



COMPLIANCE RISK OVERSIGHT: ORGANIZATIONAL CHALLENGES FOR BANKING BOARDS IN LATVIA

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Introduction

The purpose of this paper is to examine the use of systemic approach and compliance management system as an organizational framework for the compliance risk management from a theoretical perspective and practical application.

Last year at the conference author presented review [1] of the compliance risk definition in Latvia where compliance regulatory framework had been introduced in 2007. Taking this somewhat further, this paper research some important organizational aspects of the compliance risk management and how the Latvian regulatory requirements use approaches espoused in the literature.

Research is limited by the fact that it considers one financial sector system (banking). Bank based system still dominates in most of continental Europe [2] and Latvia, where banks have 92.4% of total financial sector assets [3]. Banking sector in Latvia is presented only by commercial banks and two other types namely savings and co-operatives don't exist [4].

Traditional compliance organizational structures are crumbling under the weight of ever-increasing regulations that drives greater accountability and transparency. Leading Banks are on the forefront on building new and improved structures that support and enhance this new compliance environment, and best practices are emerging [5]; [6]. The complexity of banking business and compliance function urges compliance and other bank managers to use the concepts of “systemic thinking“, the bases of the new management culture of the twenty first century [7]. There appears exist a common approach that makes it possible to understand better and describe better the organized complexity – “systemic approach” that rests on the conception of “system”.

Banking as any other business process is a socio-technical system, executed by humans and machines. Research problem of this paper is compliance management system in order to organize and manage human part of the banking business process in area of compliance. Basel Committee survey [8] confirmed that regulators in some countries promote use of such system as a compliance organizational framework. Compliance management system in a context of organization consists of three interdependent elements: Board oversight, compliance program and compliance audit program.



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In general the expectations for compliance risk management in banks are consistent with the principles outlined in a paper issued in April 2005 by the Basel Committee on Banking Supervision (BCBS) [9]. The high-level principles have become widely recognized as global sound practices for compliance risk management and oversight, and the regulators [10]; [11] different countries including Latvia endorse these principles that mainly contain *what* and *why*. While the guiding principles of sound risk management are the same for compliance as for other types of risk, the management and oversight of compliance risk presents certain challenges as banks appear to be totally averse to risks related to compliance [12]. Unfortunately, there are no off-the-shelf formulas for compliance risk management. The complexities of each compliance issue and the unique circumstances of every bank make understanding compliance risk management challenging [13] and compliance risk management process and systems are ultimately only strong as the people controlling them [14].

The current global compliance risk regulatory framework can be summarized in one sentence: compliance function must be established to manage compliance risk. But how compliance function needs to be organized and structured? Survey organized by Basel Committee [8] confirmed that this is one of the major issues for small and medium size banks and therefore relevant to many banks in Latvia. The Basel Committee and literature do not offer definitive answers to this question since there is no “one size fits all” approach. Neither is it easy task to identify what constitutes a good compliance function’s organization.

It makes sense to assume that appropriately designed and implemented compliance management systems aimed at establishing compliance responsibilities, communicating those responsibilities to employees and stakeholders, ensuring that responsibilities for meeting legal requirements and internal policies are incorporated into business processes, should improve compliance. Currently empirical evidence reported in literature is far from supporting this claim, but this paper provide theoretical basis for compliance management system promoted by regulators.

To the best of the author’s knowledge, there are no papers empirically examine theories for construct of compliance management system in a context of compliance organization. It is of interest to regulator and Banking boards in Latvia to consider the use of such system for compliance risk organizational structure.

The presented research finds that the Latvian regulator sets up requirements for compliance function, but regarding its organization address only small fraction of the dimension that literature considers important. The Latvian banking regulator has made supervisory councils (no executive functions) as an integral and important part of its compliance regulatory framework. Council is similar construct to the Board that is widely used in literature. Regulator doesn’t provide oversight framework and tools for assessment of the supervisory council’s effectiveness. Concept of system is used mainly concerning internal control and program approach is not offered.

The paper is organized as follows. First the compliance function is reviewed, then role of compliance in corporate governance discussed. In section 3 theories of complexity, organizations and systems reviewed as a theoretical background and application of systemic approach described. Section 4 reviews the best practice. Section 5 concludes.



