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Eliminating risk, cultivating opportunity: Shifting the emphasis on compliance IT investments beyond regulatory safeguard to strategic advantage

During the last few years, compliance regulations have increased dramatically in number, scope and complexity. A myriad of international, federal and state regulations — such as Sarbanes-Oxley, Basel II, the U.S.A. PATRIOT Act and others — are dramatically affecting how banks of all sizes do business and prioritize IT investments.

Most financial services institutions are fragmented along business lines, product and geography. Often, this makes response (in terms of business process change and IT investments) to regulatory mandates disjointed and redundant, eventually compromising compliance IT ROI. The arrival of the Basel II Accord, with its emphasis on analysis and aggregation of company-wide operational risk, increases the urgency to integrate these silos of intelligence.

In an April 2006 Bank Technology News article, *“Compliance: The New Rule Book Is Still Like A Maze,”* French Caldwell, vice president of research at Gartner, noted that only 25 percent of banks and other financial institutions are trying to roll together their initiatives. This, he says, is unfortunate, since in some ways “it’s an easy fix. You would have one overall compliance risk program rather than everyone doing their own thing.”

Caldwell estimated about 15-30 percent of the average bank’s IT budget goes to compliance. Larger financial institutions are more likely to overpay for compliance-related IT. Mid-sized to larger banks often have executives in charge of separate compliance initiatives such as SOX or Basel II — not surprising, he says, since multiple business units are buying their own technology, hiring

their own consultants and consuming their own labor. Caldwell emphasized, “This is suboptimal. Separate programs just add costs.”

Indeed, technology is a relatively small portion of the compliance “waste,” Caldwell says. It’s the labor and consulting costs that really eat into the budgets.

Is there a bright side?

Certainly, the business intelligence resulting from well-executed compliance efforts can also enable strategic harvesting of profitable customer relationships. These efforts provide an opportunity to retool and take an unvarnished look at operational efficiency, where shortcomings are an important contributor to risk. In turn, enterprise-wide evaluation of the “weak links” in the chain will uncover the more stable and robust connections.

Technology analysts agree that companies embracing, rather than resisting, compliance initiatives such as Basel II are more likely to achieve competitive advantage in the marketplace. Benefits include:

- Higher return on capital
- Greater shareholder returns
- Data and risk management uniformity
- Enhanced credit ratings (enhanced risk visibility)
- Reduced operational losses
- Improved credit risk/return profile

However, IT change management must also work with any new investments or initiatives. Integrity of internal controls must be reflected in the IT system. When formalizing

a more proactive compliance effort, companies should look at how technology can effect change without disrupting the controls in place, while achieving a comprehensive risk profile.

Compliance should not be a bolt-on, but rather an embedded process, easily implemented and enforced throughout the lifecycle of financial products. Embedding compliance best practices into business rules is a critical first step in reaping technology ROI and avoiding regulatory penalties.

The rationale is sound — but how can it compete with the realities of information silos and "islands of automation?"

Standardization is the cornerstone of compliance

Increasingly, banks are applying business process management (BPM) tools and methodologies to analyze, optimize and automate compliance-critical procedures. Successful application of BPM requires standardizing business rules and data across multiple systems performing common functions. Rationalizing redundant systems is one approach — either by eliminating all but one system, or by replacing all with a new solution. But this introduces a big impact on business and potential failures.

Or, one of these systems can be designated as the system of record, or master. In this case, all other systems must reconcile with it, thereby creating a consistent data definition throughout the organization. Once data has been standardized, the next step entails applying common business processes and rules across this data.

In a commercial lending environment, front-office origination systems are often individually developed for product servicing systems. However, these unique workflows and the resulting data trails often lead to fragmented customer risk views.

Nevertheless, the origination side is high ground for developing common processes, since it is the business area where product bundling and access to aggregate customer credit exposure matters most. Thus, a common commercial lending "system of

record for origination and credit decisioning" might support origination, credit underwriting, document prep and management, auditing and controls input from multiple sources for multiple products. Such a system provides a common decision-support environment for initiating management and policy decisions — and for integrating, auditing and enforcing these decisions via automated rules.

Replacing existing origination and credit management systems can result in significant business disruption. A BPM workflow engine can wrap around multiple systems and help manage end-to-end processes and obtain a consolidated data view, often for the first time.

