Editorial

Basel Committee on Banking Supervision: The compliance function in banks

The history of the international capital markets demonstrates that ineffective systems of governance and accountability in banks increases the likelihood of financial loss and failure. In the extreme case scenario the fall-out from these failures could have systemic consequences, with the risk of contagion in the banking system. In recent times, the concern for effective corporate governance has been heightened, along with the responsibility on the international financial community to combat the likelihood of it acting as a conduit for the proceeds of crime and terrorist finance.

The nexus between the regulator and the regulated in banking supervision is a complex web of obligations that ultimately tries to protect financial stability and confidence in the capital markets. This relationship between the regulator and regulated is based on trust and cooperation, in which the traditional autonomy of the regulated is preserved. Prudential supervision does not necessarily eliminate fraud or failure so attention has to be on introducing mechanisms to ensure effective governance in financial institutions. Prudential supervision requires a significant degree of delegated self-regulation to balance 'competitiveness and profitability' with 'investor protection'. It is the responsibility of banks to then have in place sound systems of corporate governance, which the financial regulators will need to ensure are sufficient.

This is reflected in the work of the Basel Committee on corporate governance and accountability in its broadest sense. In its most recent consultative paper, the Basel

Committee focuses on 'The Compliance Function in Banks' (October 2003; open for comment until 31st January, 2004). This paper builds on its previous work on, *inter alia*, internal controls, corporate governance, internal audit, customer due diligence and operational risk. These papers disseminate best practice to try and strengthen the relationship between the regulator and regulated, recognising that effective international banking regulation and supervision is a two-way process.

The compliance function is a central part of a bank's system of accountability and is required to ensure that the bank adheres to financial regulation, in its widest sense, set by respective regulatory authorities wherever it undertakes its business. In this respect, it is not simply sufficient to ensure the rules exist within a bank but show that they are applied in substance to manage risk. Moreover, compliance with legal and regulatory rules is a responsibility that transcends the whole organisation and is not a function simply located in a single department to administer.

The consultative paper sets out 11 principles that outline the measures necessary to reduce compliance risk and create the appropriate compliance culture. The Basel Committee defines a bank's compliance function as follows:

'An independent function that identifies, assesses, advises on, monitors and reports on the bank's compliance risk, that is, the risk of legal and regulatory sanctions, financial loss, or loss to reputation a

bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice (together “laws, rules and standards”).’

The central theme of the compliance function is not to act simply as an internal ‘watchdog’ in a bank by acting independently to identify adverse risks, but to work with the business units to minimise the likelihood of compliance risks occurring, in order to make sure that the bank does not, *inter alia*, breach the laws, rules and standards governing its business activities, which could result in a variety of enforcement sanctions.

The consultative paper places responsibility for the compliance function squarely on the board of directors and senior management regardless of how they are organised or prescribed responsibilities in their respective jurisdictions. It is for the board of directors to ensure that the compliance function acts with a sufficient degree of integrity and probity in the discharge of its functions. It is then the responsibility of senior management to build a compliance function within the bank and review its duties regularly. While the board of directors and senior management are required to ensure that a robust compliance function exists within a bank the compliance function also has to ensure that they observe the ‘rules’ with equal vigour. The compliance function would need to incorporate the following qualities in the way it works, namely: integrity, a questioning mind, neutrality and independence of judgment.

The effectiveness of the compliance function is ultimately measured by the status it has within a bank. Therefore it is important that the compliance function is formally constituted by way of a charter with the appropriate powers, which will need to be exercised with a sufficient degree of independence. This will mean

that the compliance function needs to work with other departments rather than in isolation, to get an understanding of the business the bank is undertaking. It will need to have access to information which, in some instances, may need investigating. Consequently, gateways need to be in place, so those findings can be communicated separately to both senior management and the board of directors.

The work of the compliance function should be independent from the bank’s business activities so that it can carry out its responsibilities impartially. The compliance function will need to be robust to withstand the pressures of disclosing instances of noncompliance. While the Basel Committee does not advocate any particular organisational structure for the compliance function, where the business of the bank is located in various jurisdictions, reporting lines should be centralised with a ‘head of compliance’ at the helm. This is to ensure that management of the business unit does not compromise the independence of the compliance function.

The compliance function needs to be coordinated so that it captures jurisdiction by jurisdiction the various compliance risks the bank’s group-wide activities may be facing. The responsibility of the compliance function is not simply to identify cases of compliance risk in banks. It incorporates a much broader role that is more proactive rather than reactive to managing risk. This means that the compliance function needs to work with the various business units to ensure systems and controls are in place to manage compliance risk and conflicts of interests — for example, advising on the appropriate compliance controls for new business activities. This is particularly important considering that many instances of corporate failure result from new ventures that are distinct from the core business.

The compliance function is simply one

facet of the governance and accountability system. The Basel Committee highlights the importance of the internal audit function to review the work of the compliance function to assess, as part of its work, the bank's system of controls to ensure compliance with the laws, rules and standards governing all its business activities.

The importance of a robust compliance function in banks is crucial to reduce the risk of loss or failure resulting from non-compliance with the relevant laws, rules and standards. This responsibility needs to be shared by the whole organisation, however, even though the burden is in the hands of a few individuals. More importantly, the principle of compliance needs to

be applied consistently across all of the bank's business activities, regardless of the jurisdiction in which they are undertaken, so that its integrity remains intact. The regulatory approach needs to ensure that both the regulator and the regulated can work together to minimise the risk of failure. The regulator cannot be too accommodating with cases of noncompliance because it would undermine the integrity of the banking system.

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