Compliance Zen: Finding the Path to a Strong Compliance Management System

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At the start of 2014, financial institutions’ identified compliance as a top growing expense. Throughout the year, the regulators kept their focus on compliance and show no signs of letting up as we enter 2015. This white paper focuses on how the Compliance Management System, or CMS, fared in 2014 and what lies ahead in 2015.

Introduction

Institutions continue to struggle to find competitive advantages in a tight market. Bank operations face immense challenges, from trying to ward off cyber threats and customer fraud to managing third-party relationships. Compliance is inundated with implementing and adapting their Compliance Management Systems for new regulatory requirements and evolving risks. These conditions ruled 2014 (and most likely will in 2015) and created an awkward environment in which risk managers were forced to keep expenses contained without disrupting their quality control environments.

With the introduction of each regulatory change or interpretation, many institutions added staff to deal with the burden. The addition of staff can introduce challenges for maintaining a strong CMS. In the Wolters Kluwer Financial Services’ Regulatory Risk Indicator issued in October 2014, more than one in three industry respondents said they had hired additional staff in the past twelve months to help more effectively manage risk. Sixty-three percent of respondents once again ranked “Regulatory Risk” as their greatest concern. While at the same time, the C-suite expressed less confidence in the ability to address regulatory requirements and manage risk across their organizations. An organization’s CMS is only effective if it contains timely feedback loops so that it can adjust as things change and is supported by a strong compliance culture driven by the C-suite; both of which are made very difficult when the pace of change is daunting and never ending. The previous year ended with institutions using more resources, spending more time and money but feeling less confident about their ability to get it right.

Yin and Yang: Culture and Employees

The culture and employees of an organization are the complementary forces that interact to form a dynamic system in which the whole is greater than the assembled parts.

In October 2014, Governor Daniel K. Tarullo, of the Federal Reserve Board, spoke about “Good Compliance, Not Mere Compliance” and related an institution’s success back to the culture observed by the employees.¹ A regulator is concerned not only with technical compliance, but also with employee behavior—is their behavior compliant and does it live up to the marketing pitch promoted in the institution’s advertising?

“In some firms the attitude we perceive is one of a mere compliance exercise. The firm proceeds to address the deficiencies identified by the Fed in a discrete, almost check-the-box fashion. To oversimplify a bit, I would say that our sense is that management at these firms wants the hurdle to capital distribution removed, but once the specific problems have been remedied, they want to move on. If this is the attitude we perceive, I suspect the working level employees of such firms do the same. The supervisory reaction in such cases is quite likely to be an inclination toward greater scrutiny.”

To prevent having a lack luster compliance program and greater regulatory scrutiny, the FRB expects to see a top down culture of compliance—a compliance program that is embodied with processes and systems to support its objectives. When an institution has a culture of compliance the conversation changes from how to fix the identified problem to identification of shortcomings in the overall decision-making and operational processes. Changes to processes and updates to documentation and training will be considered to not only ensure the problem does not occur again, but also to do it better and to create an improved customer experience.

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Mr. Tarullo describes a strong compliance program as one that does more than just comply with applicable laws or regulations. It should also influence the way an employee approaches her job. A culture of compliance will foster performing the steps in the process correctly because doing so allows the operational engine to run smoothly and provide a superior customer experience—both competitive advantages. Conversely, a culture of revenue maximization without consideration for a larger set of expectations puts employees at a cross roads between deciding to do what is right and what maximizes revenues.

The speech goes on to suggest that compliance at the employee level can be achieved by ongoing monitoring of operational processes for adherence to stated standards. For example, underwriting approvals, loan modifications, and new account openings can be monitored to stated product criteria. Your review should determine whether the original criteria used to obtain product launch are the same criteria still being used to stimulate the growth spurt or have changes been made to focus only on maximizing revenues. This is even more important when a product line’s volume and/or profits are growing rapidly. When the Compliance Management System is working holistically it can

help to ensure such growth is being done responsibly and in-line with external compliance requirements and the corporate objectives. As an industry, if this is not done we will continue to see further scrutiny, stricter interpretations and more enforcement actions.

