play. Smart technologies in particular offer the potential for performance improvements, but before jumping on board banks must ensure they have a detailed understanding of the technologies available, which can range from fairly routine programs to advanced analytics and machine learning capabilities.

Each technology may have a specific application. Some control and test-and-reporting activities are highly standardized, requiring mechanistic tools such as robotic process automation and business process management. Voice and speech recognition, meanwhile, may be used to collect data, while data mining and machine learning may enable pattern recognition — for example on the trading floor. Still, in embracing smart technologies, banks should beware over-reliance. Many regulators expect that institutions will continue to apply human oversight and expertise in the first and second lines of defense, and a wholesale assignment of responsibility to technology is unlikely to be deemed acceptable.[3]

Compliance by design can be implemented either through integration with existing systems or the introduction of new digital solutions. In an ideal world, banks would reimagine processes from scratch, but the more common reality is a stitching together of new and legacy systems. The process of amalgamation requires careful planning, a

[3] Processes must be formally documented to allow for traceability and audit assurance.

strategic approach to implementation, and a commitment to continuous monitoring and improvement.

There is no standard way forward, but banks that get it right are likely to build a reliable and effective compliance function, capable of ingesting new rules as they appear and creating a win-win for the bank and its customers.

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