



## COMPLIANCE COMMITTEE

### COMPLIANCE FUNCTION IN BANKS

#### BASIC CONCLUSIONS ON ORGANIZATION AND RESPONSIBILITIES

Widely set definition of the compliance function in the Croatian *Credit Institutions Act (CIA)* combined with numerous and various types of tasks put upon Compliance Departments/Officers (**Compliance**) have resulted in different set-ups and responsibilities of Compliance in the banks. On the other hand, Compliance Committee of the Croatian Association of Banks (**Committee**) is a common body of the member-banks with the task to represent common standpoints of the members. It is therefore useful to establish common basic conclusions of the Committee concerning the organization of Compliance and the role of Compliance, as a starting point for addressing practical issues and continuing with the development of the Compliance function in banks.

Common conclusions are based on the laws and regulations currently in place and the documents of the Basel Committee on Banking Supervision.

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- 1) There are differences in the way Compliance function is understood and regulated in Croatia compared to other countries. Although there are many similarities, tasks done by Compliance and the manner in which they are done may vary depending on the country and/or bank.**

In banking legislative of some countries such as Austria, Czech Republic or Slovenia, Compliance function is not singled out as a separate control function. In Croatia, Compliance function is explicitly defined in the Croatian *Credit Institutions Act*, and its set-up, principles of functioning, reporting and supervision are prescribed in detail in the regulation issued by the Croatian Central Bank. Depending on their size, banks determine the way in which certain compliance related tasks are going to be performed which may result in larger or smaller involvement of the Compliance depending on appropriateness and available resources.

- 2) Compliance function is performed by the entire credit institution and is not to be identified only with the Compliance Department/Officer.**

Banks must carry out their business in compliance with hundreds of specialist internal and external regulation, they must apply thousands of regulatory/industry requirements originating from tens of more or less specialized areas. Because of that, tasks belonging to Compliance function, bearing in mind wide definitions contained in Croatian *Credit Institutions Act* and the pertaining *Decision on the Internal Controls System*, cannot be under the responsibility of just one organizational part/person in the bank. Compliance represents responsibility of managing bodies and senior management of the bank and is the obligation of all employees. The way in which banks generally protect themselves from the risk of non-

compliance is in employing specialists for specific areas and forming organizational units. If provisions of the *Credit Institutions Act* would be construed so that compliance or control over compliance with all the applicable laws were the responsibility of solely Compliance Department/Officer, this in practice would lead to increasing the risk of non-compliance, instead of decreasing it.

**3) Occasional lack of understanding of the role and tasks of Compliance function and /or Compliance Department/Officer results from a number of circumstances differing from one bank to another.**

Due to the fact that locally Compliance is a relatively new function in banks, and that the implementation of this function is not identical in countries whose banking groups have daughter-banks in Croatia, but also due to the wide definition of this function in Croatian *Credit Institution Act* and *Capital Markets Act* - unrealistic expectations towards Compliance from supervisors, auditors or management occasionally arise. These expectations might be unrealistic due to the fact that they exceed the capacities and abilities of one single department and/or person, or are of operational nature and therefore not in line with the controlling and advisory role of the Compliance function.

**4) Compliance departments in the banks are given tasks which are not prescribed as compliance tasks in Croatian *Credit Institutions Act*. Such practice is not necessarily incorrect, as long as such tasks are closely connected with the prescribed compliance tasks and as long as they are in line with the controlling/advisory nature of the Compliance function.**

Compliance function and Compliance Departments/Officers are relatively new concepts in banks and the understanding of the terms in this context is still not harmonized at the international or local level. In practice Compliance is often given the responsibility for additional tasks which are not explicitly provided for in the law. This includes areas such as ethics and code of conduct, conflict of interests, treating customers fairly, combating corruption, fraud prevention, protection of customer data and banking secrecy, fit and proper procedures, active role in remuneration policy implementation, corporate & social responsibility, FATCA etc. Such practice is not necessarily incorrect but such tasks must be closely connected with responsibilities and goals of the Compliance function and must be carried out in adherence with the controlling/advisory role of Compliance. Participation of Compliance in the business activity or in operational activities of the bank would be an incorrect allocation of the compliance tasks.

