

THE ROLE OF COMPLIANCE OFFICER IN THE COMMERCIAL BANKS

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Abstract

This paper analyzes the role of the compliance officer in the banking operations in order to minimize the legal risk in the commercial banks.

These paper consists of fourth (4) parts, that are:

1. Introduction;
2. Similarities and differences between the legal risk and the compliance function;
3. The role of the compliance officer in the commercial banks; and
4. Conclusion.

In the first part: “*Introduction*”, we define and explain the subject of our research.

In the second part: “*Similarities and differences between the legal risk and the compliance function*”, we analyze the legal risk and the effective management of this risk, and also we define and explain the compliance risk, in order to see the similarities and differences between the legal risk and the compliance function in the commercial banks.

In the third part: “*The role of the compliance officer in the commercial banks*”, we analyze in detail the role of the compliance officer and the compliance function through which this role is manifested in daily banking operations.

Finally, the fourth part of this paper is the “*Conclusion*”, in which we are giving our basic conclusions that arise from our paper.

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We think that the role of the compliance officer in managing the legal risk in the commercial banks in the future should include: implementing the policies, structures, processes and culture that are directly aimed at building effective management of potential opportunities for minimizing the legal risk. In the Republic of Macedonia, the future compliance of the commercial banks with the current legislation should provide protection and elimination of all consequences that may arise as a result of non-compliance and improper application of the regulation.

Keywords: *risk, bank, legal risk, compliance function, compliance officer.*

1. Introduction

The subject of this paper is an analysis of the role of the compliance officer in the commercial banks that includes the definition and the identification of the forms in which the legal risk manifests itself in practice, as well as the analysis of the management of the legal risk through the compliance function in the commercial banks.

Given the fact that the Republic of Macedonia is a country with a financial market that mostly relies on the banking sector, it is very important to provide the successful management of all risks that commercial banks face every day in their work, and among them is also the legal risk. The well drafted legislation that would be consistently implemented in practice is a very important premise and framework for prudent risk management in the banking sector.

The events that occurred at the beginning of the first decade of the 21st century, i.e. the global financial (economic) crisis, prompted thinking about threats and vulnerabilities that come and actually can be controlled by the entity. The legal risk in banking operations especially gained significance just during this financial crisis, which contributed to the adoption of new and more stringent regulations, which in turn directly or indirectly necessitated the management, compliance and the legal requirements and problems in financial institutions.

Therefore, *the objective* of this paper is to point out the significance of prudent management of the legal risk generally speaking, and also giving emphasis on the role of compliance officer as the key important person for managing compliance risk and legal risk in the commercial banks in the Republic of Macedonia.

2. Similarities and differences between the legal risk and the compliance function

The Basel Committee on Banking Supervision, as a very important financial institution in the world, defines the legal risk as follows, and says that: "*the legal risk includes but is not limited to exposure to fines, penalties or damages, subject to penalties arising of supervisory activities as well as private settlement, but excludes the strategic risk and the reputational risk*".²

The operational risk includes *the legal risk* that in the legal system of the Republic of Macedonia is defined as "the current or the future risk to profits and own funds of the commercial banks, which is caused by the violations or disregard of legal regulations, agreements, prescribed practices, ethical standards or as a result of misinterpretation of the regulations, rules, contracts and other legal documents"³.

This type of risk occurs particularly in developing countries due to their mismatched regulation, and because of the fact that they often change other laws and bylaws because the legal system is not sufficiently stable and primarily it is dependent on a ruling set, which is a real handicap for the normal functioning of the financial institutions.

*The legal risk may appear in several sub-variants, including*⁴:

² Basel Committee on Banking Supervision, "Sound Practices for the Management and Supervision of Operational risk"; BIS, June 2011, p.5.

³ According to the National Bank of the Republic of Macedonia, "Decision on the risk management" (Official Gazette of the RM No. 42/2011), March 31, 2011.

⁴ Mantysaari P., "The Law of Corporate Finance: General Principles and EU Law - Volume I: Cash Flow, Risk, Agency, Information", Springer, 2010, pp.29-94.

1. as a result of actions taken by the commercial banks and its employees that are not fully in line with the legal framework;
2. due to the uncertainty of the effects of the implementation of the legislation; and
3. inefficiency of the legal system in the country as a whole.

So, the responsibility of the management of the commercial banks is to prevent this sub-variants of the legal risk and to monitor whether participants comply with the rules and codes of practice of the commercial banks, and this is the most important role for the positive financial results of the commercial banks.

The key activity in the conduct of prudential policy in the banking operations is the risk management. As in the life of every person, also in the banking operations, the risk simply cannot be avoided, and therefore the only thing that can be done is to professionally manage it. Therefore we say that the risk management is perhaps the most important function of the commercial banks, to insure against the risks they face in their daily operations. This commercial bank risk management consists of⁵: *the identification of the risk, its measurement, control, insurance and the elimination of the risk.*

So the key question that arise here is: who should take the responsibility for the assessment of the legal risk in the financial institutions, and the answer of this question would be: *the legal department*. However the assessment phase should be seen as a *separate issue*, unlike that of making business decisions based on the assessment that was already made.

