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FINANCIAL SERVICES
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MORE THAN PUTTING OUT FIRES

Preventing risks and creating opportunities through compliance

After years of focusing on regulatory issues, banks have built large—but not always robust—compliance control systems. Like firefighters stamping out forest fires, they extinguished the flames and deployed large teams to monitor the landscape for new sparks. But, unlike a well coordinated firefighting unit, their teams sometimes lack the organization and skill to spot where the next fires might ignite—and get to them before they spread.

Over the past few years, legal and compliance systems at many banks have grown too large and unwieldy. Many compliance departments have documented known risks but only partially mitigated them, and some may be neglecting to establish a system to screen for new risks that have not yet emerged. It's time for banks to get their legal and compliance systems up to speed.

The increasing political uncertainties and challenges in globalization may not lead to a global rollback in regulation but potentially in strengthening local regulations further. This might come on top of an increasing dynamic in e.g. the sanctions space and new more complex money laundering, bribery and fraud schemes. The expectations of the regulators in terms of capabilities to identify these schemes and in the timeframe for reacting on new information continue to become more challenging. This combined with the increased dynamic forces banks and financial institutions to manage compliance risks more effective and efficient to avoid another wave of massive disruption to their services—not to mention the huge settlement costs in case of failure.

It is crucial that these firms run their compliance programs the right way. Employing large numbers of employees will not create an effective compliance system by itself. Instead, effectiveness depends on making that system as well-integrated, streamlined, and collaborative as possible.

WHAT A SYSTEMATIC APPROACH TO COMPLIANCE LOOKS LIKE

Banks can address compliance topics in a more systematic, integrated, and comprehensive way. We have seen too many cases of regulators reproaching financial institutions for being aware of their shortfalls—like missing processes, inadequate training, and an under-experienced compliance staff—but not doing enough about it.[1] Banks have used the increasing number of compliance requirements as a reason to recruit large internal teams, sometimes very quickly. But that effort—and the organizational problems it caused—has left banks with few resources to do more than react to issues as they come up.

"Banks can improve the quality of their compliance systems by addressing overlaps, breaking up silos, and embracing the challenge of becoming more forward-looking."

Banks can improve the quality of their compliance systems by addressing overlaps, breaking up silos, and embracing the challenge of becoming more forward-looking. Building more effective compliance arms means taking an integrated and comprehensive approach to managing risks that focuses on:

- Anti-money laundering (AML) and combatting the financing of terrorism (CFT)
- Sanctions
- Tax obligations on the client side, such as FATCA, QI agreement, automated information exchange, as well as on the corporate side, such as permanent establishment of the beneficial owners
- Security compliance, such as market manipulation
- Anticorruption, such as FCPA and the UK bribery act
- Antitrust
- Product and investment suitability, such as client and investment risk profiles, and qualified investors rules

All of these areas (and many more) have the potential to become the spark that ignites a small—or large—forest fire.

WHAT'S DRIVING THESE COMPLIANCE SHORTFALLS?

These days, operating as an international firm means responding to an ever-increasing number of compliance requests from around the globe. Financial institutions are finding it more and more challenging to keep up; many fail to comply with regulatory requests on time. Although inquiries, investigations, and fines related to regulatory issues have all spiked in recent years, many banks continue to pursue risky business relationships that violate legal, regulatory, and tax obligations.

Through our close work with financial institutions, we have identified the main areas that usually lead to these shortfalls:

- **Systems:** Most institutions still operate with a patchwork of systems that do not communicate with each other and are missing key IT interfaces. Mergers and acquisitions, data protection measures, and cost-reduction programs have led to a fragmented landscape with redundant information, inconsistencies, and limited integration of historical data. Additionally, many banks lack a central repository with Know Your Customer (KYC) information, a system that should include a single, unique client ID that allows organizations to easily identify clients across different legal entities or divisions (figure 1).
- **Processes:** Their insufficient digitalization and scanning practices makes it even harder to make data available for necessary checks. Firms are not automating compliance checks and conducting ex-ante monitoring as much as today's technology would enable them to. Many systems are still based on an ex-post approach that is far more likely to lead to significant risk (e.g. letting their clients send payments to sanctioned countries), followed by repercussions from regulators.
- **Organization and culture:** Lacking a clear firewall between management and compliance teams puts a lot of stress on checks and balances. In some cases, a too-close relationship can even lead to adverse incentives. Some organizations treat legal, regulatory, tax, and investment compliance as unnecessary burdens. There can be a wide gap between how management talks about the importance of compliance—and how much they really empower their compliance departments.

