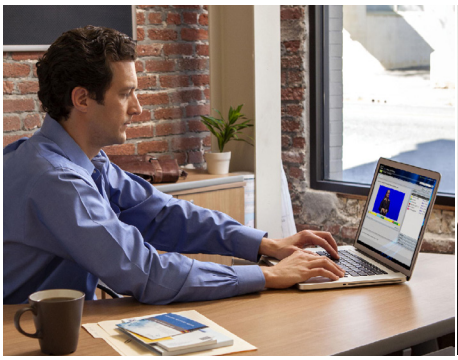
White Paper

More Effective Compliance

An Unrecognized Benefit of Improved Collaboration

Angus Hislop
Sherwin Uretsky


Looking forward, the prognosis is for more rules and tougher scrutiny.

Introduction

Since the financial crisis, governments around the world have enacted a wave of new regulations in banking and related sectors. The goal has been to protect banks, consumers, and investors, but another effect has been the large expansion of the "compliance" industry. This refers to the people who supervise the banks, internally or externally, to ensure compliance with the rules, as well as those advising all parties.

But the rules are extremely complex, and new solutions are sorely needed. Compliance rules may be national, regional, or global, and they may be specific to banking or more generic. They may also relate to areas as diverse as capital and liquidity requirements, pricing, sales processes, data protection, advertising, and product descriptions. While the costs of compliance have been estimated to be 12 percent of operating expenditures for U.S. banks,[1] the costs of not complying can be even higher. Potential consequences include fines, settlements, customer redress, external fees, restitution, loss of business, and diminished reputation.

Looking forward, the prognosis is for more rules and tougher scrutiny. As Ernst & Young explains on its website: "Worldwide, regulators are proposing a raft of changes to consumer compliance laws and regulations." New rules are already having an impact. In the United States, these include the Unfair and Deceptive Acts and Practices (UDAP), the Home Mortgage Disclosure Act, and the Foreign Accountant Tax Compliance Act (FATCA). The European Union, meanwhile, has enacted legislation on investments and financial infrastructure, including Markets in Financial Instruments Directive 2 (MiFID 2) and European Market Infrastructure Regulation (EMIR).

Data privacy and security are likely to create additional issues and complexity. Indeed, as Cisco Consulting Services has explored, the advent of the "Internet of Everything" will bring an explosion of connectivity that is projected to encompass 50 billion devices and objects by 2020.[2]

Technology can provide key solutions as both regulator and regulated seek more effective compliance.

In response to such trends, the European Commission, in particular, is looking to safeguard consumers' interests, especially regarding the use of mobile devices for financial transactions. As the Royal Bank of Scotland has observed, "risk can increase as more people use mobiles to store security credentials."[3] Relatively new regulatory bodies, such as the Consumer Financial Protection Bureau in the United States and the United Kingdom's Financial Conduct Authority, are responding with intensified scrutiny.

Technology can provide key solutions as both regulator and regulated seek more effective compliance. The potential role of data analytics, storage, and retrieval technologies has already been considered. But there has been almost no discussion of the role that collaboration technologies – including telepresence, secure web communities, video and document sharing, and crowdsourcing – could play in enhancing compliance.

This paper addresses that gap by analyzing the following:

- Examples and costs of noncompliance
- Causes of noncompliance
- Role of collaboration technologies and emerging solutions
- The opportunity for compliance

The Escalating Costs of Noncompliance

In recent years, cases of noncompliance with regulations and good practices have been common. Some have been on an international scale; others are purely domestic.

The alleged manipulation of Libor, Euribor, and other core interest rates by some 20 international banks involved traders in many of the major financial centers. The fines alone for the first three banks settling with U.S., British, and Swiss authorities (Barclays, RBS, and UBS) have totaled $2.6 billion, and the European Commission is driving for an additional large settlement. A wave of litigation by aggrieved parties may also follow, with higher potential costs to the banks.

In 2012, U.S. authorities ruled that Standard Chartered and HSBC exhibited "inadequate compliance with anti-money laundering and sanctions legislation,"[4] and they were fined $667 million and $1.9 billion, respectively. JPMorgan Chase provided $700 million in the fourth quarter of the same year to cover the "Impact of the Independent Foreclosure Review" in its mortgage business – part of a wider $9.3 billion settlement between the industry and regulators. A number of private banks in Switzerland are under intense scrutiny from U.S. tax authorities regarding documentation and due diligence on U.S. citizens' tax affairs.

