10 Things Compliance Officers Need to Consider in 2021

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Compliance officers at financial services firms have risen to the myriad challenges of 2020, not only dealing with the pandemic but also continuing to manage pre-existing problems. Risk and compliance officers have been, and must remain, front and centre in preparing their firms for all eventualities.

The impact of the COVID-19 pandemic has demonstrated the importance of culture. An effective risk-aware culture could perhaps be the most valuable asset firms can develop, and will make it easier for them to weather uncertainty and change.

Firms must take the time to assess the failures and successes, when they invoked their business continuity plans at the start of the pandemic. The crisis has shown that firms are capable of reacting to changed circumstances at speed, and while this is to be commended it is unlikely to change regulators' expectations. Firms must still be able to evidence compliance and the required good customer outcomes at all times. Regulators are seen to have had a good crisis; ideally, firms should be able to say the same.

Regulators have already committed to post-pandemic reviews. Firms will want to do the same but should continue to focus on recordkeeping and ensure all changes to policies, procedures and oversight have been recorded, and decision-making documented. Without detailed recordkeeping and retention, it will be all-but impossible to show the firm has followed (revised) procedures, and has remained compliant, during the pandemic.

The acid test of a policy is how it works when put into practice. Detailed jurisdiction-specific procedures may look good on paper but until they have been tested in the often-controlled chaos of an unexpected adverse event there is no way to know whether they are fit-for-purpose. Post-pandemic reviews should be used to refine and update policies and procedures, to reflect any new ways of working and to initiate a new round of training and awareness for the entire firm.

As ever, compliance officers will need to be fully engaged to give their firms the best chance of a trouble-free 2021. No matter the size, jurisdiction or sector of their firm, compliance officers should consider the following in 2021:

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1

Business continuity planning

Business continuity planning could be rebadged as uncertainty planning. Firms and their compliance officers need to acknowledge their ability to foresee or offset events may be limited. That should not stop them from developing policies and procedures to enable firms to be agile in their response to the unexpected.

Firms may wish to consider creating stand-alone policies to deal with events arising from uncertainty, or they may wish to align their approach to the one in place for disaster recovery or dawn raids. As with all policies it should be clearly documented, and all members of staff should be aware of the policy and familiar with its contents. The board and all senior managers should not only be briefed in detail but also asked to expressly confirm their knowledge and understanding of the agreed approach.

Firms should keep their disaster recovery and business continuity plans under review and, wherever feasible, test their efficacy. Any dependencies should be assessed carefully to consider whether the back-ups (whether IT, physical location or otherwise) could themselves be affected by, say, the continuing anti-COVID-19 measures implemented by governments. Some firms are required to build and maintain "living wills", for which the same criteria would apply.

Effective communication is essential to the successful management of an unexpected event, whatever the main cause. Firms' policies needs to state which staff members should be contacted and the order in which this should be done. While the local compliance officer should be one of the first people contacted, senior managers all the way to a top of a firm should be included in the communication ladder. The firm's press office should also be high on the contact list, with an agreed holding statement; handling the public relations of any potentially significant adverse event is a critical part of the process.

Firms also need to communicate effectively with regulators. In a single jurisdiction they will need to inform their financial services regulator of any substantive adverse event. For firms in multiple jurisdictions, the impact of such an event should be considered for reporting to their lead financial services regulator.

2

Data protection

The acceleration of digital transformation in response to the pandemic has been accompanied by a heightened focus on data protection. Many firms process data in a number of locations and jurisdictions. Firms should have central records of the location of data and the terms under which they are held. This is not only a question of compliance with all relevant data protection requirements but also one of accessibility and, where needed, retrieval, should a repatriation of data be required.

The EU General Data Protection Regulation has become the benchmark for the approach to data protection; the United Arab Emirates has been one of the latest jurisdictions to base its proposed new requirements on the GDPR. In the European Union itself, a review of the implementation of the GDPR showed it to be consistently inconsistent. As a result, both the requirements and the approach to supervision may change in future.