1. www.telegraph.co.uk/finance/newsbysector/banksandfinance/10320948/Top-10-bank-fines.html and graphics.wsj.com/lists/SEC091

DRIVING EFFICIENCY AND EFFECTIVENESS

Many financial institutions will want to address these serious issues as soon as possible. Management can start by deciding where the company's optimal position lies in the triangle of cost, capital, and claims. This approach requires knowing how much value various compliance issues put at risk.

A comprehensive perspective (including the regulators' view of the organization), clear understanding of the risks of compliance flaws, and risk quantification are all important elements. Yet these are not enough. Only by focusing on effectiveness and efficiency can management ensure that compliance teams deliver their full potential.

Banks striving for a robust compliance framework focus on these critical elements:

- **Organizational hygiene:** the department must operate independently. Management should minimize its conflicts of interest, simplify the number of management layers around it, and reduce team size, locations, and remuneration and competency models.
- **Management of compliance risks:** management should gain a thorough understanding of the goals of the current set-up, existing documentation requirements, and policies, and compare them against best practices.
- **Automation and process design:** management can also review how industrialized current processes already are, how data is currently processed, and the overall system landscape against best practices—e.g., does the firm have a oneglobal-customer-ID system? Leveraging modern technologies like machine learning, artificial intelligence, and machine-based scoring can greatly enhance compliance tasks.
- **Performance monitoring:** analyze the current KPI and management framework to understand what dimensions and criteria the current organization should be measured along. Identify gaps to help create a baseline for further discussions.
- **Compliance culture:** everyone in the firm should understand the true motivation of the compliance organization. Gaining a broad understanding of its purpose can help improve its effectiveness.

FIGURE 1: WHY FINANCIAL INSTITUTIONS STILL FAIL TO COMPLY WITH REGULATORY REQUESTS AND CONTINUE TO FAIL THEIR STANDARDS

Organization and culture	• Lacking independence of compliance function from line management • Missing link of compliance breach and management actions • Goal setting does not take costs and impact of compliance breaches into account (i.e. link to salary and bonus)
Systems	• Limited communication and missing interfaces between systems • No single, unique customer ID across the entities and geographies • Access to historical data/legacy data limited and shortfalls in digitalization and storage of data
Processes	• Lacking automation of simple compliance checks and management of complex ones • Management of red flags and hits not tiered according to potential impact • Four eye principle not appropriately implemented

MOVE TOWARDS COMPLIANCE 4.0 TO REDUCE THE RISK OF SIGNIFICANT FUTURE COMPLIANCE SHORTFALLS

WHAT ARE THE BEST COMPANIES DOING?

It can be challenging to keep up with the fast-moving regulatory landscape. But companies that embrace that challenge and build it into their business models can significantly increase their business performance and reduce risk. Put another way, compliance should be less of a policing function and more of a business strategy with integrated solutions to mitigate risks.

Some banks are already making changes to stay ahead of the game. These banks are revising processes, internal controls, and system infrastructure. Some are already enhancing their transaction monitoring process (which was originally established for AML compliance) to create alert rules that identify patterns and distinct transactions. By highlighting potential sanction violations, these alerts can eliminate gaps that the transactions-filtering process and other controls were not able to close.

By doing this, the organizations move away from the classical model for legal and compliance functions that focuses on control (e.g., firefighting) to "Compliance 4.0" (figure 2). Banks that achieve Compliance 4.0 become not only a more agile compliance partner who identifies and mitigates new risks, but also a partner for business generation.