The challenge of merging IT organizations

The impact of mergers and acquisitions continues complicating compliance efforts and challenging IT and business leadership. Many banks that have initiated multiple mergers have failed to integrate their common customer view and common exposure. This is strategically unsound, and it also invites compliance problems. Data integrity is perhaps the ultimate barometer of integration success — particularly when compliance issues are at stake. Too often, disparate systems contain conflicting information about transactions or customers, underscoring the need for corporate data cleansing and consolidation.

Nevertheless, refining or augmenting the technology is perhaps the easiest part of integration. Moving minds is often the toughest hurdle. Remaining nimble during the merger integration period is critical. Many organizations hesitate to implement process change at this time, fearing even more disruption — but this only leads to future unwelcome surprises.

Process change is where the rubber meets the road. Coaching people to make the change in mindset is critical to a successful implementation. It's not easy, by any stretch — given the interests of different IT organizations, lines of business and institutional compliance groups — but without making the effort, tremendous upside potential is left on the table, and the door to unwelcome exposure is left wide open.

Case Study

BPM helps U.S. super-regional bank stay ahead of the compliance challenges — improving key metrics

When a U.S. bank increased its asset size threefold through acquisitions in only eight years, it achieved “super-regional” status. With rank comes responsibility. First, the bank had to integrate the acquired target’s IT organizations. If integration weren’t enough of a challenge, market visibility on this scale invited closer regulatory scrutiny. Along with integration hassles, this bank’s internal credit and risk management processes changed marginally relative to its growth spurt — leading to inadequate deposits on hand and over-extended customer exposure. Clearly, additional resources were needed to address these limitations, track customer exposure and performance, and prevent regulators from imposing strict and costly restrictions on business activity. However, this had to happen without significant disruption to business practices or adding costly redundancies.

These compliance challenges rose to the fore as the bank was re-evaluating its credit origination platform. Speed to market is a crucial competitive differentiator for this bank. Acquired IT organizations had to be brought on-stream swiftly. In order to support market expansion and existing customer relationships, the bank needed a credit origination system that would easily integrate with multiple businesses — and also create a path for seamless compliance.

First, existing business processes had to be standardized to enable “one way of doing business,” a vision designed to encourage the greatest cultivation of opportunity within appropriate risk parameters. This effort was “like changing tires on a moving vehicle,” according to the bank’s chief project sponsor.

The bank implemented a BPM workflow solution for its credit origination functions. This was organized around a synchronized system of record, containing all business rules across multiple lines, products, origination channels and internal IT systems. The implementation decision was fortuitous from a risk management and compliance perspective. Shared processes are a necessary first step in achieving single views. Throughout the bank, the system delivers one real-time, consolidated view of all legal entities and related parties, their aggregate exposure with each underlying detail only a click away, along with every associated collateral and covenant detail.

The system’s Web services architecture facilitates easy access and interfacing with other bank systems. The multiple back-office systems that existed because of difficult integrations created an opportunity for the BPM workflow solution to act as a “data hub” and cleanse data over time. As the bank’s new acquisitions are brought on stream, the system is being used to support the post-integration business, while continuing to integrate legacy systems.

“Embedding compliance” has proven successful. Although enterprise risk management is centralized, each line of business within the bank has its own compliance function. Priorities for SOX and Basel II may be divergent (for example, SOX places more emphasis on business continuity and change management while Basel II looks more closely at probability of default and operational risk), but the ability to capture maximum data as early as possible in the origination process is essential to stay in compliance.

Currently, all portfolios are rated using a customized Basel II grading model with built in business rules and workflows. Risk data — offering information by client, product and geography — is updated daily in real-time. Since the system knows the “right rules for the deal,” it issues the appropriate controls and documents (such as adding new terms and conditions to a loan covenant) or escalates questionable requests. Administrators (vs. programmers) are able to adjust business rules in concert with marketplace and regulatory environment changes and add control points from regulators and internal compliance officers.

Looking ahead, the bank intends to continue capitalizing on the system’s potential for improving process efficiencies and risk management. “It’s been highly configurable and flexible in an extremely demanding environment. Compliance mandates, integration challenges and time-to-market pressures make for a tough combination, but we think the system’s intelligence and ease of deployment more than proved its worth. We’re looking forward to seeing what it can accomplish in less exacting circumstances,” said the chief project sponsor.