



The Future of Compliance, by Chris Skinner

The audit, compliance and regulatory requirements in financial services are far more onerous than in many other industries, apart from airlines perhaps. This is because governments are as concerned about ensuring that our money travels as safely from A to B as their citizens. This is why banks are licensed by governments to be trusted with our money, with a clear view that financial stability creates economic stability creates social stability.

In light of the recent financial crisis, something has been fundamentally wrong with this process however, and so governments are locking down all aspects of bank activities for compliance and audit purposes. As a result, now is a great time to consider using a high volume but low cost technology coming into prime time – digital video recordings – to store customer contact and interaction to prove compliance. In fact, it is the contention of this white paper that using video as a record of transactions could potentially give a bank the upper hand in the fight to recover from this crisis.

Introduction

A classic definition of a bank comes from Business Week's Information Exchange, which says that a bank is an "institution whose primary activity is to act as a payment agent for customers and to borrow and lend money".

That is the essence of banking. However, as banks handle money – "the root of all evil" – banking obviously has to be a highly regulated industry, subject to government licences and with highly focused regulators.

The result is that the history of banking is one of great caution and risk aversion.

Navigating the mass of complex regulatory requirements and being able to prove compliance is a huge challenge.

And this challenge is growing as a result of the recent crisis, new legislation and the complexity of the many layers of rules, procedures, processes and supervisors.

The Complexity of Compliance

The challenge is how to manage the complexity of compliance from the global to local levels of implementation and reporting. For international and global institutions this can be even more challenging, as sometimes the local rules in one country can be inconsistent or even in conflict with the rules of another.

For example, regulators exist at three major levels: Global, Regional and National. There are also sometimes sub-national regulations and regulators if you look at the USA, where states can set their own rules for bank licensing. There are also regulators for bank operations in each local business, even though the bank may be headquartered in a different jurisdiction. Finally, there are also regulators for each line of business: Retail Banking, Capital Markets and Insurance.



As you can imagine, managing the complexity of rules and reporting across these geographic and business structures is an issue, but it does not finish there as these structures are fluid and dynamically changing.

This is particularly true in light of the recent crisis.

At the global level, the G20 is working closely to draft new rules for bank capital ratios, risk management and remuneration. In April 2009, the first draft of these rules were announced, and included discussions of compliance officers working with government supervisors to even assess executive pay rewards to ensure they were not tied too closely to risk taking.

At the regional level, the USA has key bodies such as the FDIC, Federal Reserve and OCC, whilst Europe has CEBS, CESR and CEIOPS. These groups represent regional supervisors who try to ensure that cross-state and cross-border operations are co-ordinated and consistent across the major regional geographies of the USA and Europe.

Then there are the major US state level and individual country regulators, who add further layers of requirements upon these financial institutions.

By way of example, the UK's Financial Services Authority was given massively increased powers for 'heightened supervision' of the UK banks in October 2008, when the UK's new Banking Bill was announced. One of these powers included the need for a bank to be able to produce detailed customer records of all of their relationships with a customer across all of their banking operations, including all subsidiaries, within 24 hours of a request.

The Complexity of Compliance for Customer Contact

There are other changes taking place in addition to those that address the recent financial crisis. In particular, the opening of a new client account.

You would think that gaining a new client should be a celebratory process. It's new business! Isn't that great?

In fact, in the financial industry, bringing on board a new client is a pain.

This is because, over the past two decades, the requirements for banks to store more and more information about their clients and their knowledge of clients' financial situations has been growing into what today may be considered a mountain of information and documentation.

This need has arisen for a variety of reasons, particularly for:

- proof of identity;
- the identification and avoidance of politically exposed persons (PEPs) – those who may be involved in criminal or other undesirable activities; and
- proof of understanding a client's financial situation and being able to advise them appropriately as to their financial needs based upon their knowledge and assets.



These needs for client understanding have evolved consistently over the past twenty years from:

- the introduction of “factfinds” in the 1980s, where financial advisors must prove they have understood the clients situation using paper forms;
- through to the Know Your Client (KYC) documentation of the 1990s, where forms moved to electronic filing;
- through to today’s complex account opening processes, where full disclosure of customer information and capture of various proofs of identity, such as copies of passport or driving licence, are required.

In each instance, financial institutions find the challenge of bringing onboard a new client to be almost a customer avoidance process.