FIGURE 2: COMPLIANCE 4.0 ADDRESSES KEY ISSUES OF TODAY'S SITUATION AND DELIVERS POSITIVE RESULTS FOR THE COMPANY

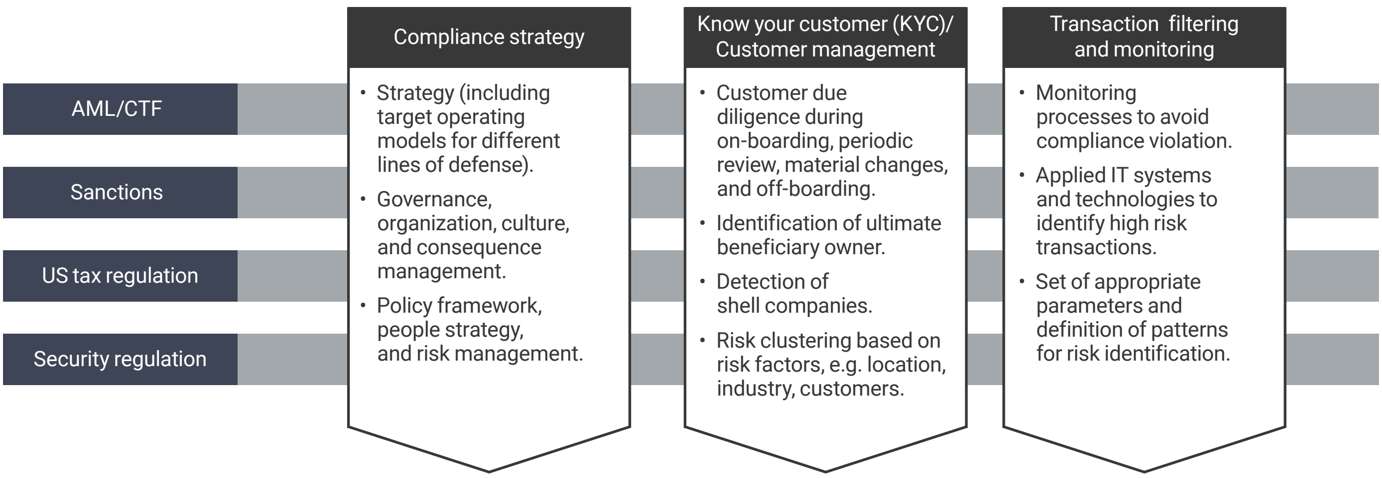
Our fundamental believes of today's situation	Benefits of Compliance 4.0
Many legal and compliance organizations have becomes too big	Rightsizing of the compliance function
Most institutions have documented known risks and partially mitigated them	Upgrade compliance to identify and mitigate new risks
There is a big risk that unknown risks are not being discovered/are missed	Information not only used for compliance but leveraged for business generation

These developments seem promising. Yet many banks are still leaving other potential improvements unexplored. One of the most important aspects of an integrated compliance approach is that banks use all the information they already have across the four corners of the organization to mitigate risks. Too many banks are failing to close critical gaps because their internal departments are too siloed to share information effectively. From a regulator's point of view, that is not an excuse; if information about a potential compliance problem existed somewhere inside their organizations, then the banks had a "reason to know" about these risks, even if that information didn't reach the appropriate compliance officer.

By taking an integrated approach that cuts through silos, banks will put themselves in a better position to discover irregularities, trigger an alert, and ensure the issue is properly handled (figure 3).

FIGURE 3: CASE EXAMPLE OF HOLISTIC COMPLIANCE MEASURES

Identification of synergies across compliance elements in three main areas



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HOW BANKS CAN PROFIT FROM COMPLIANCE EFFORTS

Ideally, compliance departments should move beyond ex-post problem solving and closer to Compliance 4.0. Using the insights generated by their sophisticated checks-and-controls systems, compliance departments can even identify new business opportunities for the company.

While running their deep background checks, compliance employees might discover valuable information that the firm can use to generate new business. For example, the compliance department could offer the sales team information about a high net-worth client's major shareholdings, connections to other high-net-worth individuals, and other useful information.

If banks fully explore all of these opportunities to enhance their compliance operations, the compliance department will no longer be the firefighters, but the forecasters instead.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.