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TAILORING COMPLIANCE RISK

AND THE COMPLIANCE FUNCTION

FOR NON-FINANCIAL ORGANIZATIONS

[A step further and beyond the Basel´s Proposal for Banks]

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ABSTRACT

This paper contends that compliance risk and the compliance function are powerful devices to enhance corporate governance not only in banks but in any other organization as well. Firstly, it reviews the contribution made by the Bank for International Settlements (BIS), which pertains to financial institutions only. Next, it upholds that compliance risk actually matters in any corporate governance environment. Afterwards, it deals with how the compliance function can be shaped so as to grant, on the one hand, its own independence and, on the other, clear-cut patterns of accountability behavior. Subsequently, it points out that there are some drawbacks in the BIS´ choice of governance principles. Lastly, it brings forth a set of governance principles for both compliance risk and the compliance function in financial and non-financial organizations alike.

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Key words: compliance risk, compliance function, accountability, corporate governance, banks governance, accountability.

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INTRODUCTION

In April 2005, the Bank for International Settlements at Basel (BIS) issued a paper under the title of *Compliance and the Compliance Function in Banks*[1].

Let us review how BIS introduced the two key notions delivered in the above-mentioned report. To start with, **compliance risk** comes defined as

the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities[2].

Afterwards, the BIS says that the **compliance function** [3]amounts to

staff carrying out compliance responsibilities[4].

There is no denying that both notions are distinctive and relevant in governance analysis. However, a certain number of questions come to my mind and the paper will attempt to find out plausible answers to each of them:

a) Are compliance risk and the compliance function tools to be only used for the improvement of banks' governance, or could we also profit from them when dealing with Corporate Governance issues that concern to any sort of private organization?

b) How would it be possible to lay foundations for the compliance function so that independence from internal auditing, even from management, it might be granted in practice?

c) What kind of accountability is to be expected from this function?

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[1] There was a preliminary draft issued in 2003 under the title of *The Compliance Function in Banks*, which was intended as a consultative document.

[2] As a shorthand, the Bank substitutes the expression "*compliance laws, rules and standards*" for likely settings on which failures in compliance may arise eventually.

[3] In the preliminary draft issued in 2003, the compliance function came defined as "*An independent function that identifies, assesses, advises on, monitors and reports on the the bank´s compliance risk.*"

[4] The Bank remarks that the compliance function should stem out of a set of governance principles that we are going to review later in this paper.

To expand on these ideas and frame a coherent set of answers, we are going to meet the following agenda:

In section 1, the BIS proposal will be briefly surveyed. Afterwards, it will be for section 2 to uphold that compliance risk becomes an issue closely related to any governance purposeful design. Section 3 will raise the problem of how compliance risk distinguishes itself from risk management. Next section will address the double-edged problem of how the compliance function can preserve its independence from the audit function, and to whom it should be held accountable.

Section 5 will discuss which are the principles of governance introduced by the BIS so as to build up compliance risk and the compliance function in financial institutions, bringing into view some pervasive downsides that arise from such approach. Last of all, and in section 6, we are going to provide a set of governance principles to match the many-sided requirements of financial and non-financial organizations alike.

1. THE BIS PROPOSAL

Failure to comply with laws, rules and standards seems a likely risk that most of financial institutions run as a matter of course in their everyday activities. Any attempt to avoid or redress the consequences of such lack of compliance seems healthy, and the Basel bank's proposal comes in handy to meet this long-standing problem.

Another rationale for being concerned with compliance risk in banks, it stems from customers' illegal activities in which the bank could become involved (for instance, tax avoidance, money laundering, international terrorism activities and political corruption).

After defining compliance risk, the BIS sets forth a managerial function that it could discharge compliance responsibilities, making a case for giving latitude to banks on how this function should be designed and put into practice. Accordingly, the BIS agrees that some banks[5] would prefer to have the compliance function as a component of the more general operational risk function, while other may split the tasks eventually. However, and in the broadest sense, stress is laid upon independence as well as full measure in resource endowment. We

[5] The BIS's proposal covers ordinary banks, banking groups, even holding companies whose subsidiaries are dominated by banks.

must bear in mind that the underlying governance structure assumed by the BIS consists of a Board of Directors and Senior Management[6].

Finally, the BIS's paper provides a collection of principles of governance linked with compliance risk and the compliance risk function.