**5) When deciding on the human, technical and other resources for Compliance, the bank must take into account all the additional responsibilities allocated to Compliance besides those prescribed by the law (CIA). Size of the bank, type, volume and complexity of its business must also be taken into account.**

When determining the necessary resources, priority should be given to the coverage of the compliance tasks prescribed by the law. Only if upon adequately covering all the tasks defined in the law there is space and need, should Compliance be allocated other tasks. Generally, the compliance resources should be determined taking into account the size of the bank, type, volume and complexity of its business, combined with the number and volume of

tasks given to Compliance.

**6) Methodologies of identification and monitoring compliance can differ depending on the bank. No universal methodology is prescribed which would apply to small, medium and large banks or banks owned by domestic or foreign entities.**

Some banks have implemented methodologies resembling those used by operational risk specialists, some use self-assessment questionnaires, some analyze compliance risks through risk mapping, some are based on a simpler model of risk assessment. It is the responsibility of the Management Board in co-operation with the Supervisory Board and Compliance to implement the methodology most appropriate for each individual bank. Differences in methodologies used by different banks do not mean one is correct and the other is not. Monitoring of any kind of risk, including the compliance risk, mostly is not an exact science but depends on many factors whose type, significance and quantity changes and differs from one bank and/or banking group to another.

**7) Duty to observe regulations and to implement regulatory requirements rests with the senior management of the bank i.e. with the specialist business units composed of experts in the particular business area. Monitoring of the relevant regulatory developments by Compliance is necessary for the purpose of controlling that key regulation is observed and implemented by management and business units, as well as for the purpose of affirmation/popularization of compliant business operation and in order to add quality to determining and assessing compliance risk.**

Compliance, within the boundaries of its tasks in a bank, monitors regulations and regulatory requirements for the purpose of controlling the business units which are the first line of defense of bank's compliance. Business specialists must organize and execute their job in adherence (compliance) with the rules governing their profession. Setting-up of the Compliance function in banks in the manner that only the Compliance Department/Officer monitors the laws, regulations and regulatory requirements, or that only the Compliance informs the Management Board and the business units of it, would contribute to turning Compliance into the support unit which Compliance should not be, and leads to decrease of Compliance's ability to perform its control function. Monitoring of regulatory developments is a part of the Compliance duties with the aim of determining and identification of compliance risks, as well as for the purpose of advising, initiating appropriate topics and raising awareness regarding the necessity of being compliant.

**8) Managing of the operational process of becoming compliant with a specific law or regulation and regulatory requirement, as well as the internal responsibility for becoming compliant should not be in Compliance Department's/Officer's domain.**

Organizing the process of becoming compliant with regulatory requirements and its implementation is not a novelty. Banks have been doing it from their beginnings. The increase of regulatory requirements in last decades has resulted in the enlargement of the existing or forming of new organizational units whose tasks are conditioned by, and depend on, this new regulation. Specialists in these organizational units have the knowledge that enables them to monitor regulation which covers issues falling in scope of their

responsibility. They have the knowledge necessary to understand this regulation and its effects on the business and the processes in their bank, and the knowledge to implement the new regulation and set a system of internal controls on the “first level of defense” to provide for compliance. The ratio of introducing the Compliance function into banks was not to allocate the responsibility for becoming and being compliant to one single organizational unit. If, within a bank, Compliance Department/Officer was to be responsible for compliance of the bank with all laws and regulations, such arrangement would undermine the impartiality of Compliance in a part of determining and assessing the compliance risk. Namely, Compliance would manage the bank’s process of becoming compliant or would confirm compliance and then control the very process. This would be a clear example of conflict of interests. The responsibility for compliance and compliance risk is present at all levels of the bank and each employee, manager and organizational unit has its role and task in this process.

**9) Methodology of the Compliance function i.e. Compliance Department/Officer is not identical to the methodology of the Internal Audit**

Compliance function is not just a sub-variety of Legal/Regulatory Audit. It is a completely different function having different aim and operational tasks than Internal Audit. While with Internal Audit the accent is on *ex post* control and Internal Audit does not as a rule participate in *ex ante* activities linked to bank’s becoming compliant, Compliance puts the accent on the *ex ante* activities covering not only controls but also informing, advising and raising awareness. This does not mean that Compliance does not perform *ex post* compliance controls, but the type of activity, methodology of work and scope of controls performed by these two functions are different.

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