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POINT OF VIEW

THE TIME TO FUTURE-PROOF COMPLIANCE IS NOW

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Compliance functions at financial institutions transformed markedly after the financial crisis, impelled by:

- Reputation crushing conduct issues.
- Franchise threatening regulatory fines and sanctions.
- Many new conduct rules.
- Heightened regulatory expectations generally and as they relate to Compliance.
- An increased focus on management accountability.

However, there are several emerging macro trends that will require an even more radical transformation of Compliance over the next few years, including the further evolution of regulatory expectations related to conduct and culture, and that compliance operate more like a risk management function, serious cost pressures on all parts of financial institutions, and technological enhancements.

Put simply, Compliance needs to rapidly evolve to be a capable strategic adviser at the key decision-making tables and to greatly improve its ability to identify, assess and help mitigate material risks, all with declining budgets. In order to achieve this, Compliance needs to emerge from its fire fighting mode to lay the groundwork for a more strategic future. New, more effective and efficient technologies should be implemented, since boards and senior management will expect more from their Compliance functions for less budget going forward.

SOME PROGRESS MADE, BUT FURTHER CHALLENGES AHEAD

The good news is that some progress has already been made. Five positive trends stand out to us:

- The Chief Compliance Officer role has been elevated, establishing him/her as a trusted adviser to senior management with a seat at the table in key committees.
- Compliance has typically received substantial resources for additional head count and technology.
- There is a shift towards a disciplined, risk oriented approach, even if the risk assessment processes are still evolving.
- Awareness of the Three Lines of Defense model has increased, providing greater understanding of the appropriate role for Compliance within the functions and more broadly within the institutions.
- Compliance efforts are complemented by conduct and culture initiatives that reinforce accountability of the business and promote an improved risk culture.

We believe the empowerment of Compliance and other key trends since the crisis are clear moves in the right direction and prudent in light of the changing environment. However, financial institutions should not rest on their laurels – we see a clear imperative for future improvements across the following dimensions:

- Re-positioning Compliance to have a continuous strategic impact at all levels of the financial institution;
- Clarifying the Compliance mandate and exiting inconsistent tasks and responsibilities;
- Focusing on the biggest risks as identified through quantitative metrics and big data;
- Broadening the Compliance mandate to not only cover rules but culture and values; and
- Resisting the impulse for resource intensive solutions and embedding efficiency and effectiveness as a core principles, leveraging technology, digital tools and advanced methodologies.

As discussed below, consideration of these dimensions is the foundation upon which to build the next generation of Compliance.

In this Point of View, we suggest that Compliance take a hard look right now at its current approach, responsibilities and people, and take the time to consider a new directional path taking into account the important macro trends at work. Compliance senior leaders must resist the temptation to believe that by just reacting to all the new issues, regulations and changes within their firm that eventually things will return to a business as usual environment. We do not believe that this will be enough, and even doing everything right tactically along the way could still lead to failure. More specifically, a non-strategic Compliance function will be unable to escape the endless cycle of backward looking demands and urgent fire drills, and will likely be short of satisfying emerging regulatory and senior management expectations. It is time to run a strategic refresh, define the next generation target-state for Compliance, and develop a road map with key initiatives and operational enhancements.

WHAT DOES THIS MEAN IN PRACTICE?

Below we provide some specific context, views and suggestions on how to transform the Compliance function to meet the new challenges.

RE-POSITIONING COMPLIANCE TO HAVE A CONTINUOUS STRATEGIC IMPACT

Typically, Compliance has taken on many new control responsibilities since the financial crisis without a reduction in legacy responsibilities. This expansion makes it crucial to review the Compliance organization, its areas of focus and scope of operation and to develop a more cohesive and rationalized approach.