2. COMPLIANCE RISK ALSO MATTERS IN CORPORATE GOVERNANCE

If we move upon the private realm, where organizations meet together in their transactional environments and are subject to complex networks of stakeholders, we must ask ourselves whether compliance risk bears for them any seemingly relevance eventually.

Let us summon again how the BIS's defines compliance risk:

the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities

Surely, the gist of this definition will be preserved if we attempt a broader framework for this truly consequential notion:

compliance risk means the risk of sanctions, or material loss of any kind, that any organization may go through if it fails to comply with the manifold constraints of its institutional environment.

We have not only changed but also trimmed off the BIS´ definition, since material losses of any kind also include reputational losses, according to a broader meaning of "material", as the one conveyed in the Black´s Law Dictionary which states that the word material means, in general, *"having some logical connection with the consequential facts"* and, in particular, "*of such a nature that knowledge of the item would affect a person´s decision-making process."*

It is noteworthy that laws, regulations, rules, related self-regulatory organization standards as well as patterns of behavior, all of them actually pertain to the institutional environment within which any

[6] Or their equivalent counterparts whenever we deal with different institutional backgrounds.

organization strives towards the fulfillment of its goals[7]. But such background is much more variegated for non-financial enterprises, including features like conventions, international regimes, gatekeepers monitoring and punishing, as well as environmental damages. We have to bear in mind that the financial system is usually restrained by tight regulation all over the world. In contradistinction with this setting, in the non-financial sector we find out broader degrees of self-governance.

Hence, it becomes apparent that compliance risk does actually matter in corporate governance, whatever the kind of organization we are interested in.

3. COMPLIANCE RISK AND RISK MANAGEMENT

Once we lend credence to compliance risk as a suitable subject in governance studies, we must give heed to the following issue:

- How does compliance risk become distinctive and separate from risk management in general, even from the tasks other centers in the organization carry out to cope with their specific risks?

For certain, almost every center[8], or department, within a modern organization meets with risk exposure, which calls for surveillance, prevention and outright expenses. The subsequent classification is only didactic and by no means intends to be complete.

a) **Production, administrative, and distributional centers**

It goes without saying that centers and departments run manifold risks whenever companies arrange to purchase insurance. There are many kinds of insurance contracts, among which we can notice:

- accident (that usually covers theft and a wide range of liability risk);

[7] By institutions, it will be meant throughout this paper and following Douglas North (1990), "the rules of the game in a society or, more formally, (they) are the humanly devised constraints that shape human interaction".

[8] Why do we not directly use the expression "department"? In fact, sometimes it is more convenient to give heed certain center that belongs to a definite department, since the former could face particular kinds of risk not shared by other centers in the same department.

- property and liability insurance (as a matter of course, multiple-line coverage except life and fire insurance);
- engineering, labor and health insurance;
- life and fire insurance;
- fidelity (against breach of contract and dishonesty losses);
- weather and lighting insurance, even political insurance (mainly in developing countries).

Closely related to governance issues, companies take out contingent contracts to cover their Directors and Managers from liability actions from third parties. Besides, in transitional or developing countries, it is customary to buy insurance on risks of kidnapping, or to prevent political disruptions like property forfeiture and populist-socialist measures intended to grab companies' assets or earnings.

b) **Trading risks**

When any company gets access to its inputs or sell its outputs there are risks arising from the underlying market transactions. Therefore, organizations must curb their risky positions with instruments other than insurance policies. Such trading environments call for the so-called "derivatives markets", through the use of futures and forwards contracts, options, swaps and, in general, bundles of these elementary financial instruments to tailor up highly complex and distinctive "combos" to shield companies from risk.

Among the main types of risk that stem from trading and current operations, we can highlight the following ones:

- commodity prices;
- interest rates;
- financial assets prices;
- exchange rates;
- systemic risk from particular financial markets.

Therefore, and from the foregoing remarks a) and b), we can lastly assert that any company crossing a natural threshold of size, scope and scale for its operations, it must regard risk as a costly hurdle to be accounted for. And such endeavor will proceed, firstly, by means of an active involvement from each center bearing risk exposure and, secondly, by setting up a managerial function to cope with risk problems.

The discussion in progress shows that the governance of any organization has to make provision of how to design a safety net for risk exposure. Failure in addressing this single topic may impair the pursuit of growth, value creation, as well as the manifold purposes established in the foundational charter.

However, compliance risk is definitely another stuff. It grows out of an institutional background any time the company fails to comply with its manifold constraints, bringing about sanctions or material losses to the organization.