There have also been landmark enforcement actions and fines issued for data protection failures. One of the most significant was the October 2020 action taken by the UK Information Commissioner's Office against Experian. The ICO decided against the imposition of a monetary penalty but required Experian to revise the ways its data broking businesses use personal information. If Experian fails to make the required changes within nine months, however, it could risk further enforcement action including a fine of up to £20 million or 4% of the organisation's total annual worldwide turnover.

The ICO considers the actions required in the enforcement notice to be the "most effective and proportionate way" of achieving compliance. The impact of implementing the actions required will be significant given the numbers of data subjects involved. Experian has personal data relating to 49.8 million (out of a total of 52 million) adults in the UK, the ICO said. The implementation of any kind of review involving those kinds of numbers will be a massive undertaking, particularly given the time scales imposed.

Firms will be fined for breaches of data protection requirements, and business models put at risk, if they fail to be transparent about data collection and the reasons for it.

3

Regulatory change

The pace of change in financial services regulation shows little sign of slowing down. In 2021, this agenda is likely to be driven by postpandemic reviews carried out by supranational regulators and policymakers, Brexit and a change in administration in the United States.

The biggest driver of the future shape of regulation is the Financial Stability Board (FSB), which operates under the aegis of the G20. As part of the suite of reports delivered to the November G20 summit, the FSB published its annual report. At a high level, the report found the G20 reforms agreed after the 2008 financial crisis have served the financial system well during the COVID-19 pandemic. Specifically, the greater resilience of major banks has allowed the system largely to absorb, rather than amplify, the macroeconomic shock.

The FSB report highlighted the progress made in implementing the policy measures set out by the FSB since the financial crisis and translated into more detailed regulatory reforms by the standard-setting bodies of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the International Organisation of Securities Commissions.

In particular, the post-2008 reforms aimed at addressing "too-big-to-fail" are considered to have been a success. Banks are now more resilient and resolvable, resulting in "significant net benefits for society". Some gaps need to be addressed, but overall banks are better capitalised and have built up significant loss-absorbing capacity.

The benefits of the reforms are seen to have outweighed the costs. The assessment was made from the perspective of social costs and benefits, where the benefits are the reduced probability and severity of a financial crisis, and the costs arise via increases in the cost of bank credit. The significant net benefits for society are increases in resilience, no material increases in the costs of funding, and more market discipline.

The FSB's high-level conclusion that the post-crisis regulatory reforms have enabled the financial sector to better handle the shock of the pandemic belies the extensive further work and coordination needed to complete the reform process, which includes:

- Continuing to promote approaches to deepen international cooperation, coordination and information-sharing, underpinned by the FSB principles for the COVID-19 response, with the support of the G20.
- Consideration of the question of whether the flexibility provided by authorities was actually used by financial institutions, one example being bank capital and liquidity buffers. This is seen as requiring "particular attention" and will inform discussions of future policy adjustments, including on the eventual exit from temporary measures.
- The extraordinary policy measures taken in response to the financial market turmoil in March 2020 raise issues which need further consideration, including on their longer-term consequences.
- The FSB's holistic review of the turmoil will consider the implications for regulatory and supervisory policies, especially for non-bank financial intermediaries in relation to the liquidity stress, and how central bank liquidity facilities have affected market conditions and market participant expectations.
- Further work to assess the lessons to be learned from the pandemic for international standards including assessments of buffer structure and usability for banks; policy proposals to enhance the resilience of money market funds; margining practices in derivatives markets; liquidity risk and its management in open-ended funds; liquidity, structure and resilience in core bond markets; potential sources of procyclicality relating to financial regulations; and crisis management frameworks.

The FSB report shows that financial stability and other policy initiatives appear to work as intended but that the regulatory change agenda will remain relentless. Firms must continue to engage with both the policy and detail of regulatory change, to keep any unintended consequences to a minimum.

4

People governance and accountability

Personal liability has featured little among the challenges thrown up by the pandemic. Firms are focusing on managing the crisis day-to-day, with supervisory forbearance likely until the pandemic has passed. Senior individuals must, however, continue to discharge their responsibilities and ensure they can evidence compliant activities in their sphere of control. Those responsibilities will inevitably include the people and associated reporting lines which may well have changed during lockdown or with working from home.