Most importantly, in considering the model going forward, we believe that Compliance requirements should be fully embedded in the mindset and decision making processes at the top level and cascaded down throughout the organization. For the future, we expect decision making at the highest level to include compliance considerations and Compliance input. This is the critical ingredient for avoiding future regulatory and reputational damage. The current Compliance function is often not well positioned to provide continuous strategic impact and is distracted by many more tactical tasks and responsibilities and may not have the right people to fulfill this role.

More senior staff, with broader experience. Compliance functions will need to diversify their talent pool with individuals with different experiences; the typical pattern of hiring technical regulatory experts from other firms will no longer suffice. General leadership ability, gravitas and understanding of the business will be as important as technical regulatory expertise in building an effective function. Similarly, Compliance will generally need more senior staff than in the past which, combined with our recommendations to reduce or streamline operational responsibilities within the function, could lead to a smaller but more senior Compliance function.

Better training. This approach will put a premium on developing more advanced training programs for Compliance officers, which has not historically been a big focus. Investing in these types of training programs promotes a globally consistent approach to Compliance, can reduce attrition rates and enables a more creative approach to hiring.

Shift of responsibility to the first line. It is essential to assess what tasks and responsibilities need to reside within Compliance rather than in the first line of defense. Compliance needs to be "at the table" for important business decisions, help design compliant control frameworks and engage further only where the risk merits the use of its limited resources. The first line needs to operate within the control framework and should no longer need to rely on Compliance for business as usual matters. A critical success factor is a clear definition of the role of Compliance versus the business and then a review of activities against this. This is discussed in more detail below.

Clear divisions of responsibility with the second and third lines. Financial institutions must clearly define the role of Compliance versus other second line functions (especially Operational Risk) and the third line of defense (Internal Audit). There are many issues that are presented when undertaking this analysis. What is the Compliance role in cyber-security data protection? Is Compliance responsible for tracking all regulatory changes or just those with a conduct aspect? A lack of mandate clarity usually ends up in wasting valuable time and effort for Compliance officers and other involved parties. Since Compliance has many responsibilities and the regulatory environment typically penalizes a lack of clarity in accountability when something goes wrong, it is very important to develop a clear risk framework and then analyze responsibilities and activities against the framework.

TRANSITIONING TO A DATA AND TECHNOLOGY DRIVEN RISK MANAGEMENT FUNCTION

In addition to only engaging where it is appropriate based on the definition of its role, Compliance must also become much more focused on risk and use its limited resources in the areas of highest risk. As such, it will need to move beyond current risk identification programs to a more sophisticated, dynamic and quantitative paradigm.

Developing a risk taxonomy. As a first step, financial institutions will need to identify the sources of Compliance risk in a taxonomy. While the use of the words "risk taxonomy" may not be familiar to Compliance officers, it is essentially a list of those Compliance themes where the function has second line accountability. If a framework is designed correctly, the risk taxonomy will flow though virtually all Compliance processes (e.g. regulatory change, risk assessment, policy, training, testing). The Compliance taxonomy needs to be consistent with the overall risk framework of the firm (e.g. those risks assigned to the Compliance Department versus other risk functions). This Compliance taxonomy must be supported by a robust rules inventory since this is the critical building block of all Compliance activities and it is a regulatory expectation in key jurisdictions.

Using metrics to drive the program. Compliance functions must focus on developing strong Compliance risk metrics aligned to the Compliance taxonomy. This begins with collecting data in an organized way. This data can include regulatory developments, exam results, suspicious activity reports, complaints, policy breaches, disciplinary actions, testing results, and surveillance driven reviews. The critical ingredient is that these metrics must be collected in a consistent way and tagged with various markers (e.g. taxonomy theme, product/service, region, country, legal entity, business unit, supervisor and/or employee). This data can be used very effectively in the Annual Compliance Risk Assessment Process and the planning process that follows. Ultimately, this information can be used to create an ongoing risk management program and can evolve into a risk tolerance framework.

