

Remarks delivered by Shri M. Rajeshwar Rao, Deputy Governor, Reserve Bank of India – July 19, 2022 – in the Conference of Chief Compliance Officers at CAFRAL

Good Morning everyone. First of all, let me thank Indrani for extending this invitation to address the gathering. I will be very brief in my remarks today and will try and highlight the emerging challenges before the CCOs and RBI's regulatory expectations from them.

1. Globally, the financial landscape is fast evolving as newer challenges continue to emerge which compel the banks to adapt and come up with novel solutions to address the challenges and remain relevant. This demands continuous reorientation of the institutional architectures, realignment of business strategies and business reengineering to upgrade the benchmarks for service delivery and enable growth. However, while dealing with these changes, ensuring that the new systems remain in tune with the regulatory and supervisory expectations as well as other statutory and legal requirements assumes importance. It is in this context that the role of assurance functions in the financial institutions, especially the role of compliance functionaries becomes important.
2. Banks and other Financial institutions perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. For orderly functioning of financial system, it is necessary that the conduct of the stakeholders is subject to certain minimum standards of safety and prudence which may take the form of laws, regulations, guidelines, and codes. Compliance to these ensures orderliness while reducing overall systemic vulnerability. Safe and sound financial intermediation is a key to financial stability, and central to economic health of a country.

3. Basel Committee on Banking Supervision (BCBS) has defined “compliance risk” as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation an entity may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its activities¹. Compliance of the laws, rules and standards generally cover matters such as observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring the suitability of customer advice.

Compliance function in the Indian context

4. Reserve Bank of India introduced a system of having “Compliance Officers” in banks in August 1992, based on the recommendations of the Committee on Frauds and Malpractices in Banks (Ghosh Committee). The role of compliance officers came into sharper focus since 1995, when the General Manager in charge of Audit and Inspection was made responsible for the compliance functions with a requirement for periodic reporting or certification on compliance functions directly to the Chairman and Managing Director.
5. As a part of robust compliance system, banks are required, to have an effective compliance culture, independent corporate compliance function and a strong compliance risk management programme at bank and group level. Such an independent compliance function is required to be headed by a designated Chief Compliance Officer (CCO) selected through a suitable process with an appropriate ‘fit and proper’ evaluation/selection criteria to manage compliance risk effectively. However, to ensure uniformity as also to align the supervisory

¹ Compliance and the compliance function in banks, April 2005

expectations on CCOs with best practices, banks were advised in September 2020 to adhere to certain minimum standards on tenor of appointment of CCO, their transfer/ removal, eligibility criteria, selection process, among others. The guidelines also detailed the roles and responsibilities of the CCO.

6. More often than not, compliance function is treated as having little strategic value, which is a very myopic view. It needs to be appreciated that compliance-related activities reflect opportunity costs for institutions. In fact, the cost of compliance can be divided into two broad heads, namely the cost associated with ensuring the compliance, *i.e.*, operational cost, and the cost of non-compliance. However, this opportunity cost must be juxtaposed against the risk of a compliance failure which at times could jeopardise the very existence of an entity. Therefore, objectively assessed, the benefits of compliance far outweigh the costs.

7. The Regulations Review Authority (RRA) 2.0 in its recently released report has made recommendations on streamlining regulatory instructions, reducing compliance burden of the REs by simplifying procedures and rationalising reporting requirements, wherever possible which should help reduce the costs of compliance. The outcome of RRA exercise should result in clarity, simplification, easy accessibility, and rationalization in regulatory instructions and returns. While many of you have actively participated in the RRA exercise, I hope all of you have gone through the report

Essential features of a compliance function

8. As the Reserve Bank has emphasized time and again, compliance starts at the top. Keeping this in view, RBI has mandated that all banks and large NBFCs should lay down a Board-approved compliance policy clearly spelling out its compliance philosophy, expectations on compliance culture covering Tone from the Top, Accountability, Incentive Structure and Effective Communication & Challenges thereof. The policy should also identify structure and role of the compliance function, role of CCO, processes for identifying, assessing, monitoring, managing, and reporting on compliance risk throughout the bank. This should, adequately reflect the size, complexity and compliance risk profile of the bank, expectations on ensuring compliance to all applicable statutory provisions, rules and regulations, various codes of conducts (including the voluntary ones) and the bank's own internal rules, policies, and procedures, and creating a disincentive structure for compliance breaches. The policy is expected to be reviewed at least once a year.

9. As such, the Board is made responsible for overseeing the management of the bank's compliance risk. They should approve the bank's compliance policy and review the extent to which the bank is managing its compliance risk effectively. Though the board has been tasked to approve the bank's compliance policy, it will not be effective unless they promote the values of honesty and integrity throughout the organisation. A bank should hold itself to high standards when carrying on business, and always strive to observe the spirit as well as the letter of the law. Failure to consider the impact of its actions on its shareholders, customers, employees, and the markets may result in significant adverse publicity and reputational damage, even if no law has been broken.

10. Senior management is responsible for communicating and reinforcing the compliance culture established by the board, and for implementing measures to promote the culture. Senior management also should implement and enforce the compliance policies and compliance risk management standards that have been approved by the board. The compliance function is central to bank's system of accountability and is required to ensure that the bank adheres to prevailing laws, rules, and regulations while conducting its business. In this respect, it is not sufficient to ensure the compliance policy simply exists, but it should demonstrate that they are applied in substance to manage compliance risk. Moreover, compliance with legal and regulatory rules is a responsibility for the organisation as a whole and is not a function located within a single department to administer.

11. Let me also say that the compliance functionaries also need to be prescient. The central premise of the compliance function is not simply to act as an internal 'watchdog' but also to work with the business units to minimise the likelihood of compliance failures. This is to make sure that the business units do not, breach the laws, rules and standards governing its business activities, which could result in a variety of regulatory sanctions.