New Compliance Requirements for Customer Contact

The customer contact and account management process has become even more challenging of late however. Here are just a few examples of new rules that impact customer contact management:

- under the USA’s Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, better known as the PATRIOT Act introduced to monitor politically motivated financial transactions which may encourage terrorism, banks must prove that their dealings, even when it is through another bank, adhere to the requirements that prove the client is who they say they are and that their motivations are not criminal or terrorist oriented;
- these rules have been extended recently by the Wolfsberg Committee, who set the global rules for bank Anti-Money Laundering (AML) rules, who have made it clear that all of the payments between banks across geographies have to be re-wired to carry full customer profile information, not just the details of the sending and receiving bank;
- the European Markets in Financial Instruments Directive (MiFID) requires that every bank holds client contract information which clearly demonstrate the suitability and appropriateness of their polices to meet the client’s needs;
- further to several bank failures, authorities globally are focused upon banks having a much clearer and more holistic view of their customers and, in particular, any loans and borrowings to ensure excessive credit is reduced; and
- the financial crisis has led to much more analysis of the finances of customers of banks, with many taxation authorities requiring a bank to fully declare the status of their clients’ assets, including those previously excluded under private banking or tax haven rules.

As can be seen, the result of terrorism and financial instability has led to a wide ranging growth of new demands for client documentation and knowledge. Any lack of such information is a cause for concern and cost.



For example, the UK's Lloyds Banking Group were recently fined \$350 million by the USA for not conforming with payments rules in cross-border transactions; Swiss Bank UBS were fined \$400 million for allowing payments to be made between Iraq and other countries in US\$'s before the Gulf War; and US-bank Wachovia has been smeared with issues over their role in enabling drug money to move between Columbia and Mexico.

It is obvious therefore that from a reputational risk and financial view, non-compliance is not an option.

Compliance options

Most compliance based customer information has been held historically as documentation in large-scale filing rooms, offsite from the main bank's headquarters. During the 1980s, this was acceptable as the costs of electronic storage were high and many financial advisors, brokers and dealers were not computer literate. Therefore a paper-based form with a signature and a witness were adequate.

However, with the growth of the internet and the associated reduction in the costs of storage and retrieval, alongside the proliferation of electronic communications, this is no longer good enough.

Therefore, banks have been given strict instructions regarding the advice, structure and capabilities they have to communicate with clients, and the requirements to reconstruct this communication at a later time to prove compliance.

By the late 1990s, this had extended to storing the clients' records along with all other forms of electronic communications including emails.

With the rise of insider trading opportunities through text messages and, more recently, social media such as Facebook and Twitter, it is now a clear policy for all financial institutions to manage all electronic forms of communication with clients in a clear policy and procedure, with associated future storage, retrieval and reconstruction of such communications in place.

In fact, during the negotiations of the European Directive MiFID, which became law in November 2007, the regulators were discussing the storage of all details of every interaction with a customer for a minimum of five years, including telephone conversations as well as written communications electronically and in print.

These rules become even more of an overhead for a financial firm offering pensions or pension related investments, as the original contracts and client interviews must be recorded indefinitely, which means up to and often after the point of client expiration physically from this Earth in the eyes of the regulator.



In summary, compliance processes for client contact have become incredibly difficult to navigate for a variety of key reasons:

- 1) banks are government regulated and must comply with client reporting requirements;
- 2) reporting requirements vary by line of business and geography;
- 3) rules and procedures are changing, and growing in vigilance daily;
- 4) there are two opposing forces at work: client service and criminal avoidance; and
- 5) non-compliance is not an option.

The result is a growing need for recording, storing, filing, indexing and retrieving records of client discussions electronically from the moment a client agrees to do business with you until their termination or longer.

The Role of Video Recording for Compliance

With the increasing burden of proof in financial institutions to be able to reconstruct client advice and dealings, firms need to find an easier way to connect with customers and manage their interactions. The difficulty with the historical approaches described above is that most only provide a piece of the picture. A document only outlines what was recorded in summary, and the fact-finding documents normally receive a dismissive “I need to sign this to get things moving” flourish of the hand on the part of the applicant at best.

The actual content of the document and its accuracy to the advice given verbally is lost.

Even in the instance where firms record the complete conversation through telephone or digital recording, the eye contact and human interactions are lost. You purely have disembodied audio.

This is why video recording can play such a critical part in supporting future compliance, especially in high risk areas internally and externally.

After all, the nature of most financial transactions, as discussed at the start of this document, is based upon financial risks. The higher the financial risks the higher the financial returns, but do customers really understand the issues they face, the risks they are taking and the potential for loss?

These are the areas their advisers have to prove capability and these are the areas where advisers often have the greatest opportunity for abusing the system through non-verbal communications and possibly pressuring the customer into decisions that may be incorrect.

This is the heart of the compliance process – ensuring that customers are treated fairly – and is the reason why some regulators, such as the UK’s Financial Services Authority, even have a program of compliance called “Treating Customers Fairly”.



This programme has six core objectives:

- To ensure that customers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- Products and services marketed and sold are designed to meet their needs and are targeted accordingly.
- Customers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- Where customers receive advice, the advice is suitable and takes account of their circumstances.
- Customers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
- Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

These tenets of service are hard to prove when disputes arise because there is no recording of the account opening and application process, except on paper. Recording such a meeting on a voice recorder would equally be inappropriate for the reasons given. However, a video recording could be the ultimate proof.