In the United Kingdom, all of the major banks have been accused of misselling payment-protection insurance attached to mortgages and other loans; as of 2012, they have had to provide a cumulative $19 billion in costs of settlement, fines, and incremental operational costs. In one large bank, some 5,000 staff members are

The total costs of a major incidence of noncompliance can be many times the value of the published fine or settlement.

dedicated to dealing with such claims from customers. Another area of alleged misselling involves derivative products related to fixed interest loans to small businesses; as a result, the four largest U.K. banks announced provisions of some $3 billion just for 2012.

In the United States, the Consumer Financial Protection Bureau, the new agency set up as part of the Dodd-Frank Act, has started levying fines and ordering customer refunds. In 2012, the card companies Capital One, American Express, and Discover paid a total of $425 million ($75 million in fines and $350 million in refunds) for "deceptive marketing." The bureau recently launched a $1 billion claim against Bank of America for so-called "hustle mortgages," loans issued very rapidly without due regard to the customer's ability to pay.

Compliance issues may appear to have arisen mostly in Britain and the United States – perhaps due to lighter rules, less aggressive sales cultures, and/or stronger preventive supervision elsewhere. But in 2010, the French Autorité de la concurrence levied fines of €325 million on 11 French banks for introducing unjustifiable commissions as part of a new check-clearing system. And in the fourth quarter of 2012, Société Générale set aside €300 million against unspecified litigation.

The total costs of a major incidence of noncompliance can be many times the value of the published fine or settlement. The total often includes payments in compensation to aggrieved customers; the costs of "restitution," or putting right the mistakes; the price of managing compensation claims; payments to lawyers, consultants, auditors, and so forth; the toll of losing business in the particular area; and the general impact on the bank stemming from a loss of reputation. It is impossible to estimate the reputational costs of misselling incidents, but the operational costs of managing such an incident have been estimated to be about 10 to 15 percent[5] of the fines and compensation to customers.

Though in recent years the immediate noncompliance costs have been high, the ongoing toll of trying to ensure compliance – specialist staff, consultants, processes, and technology – is also considerable. As noted earlier, this was estimated[6] by the American Bankers Association to equate to 12 percent of operating costs for U.S. banks – a similar order of magnitude to total IT or real estate costs. For smaller banks, the figure would be much higher and is recognized by authorities as a major and increasing disincentive for new competitors trying to enter the banking industry.

Moreover, as regulations get tougher, there will be more examples of banks simply refusing to do business in a particular area. In the United States, some community banks are reported[7] to be considering withdrawal from the mortgage market in response to stringent new rules on checking a customer's ability to repay in the future. In the United Kingdom, the costs of complying with new, more stringent restrictions on selling investment products (the so-called Retail Distribution Review rules) has led almost all the major banks to stop providing branch-based advice to all but the wealthiest customers. Many other customers are thus forced to seek advice elsewhere or accept "execution-only" status, receiving no advice from the bank in reaching a decision.

In turn, the new regulations are stimulating interest in Big Data analytics and their potential application for compliance purposes.

It is therefore not surprising that banks regard regulatory developments with great concern. In its 2012 Annual Report, HSBC listed "regulatory developments ... investigations, fines, sanctions, and requirements relating to conduct of business ..." among its top three risks.[8]

Causes of Noncompliance

What are some of the reasons for the growing number of incidents of noncompliance in banking? The sheer difficulty of following and complying with the new wave of legislation is one factor. But after every major misselling event or other systemic waves of noncompliance, there are investigations – from regulators, lawmakers, and the banks themselves. And there is rarely much agreement as to the prime or underlying causes. Most often, the combined effects of different factors are cited. These include:

- Inappropriate performance measures
- Inappropriate compensation structures
- Inadequate data and systems
- Inappropriate trade-offs between compliance and customer convenience
- Inadequate culture of compliance
- Lack of controls and supervision
- Lack of constructive dialogue with regulators

The first two causes are being slowly addressed by policy decisions. Banks are either complying voluntarily or responding to pressure from new regulations, such as the proposed EU rules on maximum bank bonuses. This will reduce the relative importance of sales incentives for their workforces, and stress the importance of advice and service over sales alone. The United Kingdom's Financial Services Authority (FSA) underscored the compliance risks very clearly in a recent paper[9]: "Our review found that most incentive schemes were likely to drive people to missell, and these risks were not being properly managed."