Discussion and Literature Review

1. Compliance Function

The compliance literature (Bryant, 2004 [15]; Haynes 2005 [16]; Apreda, 2006 [17]; Bauer, 2007 [18]; Mills, 2008 [19]; Birindelli 2008 [20]) and surveys (Basel Committee, 2008 [8]; European Commission, 2009 [21]) maintains compliance function as the function that should facilitate the implementation and maintenance of the compliance culture, arrange for or provide compliance framing, advise on regulatory matters, conduct monitoring, maintain lines of communication with the regulator, handle regulatory issues, conduct reviews, provide reports and guidance to management, assist in identifying, assessing and managing regulatory risk, manage internal, external and inter-relationships, and turn regulatory burden into competitive advantage (e.g. such as recommending IT solutions, regulation and guidance). In general terms, the inter-relationships for the Compliance function are: the Board of Directors has the responsibility for overseeing the management of the compliance function; Senior Management is responsible for establishing a compliance policy and a permanent and effective Compliance function. Some regulators [8] promote two levels of compliance function: 1) operational and 2) oversight that is independent from business.

In Latvia, the bank regulator is the Financial and Capital Market Commission (FCMC). Similar to other bank regulators, it must decide on compliance regulatory framework. The analysis of the FCMC requirements confirmed that such framework is defined in two laws [22]; [23], three regulations [24]; [25]; [26] and non-binding guidance (handbook) [27]. Author finds that FCMC requirements regarding the compliance function is similar to Basel Committee recommendations and reflect to the wording and spirit in compliance literature. A risk management framework in Latvia consists of at a minimum the following three internal control functions: Internal Audit, Risk Management, and Compliance. The roles of each of the respective functions along with the Board of Directors, Senior Management, Compliance Staff and Business Unit personnel, all have a part to play in contributing to the overall success of the three internal control functions as they form an effective risk management framework. Latvian regulator FCMC doesn't distinguish levels of compliance function.

2. Corporate Governance and Compliance Responsibilities of the Banking Boards

The compliance functions starts at the top. How banking boards can fulfill compliance oversight function and what kind of framework they can use for that? The general understanding of corporate governance is needed before to look for answers to this question. Corporate governance is a very general phrase and refers to the process and structure used to direct and manage the business. Cadbury Report [28] says: "the system by which companies are directed and controlled". Hardoiun [29] emphasizes that the governance of the financial sector goes through two channels. One is the general organization and regulation of the sector. Governance depends first from the framework defined by the regulator [30]. The other channel is corporate responsibility. After the recent financial crisis, Basel Committee on Banking Supervision (BCBS) and European Banking Authority (EBA) have called attention to the need to improve corporate governance of financial entities and issued new guidelines [31]; [32] endorsed by local regulators. Now regulators more than ever believe an efficient compliance function is a prerequisite for good corporate governance that should restore trust, integrity, and responsibility



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in the banks. They believe that compliance is key facet of governance because it shows how actually bank meets corporate responsibilities. Regulators especially advocate a governance structure composed of Board of directors and senior management that are responsible for overseeing the management of the bank's compliance risk and effective compliance function. The BCBS is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. The notions of the board of directors (some countries including Latvia supervisory board) are used not to identify legal constructs but rather to label two decision-making function within bank.

Several scholars (Handley-Schachler et.al [33], de Andres and Vallelado [34]) in their extensive banking corporate governance literature reviews found that there are many studies on corporate governance, but only few papers focus on bank's corporate governance (Ciancanelli and Reyes, Macey and O'Hara, Levine, Adams and Mehran, Caprio et al.). The literature emphasizes that regulation distinguishes the banking industry from other industries and presents several challenges in the field of corporate governance. Regulation can be considered an additional mechanism of corporate governance, but in most situations it reduces the effectiveness of other mechanisms in coping with corporate governance problems. The main aim of the regulator, which is to reduce systemic risk, might come into conflict the main goal of shareholders, which is profit. Corporate governance in banks plays a special role due to the uniqueness of the organizations. Studies above acknowledge the existence of difficulties, such as complexity and intense regulation, in the corporate governance of the banks. The reasons stated consider that bank board becomes a key mechanism to monitor managers' behaviour and to advise them. McIntyre [35] suggests that regulators can expect more from banking boards.

Recent corporate governance empirical literature beyond traditional topics such as: board size and composition, performance and compensation, has focused on effectiveness of the banking boards. Belkhir [36] using panel data set of nearly 170 banks found that there is no evidence in banking organizations that smaller boards are more effective, and induce an increase in performance. Andres [34] indicated that board members' specific knowledge of the complexity of the banking business enables them to monitor and advise managers efficiently. Careta [37] offers a model to assess the effectiveness and compliance of bank boards. He concluded that regulatory recommendations alone are not sufficient to guarantee board and director effectiveness and focused on two major drivers of board effectiveness. Board level drivers refer to size, composition, duality, committees, meetings, incentive schemes and management information reporting systems. Individual drivers refer to competencies and commitment of directors, who should develop and maintain appropriate level of expertise as the bank grows in size and complexity. Regarding compliance Corporate governance regulatory arrangements require from the boards two major things: 1) establishment of the compliance function and 2) oversight of the management of the bank's compliance risk. According risk regulations there should be a compliance framework and a common language to discuss risk issues.