12. Therefore, it is essential that the compliance function within the entity is organised in a way that is consistent with its own risk management strategy and structures. Needless to mention, irrespective of the internal structures, compliance function should be independent, responsibilities should be clearly specified, and activities should be subject to periodic and independent review by the internal audit function.

Regulatory Expectations - The role of Chief Compliance Officer

13. The role of Chief Compliance Officer (CCO) is critical and requires him/her to address demands from a lot of competing stakeholders viz. Regulators, Supervisors, Law Enforcement Agencies, Board, Senior Management, Business Verticals, Internal Audits. Even where all these stakeholders agree upon the core function of CCO, there would be areas of interests which overlap where expectations from the concerned stakeholders may be divergent. The effectiveness of CCO lies in handling such divergent expectations and arriving at an independent and objective decision without compromising on the legal and ethical frameworks.

14. In the erstwhile era of traditional banking which was characterised by plain vanilla products and micro regulations, the compliance function was relatively simple. However, with the development of the financial markets and the advent of technology, it needs to be appreciated that the role of compliance functions has widened. At times when the financial products and practices do not fit into any traditional model, the role of CCO is to ensure that there is no compromise on the underlying regulatory principles and intent. In sum, the CCO should function as an extended arm of the Reserve Bank.

15. Let me give you a few examples on how compliance function can facilitate the implementation of regulations, in both letter & spirit across spheres:
 - (i) The regulatory paradigm has, over the years, moved towards greater deregulation in all respects and banks are expected to be guided by their respective Board approved policies. Translating the regulatory principles, as well as regulatory intent into internal policies is critical, and the role of compliance function in this regard is crucial. The

compliance function essentially entails taking ownership of complying with the regulations and the internal dynamics between the business verticals and the compliance vertical need to reflect this objective.

- (ii) Apart from laws and regulations, the role of compliance function is important in ensuring adherence to various codes of conduct, particularly relating to the conduct of customer-facing barrier lines. The expectation is that these codes are duly incorporated in the internal policies, but unless these get integrated into the organizational culture, its effectiveness is likely to be compromised.
- (iii) The CCO should also strive to create/ facilitate an environment wherein employees are encouraged to communicate, confidentially and without any risk of reprisal, legitimate concerns about unlawful, unethical, or questionable practices within the bank. This can be achieved by putting in place a structured whistle blower mechanism which will allow employees to communicate material and bonafide observations of any violations in a confidential manner.

16. In the age of fin-tech, the CCO needs to be conversant with the financial product/ services structuring and delivery. While innovation is always welcome, new collaborations, products and delivery or sourcing channels shall not lead to regulatory violations or compromise of business ethics. We have seen bank's partnering with fin-techs for both asset and liability products without analysing the value proposition that they bring to the table. Many a times, we have found regulated entities to be clueless regarding the scalability, stability, and soundness of such technological platforms.

17. It is our hope that as CCOs, you are evaluating such risks in your respective organisations. Ultimately, the onus of ensuring compliance and that your

business partner is following ethical business practices and conduct lies with you. This principle has been enshrined in RBI's outsourcing guidelines for both - financial and non-financial services. Also, it would be necessary for bank/NBFCs to ensure that your fin-tech or outsourcing partner is compliant with the data protection and privacy standards and there is an effective BCP in place in case of disruptions. Many a times, greater coordination between CTO and CCO is required to achieve this.

18. In this swift-paced world, compliance with existing rules alone is unlikely to be sufficient; rather, entities will need to comply with broad principles if they are going to protect themselves against potential acts of non-compliance. For example, they should ask themselves whether practices are "fair" from a customer's perspective, or whether they would feel comfortable fully disclosing their business practices to customers, supervisory authorities, and the public. If they do not have this comfort, it is a clear warning sign to desist or modify

19. let me also urge your fraternity to refocus your efforts towards the positive affirmations. Most of the times, compliance function is focused on "what should not happen" to prevent regulatory failures. It is the prudent thing to do and I am no way suggesting that you should drop your guards on that count. However, a large amount of your efforts should also focus on – "what should happen" or "what is the best thing to happen". Let me give two examples to you to give you sense of what I am trying to convey. One, when we came out with resolution plans for business (RF 1.0) which was extended subsequently for MSMEs and Individuals to help them tough times during pandemic, we found that the schemes were not publicised by the banks. We received several complaints suggesting the branch level officials were

unaware of the remedies provided by the Reserve Bank to reduce pandemic induced stress.

20. At that time, we decided to dig a bit deeper and see if banks were making these schemes available to members of public, especially individuals and small businesses. Unfortunately, none of the banks, not even one, had displayed this information prominently in its website. A Second example was when we have issued guidelines on video-based KYC or V-CIP and simplified updation of KYC information. However, we continue to receive customer grievances on this count. I am afraid that either there is a lack of awareness at the level branch staff to implement the simplified version of guidelines or they have not been disseminated enough among the customers to alleviate their grievances. The point that I want to make by quoting these examples is that the role of compliance expands to ensuring that the regulations are integrated into business processes and the benefit of simplified regulations or accommodating schemes is passed on to the end customer.

Concluding thoughts

21. Regulatory preparedness can be achieved only if the compliance function works closely with business verticals. How to achieve full compliance and protect the bank from risks compliance function needs to be an integrative part of the thinking process at the beginning, not an afterthought. As the rules become ever more complex and the consequences of noncompliance ever more severe, banks will likely have no choice but to hardwire the right behaviours into their products, services, and processes. Where these interventions cannot be automated, robust surveillance and monitoring will be increasingly critical. This is the only way to ensure a very low error rate

within the first line of defence while ensuring effective oversight by the second line.

Thank you.