The second cause, "inadequate data and systems," is getting attention in the IT world. This is being driven by the mass of new data requirements imposed by the Basel III global regulations and Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States. In turn, the new regulations are stimulating interest in Big Data analytics and their potential application for compliance purposes. The introduction to an Institute of International Finance report, "Risk IT and Operations," refers to the causes of the financial crisis: "Some firms could not always aggregate risks they were accumulating quickly and accurately, and as a result they could not mitigate and manage them effectively. In other cases, data problems sometimes prevented timely identification or appreciation of the magnitude of risks. As everyone acknowledges, the consequences were severe."[10]

A video-based, face-to-face advice model will reduce the risk of noncompliant sales and reduce the costs of supervision.

Collaboration Technologies and Emerging Solutions

Collaborative technologies can play an important supporting role in mitigating risk from the last four causes of noncompliance that we have listed.

For example, in regard to customer convenience and compliance, there is new attention in the area of personal data collection in connection with real-estate sales, mortgages, and other loans. New rules on affordability, both in the United States and United Kingdom, require more and more sensitive data and documents. But if the bank and the customer can share information electronically, rather than physically at a meeting, the process can be both compliant and more convenient. Collaboration technologies from Cisco (Jabber) or Microsoft (Lync) enable such data sharing.

Changing a bank's culture to one that reflects more respect for compliance issues requires consistent communications – and, of course, actions – from the top, and for a prolonged period. Several banks have introduced new values programs in response to compliance issues. Standard Chartered put forth its "Here for Good" campaign, for example, while another London-based bank, Barclays, weighed in with its own statement of business purpose, "Helping People Achieve Their Ambitions – in the Right Way." Traditionally, such initiatives call for executive communications cascaded down through the organization via a mix of team meetings and written messages, including mission/value statements.

Broader adoption of video – especially high-definition, immersive telepresence – can accelerate this culture change. For one thing, it can scale the presentations and visual messages of senior executives without the need for physical visits. This can be especially useful for global banks and banks with large branch networks. In such organizations, it often takes many months for senior executives to make all the visits needed to bring new messages to life. At the present time, however, few banks have enough high-quality video facilities across their estates to support such corporate value programs.

Poor controls and inadequate supervision appear to be major factors in the alleged manipulation of Libor rates by international banks. The cost of supervising salesforces – whether bond traders, mortgage advisers, or investment consultants – is high. As a result, these tasks are generally left to physical observance by senior staff. In the United Kingdom, a bank with a salesforce offering "regulated advice" will typically have a supervisor/sales staff ratio of 1 to 7-to-10. By changing the business model to accommodate more video meetings with customers – and by audio recording those meetings – the bank's supervisors and compliance officers can check and observe much more frequently and cost effectively. There will also be a record of who said what to whom in a face-to-face meeting. In the past, the absence of such records has discouraged banks from defending against customer claims of misselling.

A video-based, face-to-face advice model will reduce the risk of noncompliant sales and reduce the costs of supervision. Several banks around the world, especially in Canada (Bank of Montreal and RBC) and Australia (ANZ) are rolling out branch-based video access to investment, mortgage, and small-business experts.

A private, secure network of telepresence rooms connecting global supervisors and systemically important banks could improve the operation of the "colleges of supervisors."

These initiatives are part of new distribution policies aimed at enhancing high-value sales and service. But additional benefits will arise in the area of compliance.

The final cause of compliance problems identified in post-crisis reports is the lack of constructive dialogue between regulator and regulated. As the IIF report[11] described it, "Regular dialogue between supervisors and industry is necessary to continued progress." Either the process has been excessively check-box-driven – with junior regulators asking questions and completing forms without enough understanding to probe – or too much emphasis was placed on occasional meetings between CxOs and more senior regulators. If regulated and regulator were part of a "collaboration community," with secure access to a range of tools and data in near real time, the chances for frequent and effective dialogue at all levels would be greatly enhanced.

Regulators are just beginning to realize the potential benefits of this approach. This may start with improved collaboration between regulators on an international basis. The Financial Stability Board, the international body set up to coordinate and monitor financial supervisory policies, has tested telepresence committee meetings organized by the Bank for International Settlements.