The analysis of the FCMC requirements confirmed that Latvian regulator FCMC obliges the banking boards to perform compliance risk oversight by approving compliance risk management policy and at least once a year to assess the effectiveness of the compliance risk management. Regulator doesn't offer particular oversight framework or mechanism.



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Compliance officer should help Board to design oversight mechanism and therefore author aims to design board compliance empirical oversight model based on theory and best practises.

3. Applying Theories for Compliance Management System

There is a need to review some basic theories covering corporate (organizational) governance, before to offer compliance management system as an oversight model. Theories broaden appreciation of organization and the world in general and open mind to new ideas and possibilities for change and transformation.

3.1. Compliance and Complexity Theory

“The world is getting more complex” [7]; [38]. Globalization and technology developments are mentioned as main drivers for the high level of complexity. De Andres and Valledo [34] analyzed studies of Furfine, Levine, Morgan and concluded that complexity of the banking business increases the asymmetry of information and diminishes stakeholder’s capacity to monitor bank manager’s decisions. Complexity greatly aggravates the governance problem and requires a board not only to monitor managers efficiently, but also to give them access to independent and valuable advice to run the bank.

Compliance complexity arises from several factors. As human society becomes more complex, the complexity of regulation also increases. Compliance as an element of order follows the same development as regulation [39]. Compliance organizational complexity is related to the fact that regardless of the compliance functions origin and make-up, regulators are demanding that compliance is built into the business process. From the risk management this requires to organize in bank three lines of defence where compliance risk taking is business unit’s responsibility.

How better understand organizational complexity? Complexity theory has been used extensively in the field of strategic management and organizational studies. The theory treats organizations as collections of strategies and structures. Anderson [40] in his extensive literature review found that since the open-systems view of organizations began to diffuse in the 1960s, complexity has been a central construct in the vocabulary of organization scientists. Theory has treated organizations as an enormously complex (Daft and Lewin) and defined complexity as a structural variable that characterizes both organizations and their environments. With respect to organizations, Daft [41] equates complexity with number of activities or subsystems within organization, noting that it can be measured along three dimensions. Vertical complexity is the number of levels in organizational hierarchy, horizontal complexity is number of job titles or departments across organization, and spatial complexity is the number of geographical locations. Organization design tries to match the complexity of organization’s structure with the complexity of its environment and technology [42]. Anderson [40] noted that both social scientists and people in organizations reduce a complex description of an organization to simpler one by abstracting out what is unnecessary or minor. To build model is to encode a natural system into a formal system, compressing a longer description into a shorter one that is easier to grasp.

3.2. Applying Organization and System Theory in Business

Organizational theory and management philosophies have undergone a dramatic change since 1960s with the emergence of the systems approach to management. Ascher [43] notes that



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this theory was developed to account for very wide range of organizational behaviors and problems and is the systematic study and application of knowledge about how people – both as individuals and as groups – act within organizations. Willmot [44] analyzed development of the organization theory during the 25 years. He observes that theory is framed by meaning attributed to the particular concepts – such as “structure”, “role”, “process”. Modernist organization theorists focus on how to increase efficiency, effectiveness and other objective indicators of performance through the application of relating to structure and control. Organization theory addresses the problems regarding complexity and organizational reactions to the complexity. Organizations cope with complexity through various modes of structure and adaptation, including departmentalization, specialization, strategic planning, etc. Ascher [43] argues that organizations need to cope with complexity through coordination. Organization theory not only supports the technical aspects of operations, but explains their socio-cultural aspects as well.