Over time, this information will offer insights into norms at all the levels of the markers. For example, is a particular employee appearing in multiple metrics even though any one metric might not indicate a problem on its own? Is one business unit an outlier in one particular metric versus a similar unit? Are there differences regionally or by country? Is one particular theme trending negatively (e.g. more complaints alleging suitability concerns)? A well developed metrics regime offers first line managers concrete information they can manage to. This type of framework can also provide Compliance with the ability to focus its efforts on the areas of greatest risk (e.g. deploying testing resources to a business that has outlier tendencies). It also provides valuable information for senior management and the board as to where the risks lie from an enterprise perspective.

Technology to drive enhanced risk detection capabilities. In addition to developing a more metrics driven approach to risk management, new technologies are emerging that may allow a jump forward in Compliance's ability to detect misconduct, thus greatly improving its risk management capabilities. Over the last few years, technology has evolved to enable the sorting of large amounts of structured and unstructured data more effectively. Many firms have invested in platforms (e.g. Hadoop) that enable easier access and analysis for this data. It is our view that the use of big data will be one of the biggest drivers of Compliance change and improved effectiveness over the next few years.

More specifically, technology and new capabilities will help Compliance functions be more dynamic (e.g. identify a problem before or in the moment it occurs) and much more effective in finding truly material issues rather than the current approach which often generates high rates of false positives. However, there are a myriad of new vendors with various offerings including machine learning, predictive analytics, data visualization, etc. Some vendors offer a completely new approach to surveillance while others optimize the use of existing tools. In large financial institutions, there are also in-house technology resources that can be leveraged to harness big data for Compliance.

To effectively identify material misconduct risk going forward, it is essential for Compliance to pursue this avenue aggressively; however, at the same time, Compliance should maintain a long-term view and proceed with caution, as the space is highly fragmented and there are many small unproven vendors. Compliance leaders must develop a well-articulated strategy for their approach to big data and this should be integrated with the overall approach to big data at their financial institution.

ADOPTING CONDUCT, CULTURE AND VALUES TO ENHANCE THE COMPLIANCE ROLE

Many financial institutions have undertaken a journey towards embedding group-wide conduct, culture and values standards throughout their organizations. Culture and values guide how employees should act when there is not a specific rule or policy at issue, strive to protect customers and maintain market integrity and move financial institutions beyond a rules-based approach. The question is no longer "can I do it" but "should I do it"? In fact, this is quickly becoming a regulatory expectation as evidenced by UK, US, Australian and Dutch regulatory initiatives in this area. These approaches are also used as a source of value provided to customers and the public as part of the current ambition of many financial institutions to become the "most trusted financial institution."

Broadening the Compliance mandate to include conduct and culture. We have observed that the board, CEO or Executive Committee typically has led the initiatives, which is appropriate. Compliance often has not held a central role in these programs. However, as these initiatives mature, they present absolutely fundamental questions regarding the role of the Compliance function. In fact, it is important to consider whether this new approach is a trigger to broaden the role of Compliance to cover the concepts of ethics, culture and conduct. This would be an important evolutionary step which entails Compliance moving from a rules-driven approach to a function aligned to the highest level principles of a financial institution. This could have profound implications on the competencies of Compliance staff who, as mentioned previously, typically have rules related expertise and orientation.

The possibility of this type of transformation is something that Compliance leaders should be discussing with their senior management and board and will be critical to clarifying the role of Compliance going forward in the organization. We believe there is merit to expanding the Compliance mandate since the way forward will combine regulatory requirements ("doing what is legally required") with conduct and ethical standards ("doing what is right") as this will help in simplifying standards for the business (rather than confusing them with two systems of "right and wrong") and ultimately be the way to affect change in employees' behaviors.