Figure 1 illustrates the range of tools and uses that would be available in a next-generation model of collaboration between regulators and regulated banks. A private, secure network of telepresence rooms connecting global supervisors and systemically important banks could improve the operation of the "colleges of supervisors." There could be discussion forums with differentiated access; "click-to-contact" services for expert advice; audio and video galleries for specific training or sharing of lessons; and many other forms of collaboration.

Some supervisory and trade bodies are starting to provide a few of these services, but they tend to be disparate, underinvested, and little used. In an ideal world, such networks would be international. But countries with a large number of different supervisors across different segments of the industry, such as the United States, could benefit from such collaboration communities at a national level.

Figure 1. Next-Generation Collaboration Between Regulators and Regulated.

Source: Cisco Consulting Services, 2013

Regulators also have an important role to play in clarifying rules around the use of new technologies.

A more recent innovative approach to collaboration on compliance issues employs "crowdsourcing" within the clearing and settlement area. This is being tested by the Clearing and Settlement Working Group (CAS-WG), which is supported by the London-based Financial Services Club. Expert members – including those from securities operations, regulators, compliance, and specialist consultants – are being crowdsourced to identify those issues most likely to have significant implications for technology. This simplifies a task that is normally very complex, given the huge amount of detail in relevant regulations across multiple jurisdictions.

One significant constraint to the development of more effective collaboration between regulators and regulated – and indeed between international regulators – is the low level of awareness and interest in the potential role of technology among global supervisors. In reporting[12] on the progress of G20 reforms within the financial sector and strengthening financial stability, the Financial Stability Board (FSB) makes no reference to the need for technology investments to underpin the changes; it also fails to mention technology requirements in its own resource plan. Not surprisingly, the combined IT budgets of seven large global supervisors (c. $525 million in 2011) were only about 10 percent of one large global bank – confirming the rather asymmetric relationship between regulators and regulated.

The Opportunity for Compliance

The financial crisis and broader social trends seem certain to drive more regulations in banking and the wider economy. And the risks of noncompliance and the resulting costs are likely to increase. Collaboration technologies such as video, telepresence, document sharing, crowdsourcing, and secure community networks can make a major contribution to reducing the costs of compliance, enhancing its effectiveness, and mitigating the costs of restitution.

Putting a monetary value to such benefits can be problematic. But considering that in 2012 just two British banks provided $6 billion to cover the costs of customer and regulator settlements, even a 10 percent reduction would be significant.

However, to obtain such benefits, the compliance community needs to view new technologies as an opportunity to improve their own effectiveness – and not, as is often the case, as a threat to their ability to monitor and mitigate the risks of new business models enabled by such technologies.

Regulators also have an important role to play in clarifying rules around the use of new technologies. As an example, throughout the thousands of pages of the Dodd-Frank rules or the FSA's "conduct of business" documentation, there is no mention of the role of video technologies in communications with clients – only telephone or face-to-face are referenced. As a result, banks are obliged to decide on their own whether video communications demand the same compliance rules that were designed around telephone or those designed around face-to-face. Such uncertainties risk discouraging the adoption of such technologies. But looking to the future, banks will continue to fear the consequences of noncompliance. And the essential benefits of collaboration tools will become ever more clear.

Endnotes

1. American Bankers Association testimony to Congress, May 9, 2012.
2. "Embracing the Internet of Everything To Capture Your Share of $14.4 Trillion," Cisco, 2013.
3. "Four Technology Super Trends and their Impact on Banking," Royal Bank of Scotland, June 2012.
4. HSBC Annual report 2012; Note 43 to Financial Statements.
5. Cisco Consulting Services experience and HSBC Annual Accounts 2012, Note 33.
6. ABA Testimony to U.S. Congress, May 9, 2012.
7. Ibid.
8. HSBC Annual Accounts, 2012, page 22.
9. "Final Guidance: Risks to Customers from Financial Incentives," FSA, January 2013.
10. "Risk IT and Operations: Strengthening Capabilities," IIF and McKinsey & Co., June 2011.
11. Ibid.
12. "Report of Financial Stability Board to G20 Leaders," June 19, 2012.

Americas Headquarters
Cisco Systems, Inc.
San Jose, CA

Asia Pacific Headquarters
Cisco Systems (USA) Pte. Ltd.
Singapore

Europe Headquarters
Cisco Systems International BV Amsterdam,
The Netherlands

Cisco has more than 200 offices worldwide. Addresses, phone numbers, and fax numbers are listed on the Cisco Website at **www.cisco.com/go/offices.**