In the early of sixties practitioners were able to translate the general systems theory of Boulding and Bertalanffy into meaningful business theory that could be applied to business-world problem solving. In 1967, Johnson, Kast and Rosenzweig [45] defined business organization as a man-made system which has a dynamic interplay with its environment – customers, competitors, labor organizations, suppliers, government and many other agencies. J. de Rosnay [46] in his famous book (1979) wrote that according to the most widely used definition, “a system is a set of interacting elements that form an integrated whole” and the fundamental concepts that recur most often in the biological, ecological, and economic models can easily be grouped into several major categories: energy and its use; flows, cycles, and stocks, communication networks; catalysts and transforming agents; the readjustment of equilibriums; stability, growth, and evolution. Each of these concepts applies to the industrial company [bank] as well as. Beyond the vocabulary, the analogies, and the metaphors there appears to exist a common approach that makes it possible to understand better and describe better the organized complexity. This approach is called the *systemic approach*, and this is the approach that presented as the concept of the macroscope. The systemic approach rests on the conception of system. It is not to be considered a “science”, a “theory”, or a “discipline”, but a new methodology that makes possible the collection and organization of accumulated knowledge in order to increase the efficiency of our actions. The concept of system appears in two complementary aspects: it enables the organization of knowledge and it renders action more efficient. The most complete definition: “a system is a set of elements in dynamic interaction, organized for a goal”. Several other scholars [47];[48] in their comprehensive reviews of the literature (A. Holl, R. Feigin, J. Kleer, R. Acoff, V. Sadovsky and others) on systems found similar system definitions and descriptions of the systemic approach. The exact definition of system depends on the users, environment, and ultimate goal. J. de Rosnay [46] defines complexity by using two important factors: the variety of elements and the interaction between elements.

Application of the system theory to business created a management technique that is able to cut across many organizational disciplines – finance, marketing and so on – while still carrying out the functions of management. This technique is called **systems management**, project management or matrix management. Practitioners of system management redefined the hierarchy of systems first proposed by Boulding [49]. The information extracted from Alvin Kayole by Kerzner [50] summarizes in his famous book: the upper level systems include the universe, solar



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system and earth. The second level is environmental level and includes those effects that may result from economic, social, political, legal, and technological conditions. The third level is the business firm system. The purpose of such system is to develop relationships and channels between organizational resources; to obtain information; to assist in the decision-making process; to be a link between the organization and the environment. A variety of business systems and subsystems can exist within organization: organization systems; information systems, financial information systems and etc. Systems are collections of interacting subsystems that either span or interconnect all schools of management. Military and government organizations were the first to attempt to define clear boundaries of systems, programs, and projects. Programs can be construed as the necessary first-level elements of a system and literature define it as the integrated, time-phased tasks necessary to accomplish a particular purpose. Programs can be regarded as subsystems. However, programs are generally defined as time-phased efforts, whereas systems exist on a continuous basis. Projects are also time-phased efforts, but much shorter than programs and are first level of breakdown of a program.

3.3. Application of the Systemic Approach

Certainly there has been a revolution in our way of thinking; what now are the practical uses to which we can put it? Beyond the simple description of the systems of nature it leads to new methods and rules of action. The construction of models and simulations are among the most widely used methods of the systemic approach [46]. Curtis et al. [51] lists five modeling goals: to facilitate human understanding and communication; to support process improvement; to support process management; to automate process guidance and to automate execution support. Warboys et. al [52] divided models up into five characterizations, which overlap: Static models; Dynamic models; Passive models; Active models; Enactable models. They wrote, “Models, either physical or graphical, provide a way of mapping and preserving a clear relationship between model and real world subject” and then listed four things that are necessary for model to exist: the part of the reality that is subject modeled; the model itself; the relationship between the model and the subject modeled; and an observer, user or creator of the model. A model is a planned abstraction of reality represented in a form that is usable by a human. Author aims to construct compliance oversight model and therefore it is valid to draw some conclusions from deRosnay [46]: “The more complex a system, the more complex its control system must be in order to provide a “response” to the multiple disturbances produced by the environment. This is the *law of requisite variety* proposed by Ross Ashby in 1956. This very general law asserts in mathematical form that the regulation of a system is efficient only when it depends on a system of controls *as complex as the system itself*. In other words, control actions must have a variety equal to the variety of the system. Not surprisingly regulators more and more stress a need for efficient internal control system and governance, where compliance plays a big role.

3.4. Practical Application of Systemic Approach and Compliance Management System in Banking

Regulators are demanding that compliance is built into the business process. Shaw et al. [53] define a business process as a socio-technical system, executed by humans and machines. Compliance management systems are widely used term by technology providers



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Several scholars [54]; [55] analyzed the automation of compliance with laws mandating risk management. Compliance technology products – known generally as “governance, risk, and compliance” (GRC) software grew tremendously. The main conclusions by Bamberger [55]: “While these technology systems offer powerful compliance tools, they also pose real perils. They permit computer programmers to interpret legal requirements; they skew decision making through an automation bias that privileges personal self-interest over sound judgment; and their lack of transparency thwarts oversight and accountability. These phenomena played a critical role in the recent financial crisis.” In authors view such systems are an expensive and not efficient for a small and medium size banks. Compliance is complex because involves behavioural business processes – fundamentally different than more transactional and structured processes within organizations [56]. The role of human system is more important in compliance risk management.