It is our contention that the management of compliance risk would be likely contested most of the time either from the Auditor's Office or the head of the Risk Management Center. Nevertheless, such intrusion might be prevented if we endow the concept of compliance risk with unequivocal focus. For this to happen, it should fulfil the following claims:

i) **topic**: could we tell what this concept is about?

ii) **scope**: does it have a specific scope of problems to deal with?

iii) **distinctiveness**: can a compliance center map out its features and goals in different ways as similar other centers do eventually?

In connection with the first demand, we suggested in section 2 a modified definition of compliance risk, which seems worthy of being recalled here:

compliance risk means the risk of sanctions, or material loss of any kind, that any organization may go through if it fails to comply with the manifold constraints of its institutional environment.

To put this another way, compliance risk deals with the hazards arising out of the manifold institutional constraints any company must comply with.

The definition also sheds light on the second question. In point of fact, compliance risk does not cope with expected hazards conveyed by production, administrative and distributional centers, still less on the wide-ranging scope of trading risks.

INTERNAL CONTROL MECHANISMS

- **Dependent from Senior Management** ⇒ ***Auditor's Office***
- **Independent from Senior Management** ⇒ ***Syndic's Office (or Supervisory Board)***
- **Internal to the Board of Directors** ⇒ ***Auditing Committee***
- **Dependent from Senior Management and the Board** ⇒ ***Compliance Function***

CONTROL LINKAGES

EXTERNAL CONTROL MECHANISMS

- **Private Sources**
  - ⇒ ***Statutory External Auditor***
  - ⇒ ***Risk-Rating Agency***
- **Public Sources**
  - ⇒ ***State Audit Office (or similar agencies according to law)***
  - ⇒ ***Central Bank***
  - ⇒ ***Securities Exchange Commission***
- **Reputational Agents *(gatekeepers)***
  - ⇒ ***Non Governmental Organizations***
  - ⇒ ***Institutional Investors***
  - ⇒ ***International Institutions***

Exhibit 1 ***Control linkages and the compliance function***

Now for the third question. When we give heed to the Auditor's tasks, it seems apparent that most of them bundle together within an *ex post* approach of compliance duties, at least from a clinical viewpoint[9].

Namely, the auditor must find out, and redress, either oversights, mistakes, any sort of wrongdoing, or misrepresentations pervading the internal network of relationships and commitments that take place in any organization.

As it follows from a standard definition, the main goal of the internal audit function is

to provide an independent appraisal function established within the company to examine and evaluate its internal control systems.

The frame of this definition is quite general[10], in spite of the fact that we have chosen, on purpose, the one that the Bank for International Settlements set forth in August 2002, when it issued a survey called: *Internal Audit in Banks and the Supervisor´s relationship with Auditors.* In that paper the BIS was foreseeing that sooner or later the compliance function would not be managed from the internal audit office, but as an independent function instead. In point of fact, this was accomplished in 2005 when it published the paper on *Compliance and the Compliance Function in Banks*.

In contradistinction to the Auditor's job, the compliance risk approach as well as its underlying managerial function should be regarded mostly as *ex ante* based. Hence, the clinical viewpoint for the compliance function focuses on the prevention of mistakes or failures in compliance matters, as well as the extent to which the company will exhibit responsiveness towards manifold institutional constraints.

Therefore, it is on the grounds of topic, scope and distinctiveness that compliance risk becomes a self-contained notion.

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[9] The expression *clinical approach* is far from being used here as a metaphor only; in fact, it has been proved itself widely helpful in organization theory. As Pranger (1965) put it: "*not only does the clinician [viewpoint] accepts the total, dynamic organization as his subject matter, passively seeing and listening, rather than actively manipulating, but also becomes absorbed in its problems as the subject for inquiry.*"

[10] It is focused on a modern approach by which the auditing function is not only concerned with financial statements.

4. INDEPENDENCE OF THE COMPLIANCE FUNCTION FROM THE AUDITOR'S OFFICE

The compliance function seems to be an innovative managerial function, but it raises at least three daunting queries:

- Provided that this function widely overlaps with the audit and the risk-management function, would it pay off to set it up as a new function instead of allowing the latter to carry out tasks and responsibilities claimed by the newcomer?
- To whom is the Compliance Function Office accountable?
- To what extent does the compliance function keep itself independent of the auditing function, even of the risk management function?