The Managing Authority, should oversee *senior management* to ensure that policies, processes and systems are effectively implemented at all levels.⁶ In many financial institutions, the responsible for managing the legal risks are: the director of the legal department or chief legal counsel, or the so called "*compliance officer*."

The compliance function implies an obligation of the commercial bank to operate in accordance with the regulations. The compliance risk covers the risk of non-compliance with:

- the existing laws and regulations;
- the adopted internal acts of the commercial bank; as well as

⁵ Comptroller's Handbook, "*Bank Supervision Process*", Comptroller of the Currency Administrator of National Banks, 2007, pp.1-25.

⁶ Basel Committee on Banking Supervision., "*Sound Practices for the Management and Supervision of Operational risk*", BIS June 2011, p.5.

- the accepted standards of the market economy.

So, it is because of the emergence of this compliance risk, that the commercial banks must develop a function that means a control mechanism and a review of internal regulations and guidelines for the overall compliance of its operations with the regulations. According to the definition of the Basel Committee on Banking Supervision it is provided that: "the compliance function of the commercial bank's operations with the regulations" should assist the management of the commercial bank to manage effectively the risks of non-compliance with the regulations that the commercial bank is facing in its daily operations.⁷

We can conclude that according to the Basel Committee on Banking Supervision, the definition of legal risk is largely identical to the definition of the risk of non-compliance with the regulations, and the risk of non-compliance with the regulations is an integral part of the legal risk. It follows that these two risks have similarities in their management of ensuring legality in the operation of the commercial bank or due to negligence that the commercial bank will be exposed to financial losses that will ultimately be reflected in the commercial bank's own funds.

But one of the differences between the management of the legal risk in banking operations and the compliance function, consists in assessing the commercial bank's losses. The assessment of the legal risk means assessing the potential losses to the commercial bank's capital in the future period, and not evaluating its existing losses, while the role of the compliance function is to care about whether the commercial bank in its operations complies with legal regulations and the same applies, and if this is not the case, then the compliance officer has a preventive function - to prevent the legal risks that might arise in the future from the banking operations.

Also the risk of non-compliance with the regulations can become a legal risk for the commercial bank as a result of lawsuits by customers of the commercial bank or for penalties and sanctions from regulators because of the operation of the commercial bank that are contrary to statutory rules and regulations.

⁷ Basel Committee on Banking Supervision, "*Review of the principles for the sound management of operational risk*", Bank for International Settlements, 6 October 2014, p.1-5.

The risk management of non-compliance with the regulations is a corporate culture of compliance work, and the management that is in charge for this is the Board of Directors through its *compliance officer*. The role of the compliance officer in the commercial banks should be at the highest level in order to ensure the postulates of ethics, conflict of interest, integrity and harmful behavior which can easily be translated and transferred to the commercial bank.

Hence, *the functions of the compliance officer of the commercial banks in the Republic of Macedonia are:*

- ✓ the identification and the monitoring of risks from incompliance of the commercial bank's areas of banking operations with the Banking Law, The Payment Operations Law, The Foreign Exchange Operations Law, The Law on Consumer Protection in Consumer Loan Agreements Act, The Law for fast money transfer, The Securities Law, and the Law on protection of personal data, including their bylaws; as well as
- ✓ the monitoring of the risks of imposed measures and sanctions for non-compliance of the commercial bank's operations in other areas of non-banking operations, by the authorities and institutions responsible for the inspection or supervision, or courts that are competent to assess the legality.

3. The role of compliance officer in the commercial banks

In the past the only controllers (gatekeepers) in the commercial banks were the persons that were employed in the internal audit, but as the commercial banks have grown, their functions and activities, the number of customers grew and communications with

several interested parties also grew, and beside to the persons employed in the Internal Audit Department in the commercial banks, also appeared the need of specialized services or departments that will also constitute a control in turn lead operation of the commercial banks, and it is the department's compliance operations with commercial banks and the departments responsible for risk management, which will contribute their knowledge and expertise in the assessment of areas that are audited.

The control function and the compliance of the commercial banks with the regulations is an independent function of the people/services in a commercial bank, aiming to identify, assess, monitor and inform the commercial bank's management of the risk of violation of internal regulations of the commercial banks, regulatory requirements and the legal regulations governing the operations of the commercial banks. This function should start from the top of the organizational structure of the commercial banks, or by the Supervisory Board and also up to person/service that will be responsible for performing the compliance function. This feature is best appreciated in commercial banks with established ethical standards of operation, high moral integrity of the members of the commercial bank's management and adhering to the best practices of corporate governance in the commercial banks.