RESISTING THE IMPULSE FOR RESOURCE INTENSIVE SOLUTIONS AND EMBEDDING EFFICIENCY AS A CORE PRINCIPLE

Compliance spend has grown substantially since the financial crisis in almost all major financial institutions; this level of growth is not sustainable, so whether it has already been mandated at the enterprise level or not, it is imperative that efficiency become an important consideration going forward. Up to this point, Compliance issues have typically been solved by providing additional resources to the function. However, at this point in the cycle, senior Compliance leaders should not reflexively look to add resources every time there is a new challenge. In fact, Compliance leaders should embrace efficiency initiatives since there are usually clear opportunities to improve performance if executed with a strategic approach and not a reactive one (e.g. percentage headcount reductions). Embedding efficiency in the Compliance function will also require a substantial mindset change for Compliance professionals.

Internal levers of efficiency. Because Compliance functions have grown so rapidly since the financial crisis, and often in a reactive way, there are typically many efficiency opportunities still available to Compliance senior managers including: offshoring, near-shoring, outsourcing, process simplification, automation of manual processes and consolidation of multiple systems. There are also opportunities for efficiency available to Compliance senior managers in revisiting the Compliance organizational structure. For example, centralizing functions (e.g. risk assessment, regulatory change, testing) can often lead to cost savings as Compliance responsibilities are able to be executed at scale. As referenced above, big data techniques ultimately have the possibility of driving substantial efficiencies as they gain traction that will enable optimization of the current trade surveillance, electronic communications and AML/sanctions transaction monitoring programs and technologies.

Cross functional levers. To attain a greater and a more lasting change, it is often useful to look more broadly at the financial institution and processes in connection with a Compliance efficiency project. One of the main components is clarifying the Compliance role within the organization which has been discussed above. In doing so, headcount and tasks can move to other functions, including the first line and other second line functions. Compliance is often involved in transaction level approvals which could be transferred to the first line (e.g. personal account dealing, gifts and entertainment requests). Compliance should only be involved in high risk specific situations and looking for patterns of risk that truly pose a material regulatory threat to the financial institution. In addition, clarifying mandates may also uncover duplication where more than one party is conducting a similar activity (e.g. developing similar management information for different audiences). Finally, clarifying roles and responsibilities offers opportunities to develop "reliance frameworks" where, as an example, Compliance can rely on first line testing or quality assurance and Internal Audit can rely on Compliance testing. This ensures that audit and testing activities are coordinated, efficient and optimized to the risk.

Since efficiency will be such an important driver going forward, we believe that more aggressive approaches should be considered now since these pressures will likely build over the foreseeable future. For example, depending on the financial institution, it could be appropriate to combine Compliance and Operational Risk organizationally to achieve a greater degree of synergy and efficiency. It is also worth exploring combining common second line functions, such as testing, into utility type structures and rationalizing or collapsing related/parallel processes (e.g. risk assessment). In addition, consideration should be given to migrating to common systems across the risk functions or the lines of defense. For example, many financial institutions are currently pursuing solutions that will maintain control and governance related information in one central repository (e.g. GRC system) thereby avoiding resource-heavy data collection, rationalization and reporting regimes. Further, the current construction of Compliance functions often includes some processes that have operational characteristics. Financial institutions could consider whether these types of functions might be more appropriately managed by Operations since Compliance officers are sometimes not as adept at running large scale processes as Operation functions.