A first step to discuss the foregoing queries consists in finding out whether the complexity of the organization bears the expense of building up any kind of risk management center or a full-fledged audit department. It seems plausible that if we were the owners of a corner shop in the neighborhood, such an organizational design would be ruled out since it could be so expensive as to impair the minimal earnings from day-to-day transactions that grant the survival of any convenience store.

As for companies that already have an audit function, framing up compliance functions does not seem out of place although cost-benefit analysis and regulatory constraints should have the last word in this issue. Otherwise, the auditor ought to carry out the compliance function as a matter of course. All in all, it is for size, scope and scale to have the last word on this issue.

If we now draw our attention to the matter of accountability and independence, as **Exhibit 2** tries to depict, the following remarks should be underlined:

a) To all intents and purposes, the compliance function should fall under the scope of the Internal Audit Center, as it happens to any other center or department in the organization. In other words, a line of accountability starts from the Compliance Function Head´s Office to end at the Internal Auditor´s Office.

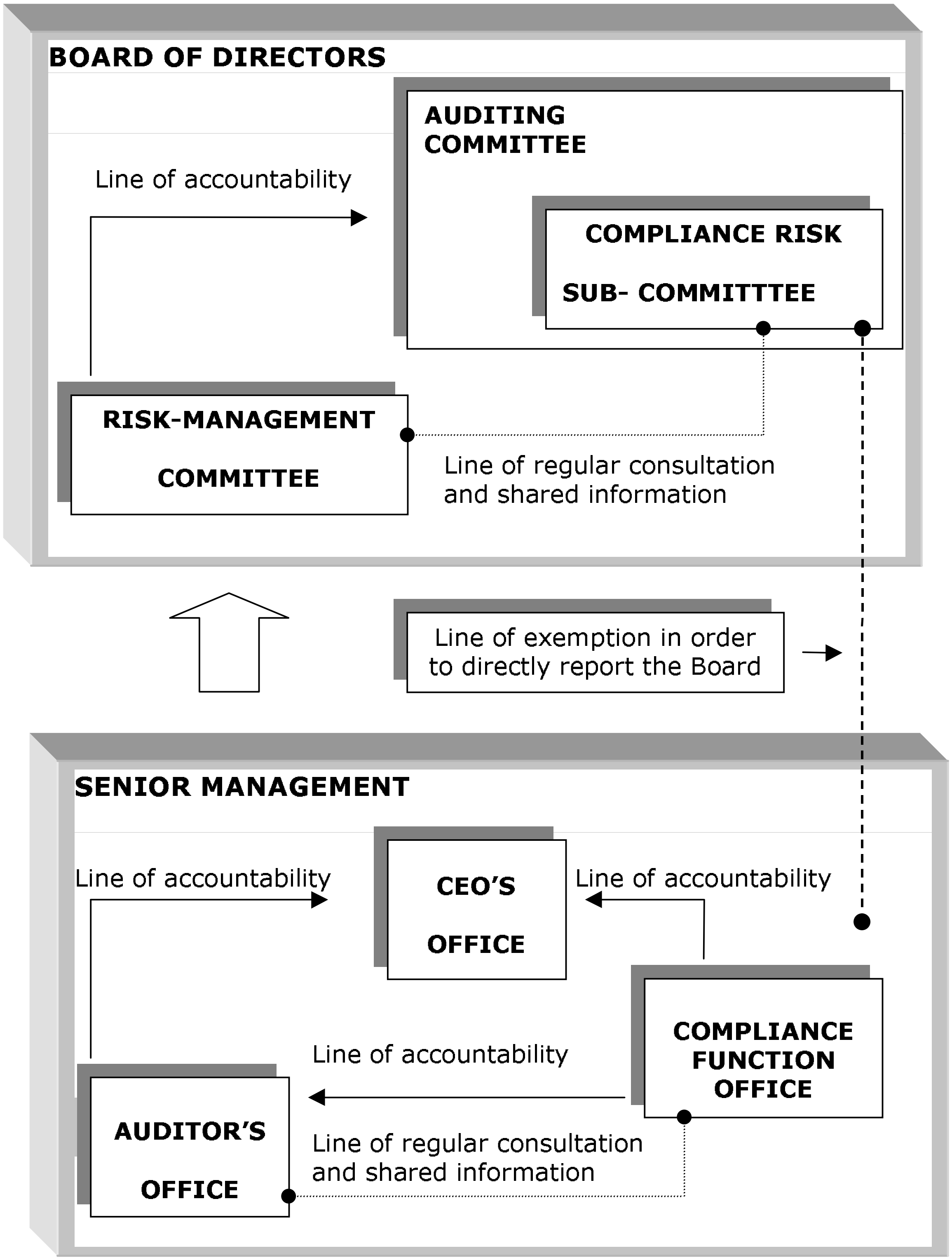

Exhibit 2 Lines of accountability, regular consultations and shared information, and the line of exemption granted to the compliance function office to report directly the Board of Directors.