As for the situation in the Republic of Macedonia, the Banking Law that was adopted in 2007 foresaw the obligation of each commercial bank in the Republic of Macedonia to establish a service, or to appoint a person (depending on the type, scope and content of the activities carried out by the commercial bank) that served as the control function officer. In this way, through the establishment of a legal obligation, each commercial bank had the right to regulate the status of persons who will perform this function. If in the past the most commercial banks perform the same function by certain persons within the legal wards, or the risks or persons who have an advisory role in the commercial bank, today their powers, responsibilities and status in the organizational chart of the commercial banks are clearly defined.

At the same time, the practice has shown that some of these people, more clearly - the compliance officers – are effectively organized with the framework of the Association of Chambers of Commerce, and they are establishing a special Commission for AML and compliance, which very effectively deals with various problems and dilemmas of everyday work of the commercial banks in relation to the commercial banks in accordance with the

regulations, and also the way the Commission works and communicates with the regulators of the commercial banks which further attaches the importance of the control function.

According to the Banking Law of the Republic of Macedonia, the persons that are the employees in this sector, perform only things that relate to control of compliance with the regulations and they are independent in the performance of the activities under their jurisdiction. The compliance officers or the employees in the commercial banks are obliged to provide insight into the available documentation and to provide all necessary information to all employees in the commercial bank. The person or the management of the compliance service submits a monthly report to the Board of Directors and quarterly report to the Supervisory Board of the commercial bank for their work.⁸

The responsibilities of the person that is responsible for the compliance with regulations and control (*the compliance officer*) in the commercial banks are ⁹:

- ❖ to monitor and to observe the regulations and the internal regulations of the commercial bank;
- ❖ to monitor and to test the compliance of banking work with the regulations;
- ❖ to identify, to evaluate and to control of the risks of non-compliance during the banking operations, and to reduce this risks;
- ❖ to advise the members of the Management Board of the commercial bank on issues that are related to the application of regulations and any change, and to prepare reports to the managing bodies of the commercial bank;
- ❖ to evaluate the compliance of the new products and the business processes in the commercial bank with the regulations;
- ❖ to provide staff training and to suggests ways to improve performance in accordance with the regulations;
- ❖ to implement the policies, i.e. the minimum prescribed standards in daily banking operations;

The Basel Committee on Banking Supervision also prescribes the best practices and standards related to the work of the compliance function of the commercial bank with the

⁸ Banking Law (Official Gazette of RM No.67/07, 90/09, 67/10, 26/13, and 15/15/), Articles 97.

⁹ National Bank of the Republic of Macedonia, “*Decision on the basic principles of corporate governance in a bank*”, (Official Gazette of the Republic of Macedonia No. 159/07), p.11.

regulations¹⁰, as well as examples of these practices for the compliance officer, that we believe that every commercial bank should implement in its daily operations if the commercial bank wants to achieve great results.

4. Conclusion

The legal risk in the banking operations as an integral part of the operational risk, may appear in several sub-variants, that are: as a result of actions taken on the commercial bank and its employees that are not fully compliant with the legal framework; because of the uncertainty of the effects of implementing the legislation; and because of the inefficiency of the legal system in the country as a whole.

However the process of the risk management is perhaps the most important function of the commercial banks' insurance risks they face in their daily operations. This commercial bank risk management consists of the: *identification of the risk, its measurement, control, the security and the removal of the risk.*

The managing with the legal risk in the future should include the implementation of the policies, structures, processes and culture that are directly aimed at building the effective management of the potential opportunities and the adverse events which has the source of the legal risk and other risks that can be treated with remedies.

The Compliance function should be seen as the part of an internal corporate image of the commercial bank (the internal governance), clearly as one important link in the chain of the corporate management in the commercial bank.

As for the Republic of Macedonia, *in the future, the compliance of the commercial bank with the applicable legislation* should provide the protection and the elimination of all consequences that may arise as a result of non-compliance and improper implementation of the regulation. This objective will be accomplished by monitoring the new regulations,

¹⁰ Basel Committee on Banking Supervision, “*Compliance and the compliance function in banks*”, April 2006, pp.1-5.

amendments, and assessment of its impact on the commercial bank's operations and recommending the corrective measures for the full compliance of the commercial bank.

In the future we consider that the compliance officer should:

- ✓ understand more clearly all aspects of the commercial bank's business and the compliance officer should also increase the communication with the overall management of the commercial bank and its employees;
- ✓ analyze more professionally the contracts which are concluded by the commercial bank with the customers and to continuously control the compliance of banking operations, and analysis the commercial bank relations with its employees; and also the compliance officer should
- ✓ care for the implementation of the international standards and the working principles that are laid down by the Basel Committee on Banking Supervision, and the rules of the European Banking Agency, and also the regulations and the directives of the European Union.

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