The shifting political approaches to manage the virus contagion risk have put a spotlight on where employees work, and on the greater likelihood that they may be, in large numbers, unwell. Management of the (self) isolation or sick leave of employees is likely to be primarily the responsibility of the human resources function, but compliance officers will need to keep terms of regulatory registrations up-to-date and ensure the firm is not left with any undue long-term gaps in significant roles and skill sets.

An interrelated issue is people governance. All firms will have an organisation chart setting out who reports to whom. Many firms also capture, explicitly, who is responsible for what, and where, in the business. Those firms which do not already do so may wish to build the next level of detail into their organisation chart. It is simpler for firms to respond with agility to events if there is immediate clarity about who is in a position to take which of the required actions to remediate an unexpected event.

The pandemic has changed ways of working, probably permanently. Many financial services firms have cut bureaucracy to focus on decision-making. Governance and reporting structures have been made more flexible. Boards, committees and teams often are meeting more frequently, sometimes in smaller groups made up of key decision makers, and usually online. The changes have extended to the compliance function itself, with new governance structures being adopted to ensure the flow of management information remains tailored to the evolving circumstances to facilitate better awareness of the risks at the most senior levels of the firm in particular.

5

Compensation and remuneration

Compensation and remuneration practice remain work-in-progress, and require attention from compliance officers. Remuneration and compensation practices have been in the spotlight since the 2008 financial crisis. One of the first acts of the FSB following the crisis was to articulate the principles for sound compensation practices. The principles were intended to reduce incentives toward excessive risk-taking that may arise from the structure of compensation schemes. They were not intended to prescribe particular designs or levels of individual compensation.

The principles are supported by implementation standards which focus on the areas where "especially rapid progress is needed". The standards omitted some of the principles but prioritised areas that should be addressed by firms and supervisors to achieve effective implementation of the principles.

The FSB's work on compensation and remuneration practices has continued ever since. In May 2020, the FSB published the main takeaways from a workshop it held in November 2019 for 19 banks, insurance companies and asset managers to discuss their experiences with implementing the principles and standards. The objective was to gather information on compensation issues and challenges, to help inform the FSB's assessment of how well the principles and standards had been implemented.

The workshop covered the effectiveness of compensation policies, the use of data by firms as part of compensation practices, regulatory and legal issues as well as developments on compensation and risk alignment research.

Six themes emerged from the discussions at the workshop:

1. *Effectiveness* — firms, generally, are still at an early stage of developing frameworks to assess the effectiveness of their compensation policies and practices.
2. *Risk alignment* — effective risk alignment is at the heart of regulators' efforts to reform compensation structures. All firms reported that they take steps to align compensation with risk. It was also noted that, given the earlier regulation for banks in this area, banks are often at a more advanced stage with this work than firms in other parts of the financial sector. Firms reported that efforts to prevent and address instances of misconduct mean that non-financial metrics play an increasingly important role in compensation schemes.
3. *Data use* — a number of firms reported improvements in systems and processes for gathering and analysing compensation data.
4. *Governance* — firms highlighted the central role control functions play in compensation processes with, for instance, risk and compliance functions having input to individual compensation decisions.
5. *Compensation tools* — firms said the use of malus and clawback is limited because of complexity and, in some jurisdictions, legal challenges. In-year adjustment is the ex-post adjustment tool used most frequently. Firms reported an extremely limited use of clawback given the legal risks associated with its application.

5

Compensation and remuneration

6. *Competition for talent* — firms said it had become harder to hire staff with the necessary skills.

To add to the work undertaken on remuneration and compensation practices, in August 2020 the Bank of England published a staff working paper which considered the practical ramifications of the bonus cap for material risk takers introduced by the European Union. The EU bonus cap restricts variable pay to no more than 100% of fixed pay, or 200% with shareholders' approval.

A proportion of the variable pay also needs to be deferred and is subject to "malus", which enables deferred bonus payments to be forfeited if certain conditions materialise. In the United Kingdom, at least 40% of a material risk taker's variable pay needs to be deferred for a period of no less than three to seven years, and can be clawed back under certain pre-specified circumstances for a period of seven to 10 years after it is awarded.

The working paper detailed the results of a laboratory experiment carried out by the Bank which examined how constraints on bonus payments, such as bonus cap and malus, affected individuals' choices of risk. The aim of the experiment, which involved 253 participants, was to investigate whether such bonus restrictions could curb risk-taking as intended, and how they interacted with relative performance benchmarking, which is commonly used in the financial sector.