b) However, there may be some sensitive topics on which the compliance function must report to the CEO´s office instead of the Auditor´s own. In this case, a line of accountability links the Compliance Function Head´s office with the CEO´s own.

To see how independence may become an in-built feature of the compliance function, three further qualifications must be added:

c) Generally speaking, independence means to not be under the control of any other body in the staff of the company. In a sense, overlapping with accountability lines would make impossible for the compliance, or any other managerial function, to become truly independent.

d) But independence also stands for capacity to perform expected tasks in a self-contained way, which comes closer to the current usage in Corporate Governance. Following this line of analysis, we are going to stress four key factors that make the compliance function independent:

- At staff level, it should be held accountable only to the Internal Audit Office and the CEO´s own.

- The Head of the Compliance Function Office is granted a statutory exception from reporting the CEO´s Office so that it could directly report the Board of Directors or its Auditing Committee.

- The Compliance Function Office must get unlimited access to any information regarded as relevant to meet its duties, from any other center in the company.

- The Board of Directors is to request and review a Performance Annual Report from the Head of the Compliance Function Office.

e) The foregoing four key factors are to be included in the Compliance Risk Charter. Our proposal bundles them in the Principle 5 (see section 6 and Exhibit 3).

5. BASEL PRINCIPLES OF GOVERNANCE FOR COMPLIANCE RISK AND THE COMPLIANCE FUNCTION

In the Basel's proposal, new principles of governance are predicated to lay foundations of compliance risk and the compliance function.

a) Principles concerning compliance risk

From the four principles that the BIS´proposal devotes to compliance risk, we bring forth the following features around them:

Firstly, it makes de Board of Directors in any bank responsible for managing compliance risk, approving the compliance function statute, designing a compliance risk policy, and assessing how well the bank is performing on this issue for at least once a year.

Secondly, it delegates the working of the compliance risk policy to Senior Management, which will be held on this regard fully accountable to the Board.

At this juncture, we can't help remarking that there are too many principles and, surprisingly, they overlap too much. In point of fact, it seems a sound methodology, as we are going to develop in next section, that principles should be enabling, the fewer of them the better, and they must not be mixed with good practices.

b) Principles concerning the compliance function

As regards the compliance function, four principles are displayed in the BIS´proposal, and we believe that some of their contents are in excess or redundant eventually. We are going to lay stress on two of them.

Principle 4: *The Management is responsible for establishing a permanent and effective compliance function within the bank as part of the bank's compliance function*.

If the compliance function intends to be managerial, then this principle stands out as redundant. In contradistinction, we are going to introduce a principle on Accountability that lays bare the fact that it is for the senior management to carry out the compliance risk charter and to be held accountable (see Exhibit 3, Principle 3, Accountability).

It is on the subject of accountability lines that the Basel's proposal lacks of precision since it provides with some weaker, even faulty, procedures to build up the compliance function. For instance, letting the function to meet its job within another staff center, which would entail an almost fatal conflict of interest in the end.

Afterwards, **Principle 5** says that the compliance function should be independent. Apparently, the Bank for International Settlements at Basel expands on this principle, qualifying independence by the fulfillment of four requirements:

- formal status within the bank;
- the function must have a compliance head;
- the function should not be placed wherever conflict of interests may arise;
- the function must be suitably staffed and any other center in the bank must give full access to information needed for the staff of the compliance function to discharge their duties.

Yet true as such requirements are bound to be, they do not touch the heart of the matter. In our opinion, the contents of this principle turn out to be misplaced. It is the case that for any managerial function three things should not be argued: staff and resources provision, nomination of a head, and formal status within the organization. So, it seems that the only characteristic worthy of being noticed is the one that prevents the function from being located wherever conflicts of interests may arise, albeit for most managerial cases this should also be predicated as a matter of course and better governance.