**How to Achieve Zen through Feedback Loops**

Compliance within financial service organizations has two parts:\(^2\)
1. **External** – acting in accordance with the external rules that are imposed upon the organization as a whole; and
2. **Internal** – the system of controls that are imposed to achieve compliance with the externally imposed rules.

An institution’s culture of compliance and employee behavior is connected via the CMS, a set of interrelated parts updated through continual feedback loops.

No two organizations are exactly the same, and neither should their Compliance Management System. A CMS should reflect (1) the nature of the business the institution conducts, (2) the diversity of its operations; particularly decentralized vs. centralized operations and the use of third-party vendors, (3) the complexity of the business and products offered, and (4) the volume and size of transactions.

While the Consumer Financial Protection Bureau (CFPB) does not require a particular CMS structure they have found that effective CMS programs commonly have four interdependent control components (see Figure 1 below):\(^3\)
1. Board of Directors and management oversight;
2. A compliance program (which includes policy and procedures, training, and corrective action);
3. A consumer complaint management program; and
4. An independent compliance audit.

These same four components are included in the Office of the Comptroller of the Currency (OCC) definition of a Compliance Management System. And per the examination manual, “a compliance management system is the method by which the bank manages the entire consumer compliance process. All banks, regardless of size, should have a compliance program. A carefully devised, implemented, and monitored program will provide a solid foundation for compliance.”\(^4\)

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**Figure 1**

- Board and Management Oversight
- Compliance Program
- Consumer Complaints
- Compliance Audit

- Set risk appetite
- Set compliance culture
- Appoint qualified CCO
- Allocate resources
- Adopt policies
- Receive reports and ensure issues are being properly addressed

- Establish Policies and Procedures
- Training
- Identification and assessment of risks
- Monitoring and corrective action

- Capture
- Analyze
- Report on trends and resolution progress
- Timely resolution
- Escalation process
- Adjustment to business practices

- Independent review
- Approved scope, schedule and coverage
- Meaningful reporting and follow-up

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The four components of a CMS cannot be disjointed and must continually interact in order to keep the CMS up-to-date and properly functioning. The CMS components assure management that their institution is in compliance with laws, regulations, and internal policies and procedures; and that regulatory change has been fully and correctly implemented—it is the cornerstone of the compliance process. A compliance officer may conduct an \textit{ad hoc} risk assessment (assessing the risk within the business line procedures and processes) or targeted control testing (pulling a sample of files to confirm a prohibited action did not occur) to provide assurance to management and the Board that they are properly mitigating the risk. The addition of more bodies to the process, if not tightly aligned, will lead to inconsistencies. For example, policy and procedure updates that don’t follow a consistent template will lead to confusion when the document is reviewed for approval or interpreted for training and implementation.

The CFPB Supervisory Highlights issued in the spring of 2014 indicated that “every CFPB examination contains some level of CMS review”\textsuperscript{5}. The following list was included in the report as the CFPB definition of the Compliance Management System within an organization’s operations. Below each CFPB definition we have included how it relates to the four stated components and operational processes of a financial institution.

1. Establishes its compliance responsibilities, by determining the regulatory requirements applicable to its business operations

The Board and senior management set the risk appetite and compliance objectives for the institution. Part of doing this is having an identified understanding of what requirements match the business the institution conducts. Not all requirements are created equal to all institutions. The objectives, and culture, of the organization should be unique to that institution and will serve as the blueprint for the compliance program.

2. Communicates those responsibilities to employees

In order to gain adherence across diverse lines of business and multiple employees the compliance objectives must be written down and documented in policies. The policy should state the legal requirement (external compliance) and corporate objective (internal compliance). Policies must have version control and document attestation archives in order to provide evidence of the firm’s understanding to an examiner. The most effective policies (and corresponding procedures) will use a consistent format, review and approval process. This eliminates interpretation barriers and ensures everyone knows where in the document to find each relevant piece of the requirement. Policy and procedures should be reviewed at least annually to ensure they remain current and in line with corporate strategies. Policies (and procedures) that remain up to date and in sync with business operations support a culture of compliance.