COMPLIANCE AT THE TIPPING POINT-NEED TO RESET STRATEGY

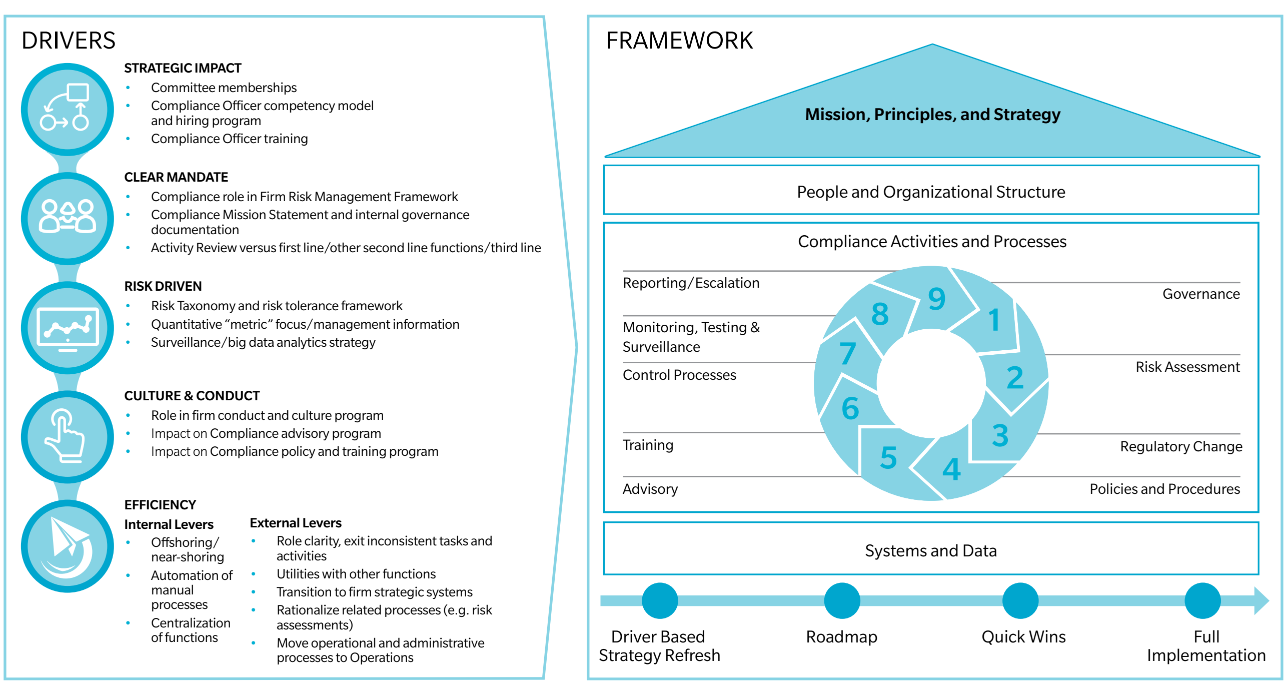
There are many forces at work with direct impact on Compliance functions, including continued regulatory change, increasing regulatory expectations, increased personal accountability and a high degree of cost pressure. In most financial institutions, Compliance functions have jumped forward since the financial crisis in a meaningful way, but are typically still in a state of relative immaturity since so much has happened so quickly.

We believe that this is exactly the right time to think more deeply about the strategic changes that will be necessary to "future-proof" the function. A Compliance function that continues to stay in reactive mode over the near to medium term will not be successful as the environment is changing at the micro (reactive) and macro (strategic) level. The areas discussed above create a basic framework and some substantive content for such an exercise. To say it more simply, the short to medium term goal is a Compliance function that:

- Has a continuous and multi-level strategic impact on the decision-making of the organization;
- Has a clear and well defined second line role that it sticks to it, and is not afraid to relinquish to others those tasks and processes that they (first line and other second line stakeholders) are required to do;
- Has a laser focus on identifying and helping mitigate the biggest compliance and conduct risks that is powered by quantitative metrics and big data enabled technology;
- Promotes, champions and helps enforce the risk culture of the financial institution, and is not bound by a rules-based approach; and
- Is strategically reducing its cost base and consistently strives for efficient solutions.

We think the time is now right to conduct a Compliance Strategy Refresh, supported by the framework discussed herein. This exercise can lead to productive discussions with senior management, the board and regulators about what Compliance will need to be to stay effective and help anchor their support for the function in the future. In articulating a more thoughtful approach for the future, Compliance leaders will still be able to steer the ship in the right direction, even though inevitable storms will continue to drive them off course for periods of time, and can help inform strategic decisions along the way.

Exhibit 1: Compliance Strategy Refresh



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