Hence, it is my contention that the truly relevant feature that grants independence to the compliance function should be rooted in matching both accountability and exemption lines by means of a stand-alone principle of governance, as I did in section 4 (see Exhibit 3, Principle 5).

6. PRINCIPLES OF GOVERNANCE FOR COMPLIANCE RISK AND THE COMPLIANCE FUNCTION: THE GENERAL CASE

Taking advantage of the foregoing discussion, it’s time for dealing with a minimal set of governance principles to give account and constrain the exercise of an internal compliance function not only in financial but also in non-financial organizations (see **Exhibit 3**).

As regards the issue of which principles should qualify to be included in a minimal list, this becomes an open-ended question. Albeit there is a wide range of options, both empirical evidence and academic spadework point to the suitability of meeting some criteria on which sound judgement or decisions can be based. We choose the following set of standards as our criterion:

a) Principles should be enabling.

b) The fewer, the better.

c) Principles must not be mixed with good practices.

Let us handle each of these criteria in turn.

As for principles to be enabling, this means that they give organizations latitude to do things without hindering either its inner workings or stated goals.

Contention about the number of principles has to do with pragmatism, but also with the fact that principles are benchmarks that lay down guidelines for prudential decision-making. It should not be forgotten that the Founding Fathers needed only seven articles to set up the Constitution that still rules the United States.
Most of the time, the third issue turns out to be a thorny one. Although we have dealt with it elsewhere[11], it's worth recalling here what I understand by a Code of Good Practices:

*By a **Good Practices Code** we mean any set of rules of behavior that allow a distinctive governance structure to be put into practice and held accountable, provided that such rules meet the following constraints:*

- *by necessity, they stem from the underlying governance structure;*
- *they match the institutional framework within which the organization not only lives and develops, but also abides by the law;*
- *they are in agreement with the organization's Charter and by-laws;*
- *and last but not least, they should become fully operational: the rules are set up within a framework that allows monitoring, assessment, updating and improvement.*

[11] Rodolfo Apreda, *The Semantics of Governance* (2005). Corporate Ownership and Control, volume 3, issue 2, pp. 45-53.

Principle 1 On compliance risk

Compliance risk is about assessing and preventing the risk of sanctions, or material loss of any kind, an organization may suffer as a result of its failure to comply with the manifold constraints of its institutional environment.

Principle 2 About the compliance risk charter

The Board of Directors must request from the Senior Management, or a qualified external source, to draw out the company's compliance risk charter as well as mechanisms to make it enforceable.

Principle 3 Accountability

It is for the Senior Management to be held accountable to the Board of Directors for the fulfillment of the compliance risk charter.

Principle 4 On the compliance function

In order that the compliance risk charter could be enacted, run and enforced, the Senior Management must set up the compliance managerial function.

Principle 5 About the compliance function independence

For the compliance function to be independent from any other center four requirements should be met:

- *At staff level, it is held accountable only to the Internal Audit Office and the CEO's office.*
- *The head of the compliance function office is granted a statutory exemption from reporting to the CEO's office so that it could directly report the Board of Directors or its Auditing Committee.*
- *The compliance function center must get unlimited access to any information regarded as relevant to meet its duties, from any other center in the company.*
- *The Board of Director must request and review a Performance Annual Report from the Head of the Compliance Function Performance.*

Exhibit 3 A minimal set of principles of governance for compliance risk and the compliance function.

Hence, one thing is a principle of governance, quite another a good practice. For each good practice we should track down its actual foundation on some matching governance's principle. The latter involves a precept, the former makes it a real accomplishment, a course of action.

Exhibit 3 features the minimal list of governance principles advocated in this paper, intended as alternative guidelines for any organization, financial or non-financial. They should be embedded in the compliance risk charter.

CONCLUSIONS

The proposal of the Bank for International Settlements about compliance risk and the compliance function seems a sensible starting point in pursuit of fostering better corporate governance in financial institutions. However, we contend that it should be improved in issues regarding independence and accountability.

The main contributions of this paper can be summarized as follows:

a) It laid foundations on how compliance risk matters in corporate governance.

b) It has broadened the scope of compliance risk and the compliance function not only for financial but also non-financial organizations.

c) It has brought into a sharper view that independence and accountability are at the core of these governance devices, and has brought to light two distinctive governance principles:

- One for compliance risk, ruling that the CEO and the senior management are accountable for carrying out the compliance risk charter.

- Another one about the independence of the compliance function, which is endowed with exemption lines to report the Board of Directors outright.

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