3. Ensures that responsibilities for meeting legal requirements and internal policies are incorporated into business processes

Accountability lies with the line of business as the owner of the risk. The line of business uses procedures to document how compliance will be achieved within the daily activities. The implementation of such policy and procedures is achieved through training. Ongoing assessments involving the business will ensure that requirements, existing and new, continue to be tightly integrated into the business processes.

4. Reviews operations to ensure responsibilities are carried out and legal requirements are met

Ongoing assessment of employee understanding of the policy and procedures as well as practicality of the implemented process is crucial to ensure that the stated objective actually can be achieved. Sometimes the best intentions are thrown astray by a misunderstanding of a term or process. Unfortunately, with compliance such missteps can have a devastating technical, reputational or financial impact. Quickly finding and correcting those missteps can be accomplished when monitoring for compliance is used as a proactive feedback loop to the CMS program. Typically, compliance monitoring will provide more frequent and less formal feedback than compliance auditing.

5. Take corrective action

Regulatory enforcement actions often contain stories of a failed process that wasn’t properly followed up on. The failure often was noted in a review and includes a notation that staff was reminded of the requirements via email. However, a real feedback loop requires that people are provided with information about their actions in real time, then given a chance to change those actions, all while leading them toward the desired behavior.

An everyday example of this is the use of “Your Speed” radar signs on public roadways. The signs tell drivers information they already know and with no consequence. However, in location after location, just encouraging drivers to do the right thing has resulted in cars slowing down in the designated area.\textsuperscript{6} In a customer service center, the pop-ups that lead the customer service representative through the process are a real-time feedback loop; and when done in collaboration with compliance leads them via a compliant path.

\textsuperscript{5} CFPB, Spring 2014 Supervisory Highlights. \url{http://www.consumerfinance.gov/reports/supervisory-highlights-spring-2014/}.

\textsuperscript{6} Harnessing the Power of Feedback Loops, Thomas Goetz, 6/19/2011. \url{http://www.wired.com/2011/06/ff_feedbackloop/}. 
Examiners will check to ensure that corrective action identified during monitoring is completed in a timely fashion and where necessary findings are escalated to management and the Board of Directors. Issue management and corrective action is expected to be holistic across the organization. Compliance and operational risks were two of the key risk themes the OCC found as they aggregated data on risks facing the banking industry.

“The weaknesses in managing compliance and operational risks are documented in matters requiring attention, or MRAs, issued following exams. Over the last six months, 15 percent of all small bank MRAs have involved compliance related issues. For large banks, 21 percent of MRAs involved operational risk, 14 percent involved compliance with Bank Secrecy Act and Anti-Money Laundering (BSA/AML) laws and rules, and 11 percent involved consumer compliance specifically. When not addressed adequately, compliance and operational risk failures can and do result in enforcement action, and the failures in these areas are well publicized and have resulted in billions of dollars in penalties and restitution.”

6. Update tools, systems, training, and materials, as necessary

Whether a change is the result of a new regulatory requirement, feedback from an audit or based on analysis of captured complaints, once the change is identified that information is pushed back into the CMS by updating each of the parts of the program. As you build reports to support your program, think of the type of feedback needed to ensure your CMS stays current with what is happening in the business, market, and with regulators and customers.

Data, Information, Consequence, and Actions

Feedback loops have been used in many fields of study since the 18th century. For organizations, feedback loops can be studied in the context of systems theory. The system, or organization, is a set of distinct parts that act together to form a more complex thing. An organization is a set of resources, people, and information that come together to form a system. A CMS is formed by and responds to the resources, people and information of the institution. It includes resources such as documented requirements, procedures, and applications; people in the first, second and third line of defense; and information received from direct employee feedback, monitoring and auditing reports, data analysis and customer feedback.

A CMS is formed by and responds to the resources, people and information of the institution.

Figure 2 builds on the customer service example discussed on page 4 and outlines how an organization receives real-time feedback from its customers daily through customer interactions. It’s how an institution uses this information that sets it apart from its competitors.