The use of systemic approach is not a new in Latvian banking. Solovjova [49] defined and constructed model “Komerbanku sistema”. Author performed analyses of Latvian compliance regulatory framework and found that term system is used mainly in context of internal control system. The term program is not used at all. Due to limitation of this paper the separate discussion is needed regarding above mentioned analyses.

4. Best Practice and Compliance Management System in US

Some banks may still be considering how they will structure the compliance function going forward and Caret et. al [37] in his board effectiveness model offers best practice as one of the tools. To truly be considered a “best practice”, a practice would need to have a great deal of history and consensus from many users. The United States (US) has the longest history for the compliance function of any country. The compliance in US started in 1930th and therefore could be looked as place for a “best practice”. The US banking regulators all defined compliance management system as framework for compliance function.

The Office of Comptroller of currency (OCC's) was established in 1863 and have primary mission to charter, regulate, and supervise all national banks and federal savings associations as well as supervise the federal branches and agencies of foreign banks. The Federal Deposit Insurance Corporation (FDIC) is an independent agency created 1933 by the Congress to maintain stability and public confidence in the nation's financial system.

OCC first in 1996 and FDIC in 2009 introduced requirements [57]; [58] regarding compliance management system and defined such system as the method by which the bank manages the entire compliance process. A compliance management system is how an institution: 1) learns about its compliance responsibilities; 2) ensures that employees understand these responsibilities; 3) ensures that requirements are incorporated into business processes; 3) reviews operations to ensure responsibilities are carried out and requirements are met; and, 4) takes corrective actions and updates materials as necessary.

An effective compliance management system is commonly comprised of three interdependent elements:

- 1) Board and management oversight;
- 3) Compliance program; and
- 3) Compliance audit.



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When all elements are strong and working together, an institution will be successful at managing its compliance responsibilities and risks now and in the future.

Conclusions

Compliance function must be established to manage compliance risk in banks. FCMC requirements regarding compliance function is similar to Basel Committee recommendations and reflects to the wording and spirit in compliance literature.

The Basel Committee and literature do not offer definitive answer to the question how the function should be organized and structured.

The literature confirms that banking business and compliance function as a part of it is very complex business and as any other business process is a socio-technical system, executed by humans and machines. Literature concludes that due to information asymmetry banking business is very complex. The role of Board of directors in the bank plays a more important role as in other organizations. Complexity greatly aggravates the governance problem and bank board becomes a key mechanism to monitor manager's behavior and advise them.

Effectiveness of the banking boards is one of the hot issue in current debate in cooperate governance literature and evaluation models are offered. The best practice is among the evaluation tools.

The compliance management system (CMS) is promoted by few regulators as a compliance framework to better perform their oversight of the compliance function. The two levels of compliance function is recommended: oversight and day-to-day.

The compliance literature confirms that CMS could mean different things for different people. Literature critically appraises the potential of technological compliance management systems, but the empirical evidence is not provided regarding compliance management system as part of socio system. Regulators define such system as system that has three interdependent elements: Board oversight, Compliance program and Independent audit.

Complexity, organization and system theories support those regulators that are promoting compliance management system as an organizational framework. Organization theory argues that organizations need to cope with complexity trough coordination. Complexity theory treated organizations as an enormously complex and define complexity as a structural variable that characterizes both organizations and their environments. The system theory offers systemic approach that makes possible to understand better and describe better the organized complexity. According system theory: a system is set of elements in dynamic interaction organized for a goal. Theory defines complexity by using two important factors: the variety of elements and the interaction between elements. A variety of systems and subsystems can exist within organization. Systems are collections of interacting subsystems. Programs can be constructed as the necessary first-level elements of a system and generally defined as time-phased efforts, whereas systems exist on a continuous basis. Projects are also time-phased efforts, but much shorter than programs and are first level of breakdown of program.

The construction of models and simulations are among the most widely used methods of systemic approach. A model is a planned abstraction of reality represented in a form that is usable by human. Models could exist either physical or graphical.



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In some ways, theory supports creation of a compliance management system as model that could be used to better deal with organized compliance risk complexity.

The US best practice confirms that compliance management system exists and could be used as a benchmark for designing model for particular bank.

The FCMC compliance framework provides mixed feeling regarding use of systemic approach and concept of systems. Concept is proposed for internal control system that is described as set of elements and could be presented as a graphical model. Systems or systemic approach is not used for compliance function. The regulatory framework offers only in one occasion term program for staff training.

Further research is needed to review how actually besides the FCMC regulatory framework banks in Latvia are using compliance management system.

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