The Bank was careful to couch the findings of the experiment as "suggestions".

"While strong conclusions on policy should not be drawn based on a lab experiment alone, our study highlights a number of ways in which bonus structure could affect risk taking," it said.

The findings add further weight to the conclusion that the design of bonus schemes may affect risk choices, and certain restrictions on bonus payments might reduce risk-taking. There is the clear inference that "some appropriately designed restrictions on bonus payments could mitigate excessive risk-taking".

A note of potential concern is sounded in terms of relative performance pay, with the findings suggesting that commonly used bonus practices (such as relative performance benchmarking) may well undermine the risk-offsetting effects of regulatory bonus restrictions.

One of the main causes of the financial crisis was excessive risk taking, incentivised by inappropriate compensation and remuneration practices. Despite the "rapid progress" advocated by the FSB's 2009 implementation standards, further refinement is needed to determine what good or better practices look like for compensation practices. The question of effectiveness needs focus.

The high-profile example of Goldman Sachs seeking to claw back around $174 million from current and former executives as a result of the 1 Malaysia Development Berhad (1MDB) debacle illustrates developing compensation practices in action. The clawback includes a $31 million cut to the compensation of David Solomon, chief executive, and two of his deputies. Goldman is also seeking $76 million from three former employees directly implicated in the scandal.

6

Product governance

Product governance is at the heart of investor protection, and investors are seen to have become increasing vulnerable as a result of the pandemic. Regulators' expectations with regards to good customer outcomes remain the same and will continue to look "upstream" to the approach taken by firms in the development, manufacture and post-sale review of retail products.

One area which is financial services-sector neutral is product testing, which forms an important part of the overall product oversight and governance requirements. Product testing should assess whether a product meets the identified target market's needs, objectives and characteristics throughout the lifetime of the product. It is important for identifying any potential drawbacks, understanding the future use of the product, testing the communication with, and distribution to, consumers, and putting the customer at the heart of the product design. It further assesses whether any changes need to be made to the target market, to the product and/or to the distribution strategy as a result.

From the regulators' point of view, when assessing the product-testing methods used by manufacturers, the supervisory activities aim to consider the product-testing structures that are in place at a firm (i.e., what product testing looks like on paper) and whether the product-testing processes and procedures are fully embedded (i.e., how product testing is implemented in practice).

Supervisory activities seek to establish whether the overall focus of product testing is on the target market's outcomes. Such activities look at multiple aspects of the product-testing process, for example:

- whether manufacturers have adequate and comprehensive product-testing policies and procedures, and the scope of such producttesting policies and procedures;
- whether the policies and procedures adequately assess the "fairness" of a product, taking into account whether it is cost-efficient, useful for the target market and comprehensible;
- whether the approach to product testing is adequate vis-à-vis the specific products commercialised; and
- whether the product-testing structure put in place is effective.

Supervisors may decide to carry out a more extensive assessment of the embeddedness of product-testing policies, which includes establishing:

- whether a process exists to test that terms and conditions deliver fair outcomes for the target market, including whether product features (such as policy exclusions for insurance products) have been carefully considered to ensure the product has an added value for the customers;
- whether a process exists to test that terms and conditions are not difficult to understand;
- whether a process exists to test product attributes (such as features, benefits, customers' eligibility to purchase, customers' obligations, etc.,) to ensure they are designed to meet the needs of the intended target market;
- whether tests are applied to each product, and whether these are appropriate in respect of the target market;
- whether product tests envisage quantitative thresholds to consider whether the product is compatible/incompatible with the identified target market; and
- the types of actions manufacturers take following product testing (for example, have proposed products been withdrawn or altered?).

Firms should benchmark their approaches to product oversight and governance following the pandemic to ensure products have performed as expected and good customer outcomes have been maintained. Any review of products should be meticulously documented, particularly where there have been any changes to products or target markets as a result of that review. Regulators will undertake a post-pandemic review and it will put firms on the front foot if they have already benchmarked their approach to product governance.