A video recording captures voice and actions during the account opening process, including all of the non-verbal language of nods, blinks and winks that can subtly alter best advice into worst advice, and vice versa.

For example, a recording of the words: "I cannot recommend this strongly enough" could later be construed as "I did not recommend this". However, at the moment this statement is made, a visual recording of the meeting could show the advisor pointing at documentation which subsequently is the product the customer purchased. This then would be evidence that proves irrefutable as clearly illustrating the advisor recommending the product.

Irrefutable evidence is the key and, like CCTV in the high street, irrefutable evidence is the key to the future of compliance in financial transactions and particularly during the account opening processes.

The beauty of this evidence is that visual recordings of client-advisor meetings can provide neuro-linguistic analysis of customer interactions. This analysis will become pervasive in demonstrating whether the customer did or did not know the risks they were taking, and whether the advisor gave the correct and appropriate advice.

**The Future of Compliance**

From Treating Customers Fairly in a retail context to Best Execution in an investment markets context, the future of compliance is increasingly reliant upon financial institutions being intimate with their customers and their customer's needs.

From identifying potential money launderers and terrorists to ensuring that appropriate and suitable advice is given to a retail or professional investor, the burden of proof that the institution behaved correctly is firmly with the financial provider. The recent financial crisis is even moving that burden of proof to on-demand, real-time requests for evidence.

From being able to produce full records and disclosure of a customer account history in its entirety within 24 hours; to being able to show the banks dealings with those clients across multiple bank relationships, including third party banks; the financial industry will struggle to keep up with the requirements, requests, processes and procedures expected of them.

The result will be increasing duties to record customer contacts and interactions consistently in real-time, with indexing and retrieval of such interactions on demand to deliver to regulators and policymakers.

Using the latest technological capabilities of unlimited low-cost storage and high bandwidth, financial institutions can make this regulatory, compliance and audit overhead far more flexible and less onerous by incorporating simpler techniques into their processes, such as the standard usage of video recordings of internal and external conversations and interactions as a matter of policy.

The fact is that if the institutions do not mandate such storage and capability, they will more than likely be mandated to do so by the regulators. This is because, as regulators realise the opportunities visual recording of client-advisor meetings provides, they will be demanding the neuro-linguistic analysis of customer interactions outlined above along with the documented detail. Therefore, far-sighted institutions will find this transparency of storage and recording a bonus sooner rather than later.

Conclusion

In light of the recent financial crisis, the issues of money laundering and terrorism, and the general requirements for firms to know their customers, compliance duties are becoming more and more rigorous and onerous. The old days of having a few documents with ticks in boxes will no longer work. In fact, contractual documentation and voice recordings may not even cut it in this new world of the burden of proof being upon the institution, when requested, to demonstrate that they followed guidelines and acted in the customer's and the country's best interests.

A high volume and scalable solution for recording customer contact visually and verbally is where the future of compliance is heading.

Those firms that pre-emptively use video and full recording of customer contact for compliance and audit will therefore be ahead of the curve.

**Glossary:**

Anti-Money Laundering (AML): rules which ensure banks adhere to the legislation of major global economies as they relate to the criminal activities of potential money launderers, drug lords and terrorists. These legal systems are very particularly based upon the USA Patriot Act and subsequent rulings post 9/11, and are enforced by banks through the Wolfsberg Principles, an agreement on how to track global monetary movements in a way that avoids criminal activities. These principles are self-regulated by the industry, and demand that very specific documents are maintained especially during a new account opening process, in order to verify, track and authenticate accountholder's identities.

Best Execution: a principle of the investment markets, where dealers must ensure they have arrangements in place to obtain the 'best possible result' for their clients based upon the price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the order.

Know Your Client (KYC): supports AML and Best Execution in proving that the bank has understood the client and their needs, has documented their understanding and agreed these views with the client, and can therefore prove (a) that the client is who they claim to be and (b) that the bank has advised the client appropriately.

Treating Customer Fairly (TCF): a UK-generated principle which aims to raise standards in the way firms carry on their business, by introducing changes that will benefit consumers and increase their confidence in the financial services industry.

The main regulatory bodies referred to in most instances are those of the USA:

The Federal Deposit Insurance Corporation (FDIC)
The Federal Reserve
The Office of the Comptroller of the Currency (OCC)

and Europe:

The Committee of European Banking Supervisors (CEBS)
The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)
The Committee of European Securities Regulators (CESR)

Chris Skinner is an independent commentator on the financial markets and runs Balatro Ltd as well as being Chairman of the Financial Services Club. His daily blog can be found at www.theFinanSer.co.uk.