Feedback loops can be a profoundly effective tool for managing your CMS if the information is timely and relevant to the situation. There may be multiple feedback loops within an organization. However, each feedback loop should have four stages:

1. data is collected;
2. the information is analyzed relevant to the situation (customers are complaining because they cannot locate a contact number on the website or obtain the right associate through the phone system);
3. what are the consequences of the information collected and analyzed; and
4. what action, or output, should be pushed back into the process to make a positive adjustment. Any such adjustment is a new input to the feedback loop that is monitored and measured to ensure the intended effect is achieved.

Feedback loops provide information about the successes or failures of the CMS system. Ongoing proactive feedback allows you to quickly adjust when negative information is received. Positive feedback provides the evidence you need to prove that your compliance

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program is strong and working as an advantage for the institution. When the four stages function in an environment that is based on a strong culture of compliance the organization can almost seamlessly absorb a new regulatory requirement. The change is quickly outlined in their template policy and procedures, updated steps are incorporated into the operational process, training provides not only the “how to perform” the new steps, but also why the steps are important for maintaining the culture of compliance and providing a good customer experience. Then when monitoring and auditing are conducted they find the small tweaks that need to be made to continue to reinforce the positive behavior and Zen-like compliance environment.

Zen Comes in Multiple Pieces

Each of the regulations is a piece within the CMS program. Each regulation has a policy and is implemented, trained and executed upon. Throughout 2014, the regulators gave heightened attention to different regulations.

In August 2014, Grovetta Gardineer, Deputy Comptroller for Compliance Policy at the OCC, indicated that the OCC is increasing its focus on Servicemembers Civil Relief Act (SCRA) compliance and now requires examiners to evaluate SCRA compliance during every exam cycle. The report drew attention to the failed components of the entities’ CMS. Repeatedly the report stated a lack of policies, procedures, Board oversight, inadequate complaint processes and compliance audits—each a cornerstone requirement of a CMS program.

In October 2014, Governor Daniel K. Tarullo, at the Federal Reserve Bank of New York Conference, highlighted the importance of a strong compliance program in antitrust, securities laws and consumer protection. For the Federal Reserve Board, the goal of examinations of banking organizations is to understand and be well informed about the policies, procedures, risks, condition and compliance efforts of these organizations, and to ensure that these organizations comply with applicable laws, regulations and policies established by the Federal Reserve Board.

From recent actions of the CFPB, 2015 looks to be a continuation of scrutiny on mortgage servicing, student lending, overdraft programs, debt collection, and auto lenders—each with their own requirements strung through an institution’s CMS.

Examination findings are only one piece of the CMS puzzle. The ability to maintain a strong CMS is affected by each regulatory change, IT change, business change and even employee change. From our own interaction with regulatory changes, Wolters Kluwer Financial Services understands the magnitude one regulatory change can have on the system as a whole. Take the TILA-RESPA change effective this August. Our attorneys have identified 400 regulatory changes that need to be implemented across documents, systems and policy and procedures. We alone have approximately 100 people involved in the effort to update our documentation and systems. Just getting the changes right won’t be enough this time as it appears the new disclosure will fall under the heavier hand of TILA and its enforcement measures.

Jeanne Erickson, a senior attorney at Wolters Kluwer Financial Services, believes, “HMDA could turn out to be the most significant rulemaking development for lenders in the coming year. Rule makers have been trying to finalize it, but have faced challenges related to concerns about operational scope.” These two changes will be important to watch in 2015 as will the fast pace of innovation anticipated to bring new and sought after experiences to customers. Each piece requiring a review and feedback into the institution’s CMS.

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Good Compliance, Not Mere Compliance

The next meeting you attend to talk about a strategic or regulatory development will no doubt include a compliance officer considering the impact to their CMS; however, that meeting should also include compliance awareness by all participants. Compliance, and the CMS, is a strategic business representative within each institution. Compliance Zen can only be achieved when the language of compliance is spoken from the top down and every employee can feel its importance and commitment. Is your organization committed to good compliance?

About the Authors

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