7

Shifting skill sets

Compliance officers have always had to be polymaths, and that will continue in 2021. The 11th annual cost of compliance report from Thomson Reuters Regulatory Intelligence found the three main skills required for an ideal compliance officer were subject matter expertise, followed by communication skills and interpersonal/stakeholder management skills and digital/technological understanding. This flexed slightly in the COVID-19 update to the cost of compliance report: subject matter expertise remained in the top spot but communication skills in a virtual world and digital/technological understanding were in second and third places.

The clearest need for skill-set building is in technology, whether regtech, fintech, artificial intelligence and machine learning or digital transformation in general. Expertise in this area will become even more valuable as the more rote compliance tasks begin to be undertaken by regtech solutions.

Equally, when it comes to the approach needed to handle culture, conduct risk and personal liability, a skilled compliance officer is a fundamental part of a firm's capacity to manage all relevant risks.

Climate risk is rapidly coming into the mainstream for financial services. Many regulators have set out their expectations for firms, making this is another area where compliance officers may need to seek additional knowledge and training. Whether it is sustainability or greenwashing, or the environmental, social, and corporate governance (ESG) agenda, compliance officers are having to get up-to-speed, particularly in terms of disclosure requirements and transparency.

Islamic finance is another area in which compliance officers may wish gain expertise, post-pandemic. In a December 2020 speech entitled "Why Islamic finance has an important role to play in supporting the recovery from COVID – and how the Bank of England's new Alternative Liquidity Facility can help", Andrew Hauser, executive director, markets at the Bank of England, announced the Bank's new sharia-compliant non-interest based deposit facility — the first such account from a Western central bank.

"The core principles of Islamic finance are strikingly well-suited to responding to some of the biggest challenges we will all face in rebuilding our economy once COVID has passed. Prioritising equity-like risk-sharing over debt. Factoring ethical and environmental considerations into investment decisions. And embracing innovative financial solutions beyond traditional banking. And that lies four square within the Bank of England's mission to promote the good of the people of the United Kingdom, Muslim and non-Muslim alike," Hauser said.

8

Compliance resources and budgets

Compliance functions are far from immune to budget cuts, but firms need to appreciate that investment in a highly skilled and appropriately resourced in-house compliance function is one of the best risk reward decisions that can be made. There will be competing priorities, but in a post-pandemic world firms will need to ensure that they are, and can remain, compliant, have embedded culture and conduct risk and have a control infrastructure. Without those basics in place firms will struggle to thrive into the medium term and senior managers will be increasingly vulnerable to personal liability.

There are signs that, even before the pandemic hit, compliance functions were being starved of resources.

In 2020 the Central Bank of Ireland (CBI) published a series of "Dear CEO" letters and thematic reviews covering areas such as antimoney laundering compliance, best execution and the fitness and probity of individuals. The publications read like a shopping list of actions for the boards of financial services firms in Ireland. Throughout, the CBI remained clear it is the board's responsibility to ensure there are adequate governance processes and sufficient resources in place for the effective oversight and monitoring. A root cause of the findings was sparse compliance resources and unfilled compliance function vacancies, it said.

It is a Catch-22. Irish firms have found themselves in compliance difficulties due, at least in part, to an under-investment in compliance, and yet without that investment they have no chance of being able to remediate the issues and complete the actions expected by the regulator. Without the requisite expert compliance skill sets firms will be unable to achieve, maintain or evidence compliance with the gamut of requirements and expectations risking enforcement action for firms and individuals alike.

9

Digital transformation dependent on data governance

One of the few pluses from the pandemic has been the acceleration of digital transformation by, in some estimates, up to three years. This is not devoid of challenges, one of which is the key cultural indicator of the need to invest equally in both front and back office functionality. There is, for instance, little point in having an artificial intelligence/machine learning-enabled trading desk if the back office and compliance function lack the ability to monitor those activities.

At the heart of many of the successful digital transformation projects is data governance and the management of data risk. The proper functioning of trading, reporting, compliance and risk management in general is critically dependent on the security, accuracy, timeliness and integrity of data. Firms are having to face the growing challenges of data management — standardisation and good data governance will be essential to offset the associated risks.

Data risk comes in many forms and depends on the specifics of an organisation, its management of technology and its framework for governing data. The sources of data risk include:

1. Business continuity and operational risk where a dependence on critical data sources can lead to significant loss of capability should those sources be interrupted or corrupted.
2. Security and confidentiality risk where ineffective controls to protect data can result in inadvertent disclosure or unauthorised access to data either internally or externally.
3. Commercial trading risk where both humans and machines rely on accurate data to achieve optimal outcomes in trading, investing and risk management.
4. Aggregate exposure risk which occurs when data pertaining to risk positions in different parts of a firm or running through different systems cannot be aggregated into a consistent centralised picture of risk exposure in a timely way, then this could give rise to significant and unanticipated firm-wide exposures.
5. Regulatory enforcement risk where regulators are increasingly taking punitive action against firms which consistently fail to meet their reporting obligations in an accurate and timely manner. If firms cannot accurately map their data to the requirements of a multitude of different reporting obligations, then these risks can result in material financial, reputational and regulatory consequences. Regulators can take enforcement action over a range of other data-related failures that lead to operational instability, lack of transparency and conduct issues.
6. Ownership and rights risk whereby ambiguity and misunderstanding of commercial rights regarding data is an increasing risk
7. Security and conduct risk resulting from inadequate controls concerning permissions for access and manipulation of data which may lead to opportunities for misconduct.

As with all forms of risk management there is no one-size-fits-all approach to data governance and controls. Firms can, however, gain long-term benefits from a focus on the important building blocks and areas of developing best practice in the design, construction and maintenance of data architectures.

There are a number of elements for firms to consider including whether or not to move to a centralised approach to enterprise data architecture or whether a more hybrid approach would be preferable. Firms also need to build a data governance strategy that can deal with inconsistencies across an ever-wider array of external data sources including other firms, vendors and regulators.

As with so many challenges, compliance officers will need to be involved fully in a firm's approach to data governance (and hence digital transformation) to achieve the best results.

10 Personal accountability

Regulators have extended considerable forbearance during the pandemic, but such patience is not infinite and firms and senior individuals (compliance officers expressly included) need to ensure they are fully aware of their sphere of responsibility and can evidence the discharge of their obligations.

Personal accountability regimes have proliferated as regulators seek to drive better, risk-aware standards of behaviour. Singapore

is just one of the latest jurisdictions to implement a personal accountability regime for senior managers. The accountability regimes are, by design, making it simpler for supervisors to hold people to account with all the possible causes of misconduct, from incentives to culture, coming under policymakers' spotlights. Regulators have also focused on making it harder for "rolling bad apples" to keep changing firms or jurisdictions to stay ahead of supervisory attention.

In the 2020 cost of compliance report, compliance officers' expectations about their personal liability reflected their perennial concern. Consistent with previous years more than half (58%) of respondents expected the personal liability of compliance professionals to increase in the coming year (41% slightly more and 17% significantly more). Just 2% thought that the personal liability of compliance professionals would decrease either slightly or significantly.

It is not only the spread of accountability regimes which have the potential to raise the personal liability of senior individuals in financial services firms, but also the regulatory focus on culture and conduct risk issues.

In 2020, almost three-quarters (73%) of practitioners believed the regulatory focus on culture and conduct risk will increase the personal liability of senior managers. This increased to 77% among G-SIFIs. Regionally, 94% of firms in the Middle East and 91% of firms in the UK expect the regulatory focus on culture and conduct risk will increase the personal liability of senior managers. At the other end of the spectrum just more than one-fifth (21%) of firms in the United States do not expect the regulatory focus on culture and conduct risk to increase the personal liability of senior managers.

Given the continuing focus on individual accountability, compliance officers and other senior managers would be well-advised to consider three basic principles for managing their personal liability:

1. Be aware — build the capability to keep abreast of all changes to relevant rules, requirements, obligations and expectations, bearing in mind some applicable rules may arise outside an individual's home jurisdiction.
2. Compliance by design — know exactly what they are responsible for at any point in time and how compliant activities in their areas of responsibility are structured and tested as operating effectively.
3. Evidence — invest in comprehensive recordkeeping so that, after the event, compliant activities — and hence the discharge of relevant obligations — can be demonstrated.

ABOUT THE AUTHOR

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