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## **CORPORATE GOVERNANCE, COMPLIANCE AND BANKING BOARDS IN LATVIA: THE RESULTS OF A SURVEY**

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### **Abstract**

**Purpose** – After the recent financial crisis, Basel Committee on Banking Supervision (BCBS) and European Banking Authority (EBA) have called attention to the need to improve corporate governance of financial entities and issued new guidelines endorsed by local regulators. The purpose of the paper is to analyze how banking boards in Latvia fulfill compliance oversight function.

**Design/methodology/approach** – The empirical study consisted of survey and interviews with experts in compliance risk management who are the members of the Compliance Committee of the Latvian Commercial Bankers Association. To carry out the empirical research, a web-based survey was conducted from December 2011 through January 2012 to collect information about relation between compliance function and banking boards in Latvia.

**Findings** – The benchmarking approach has been used to compare results from banks in Latvia with similar survey in US. In general, banking boards in Latvia use the similar tools and methods to oversee compliance function as the banks in the US. The level of support to compliance function from boards differs in both countries.

**Research limitations** – For this paper, only banks are reviewed, which may result in an incomplete picture of compliance function in Latvia's financial sector.

**Practical implications** – The results of the research are used by the Compliance Committee of the Latvian Commercial Banking Association.

**Originality/value** – Latvia implemented a compliance regulatory framework in 2007. The value lies in the fact that compliance risk management has never been subject of research in Latvia before.

**Keywords:** banks, Latvia, corporate governance, compliance, risk management.

## **1. INTRODUCTION**

The European banking industry recognizes (EBF, 2010) its vital role to play in any economy, mainly as a facilitator of activity in other sectors. Health and efficiency of banking industry provide a foundation for economic growth and social welfare. The interconnectedness between the financial sector and the rest of the economy is subtle yet significant: changes in the economic climate of the real sector directly impact on the health of banking, and *vice versa*. The banking business is crucially dependent on public trust. The ongoing financial and economic crisis has exposed frailties in the financial sector and of the regulatory and supervisory frameworks, which are now being addressed both at the EU and international level and aim to restore a public trust. An understandable response to the crisis on the part of the European and international authorities is to create new rules and regulations. Their main effort has been to correct institutions' weak or superficial internal governance practices as identified in the financial crisis. These faulty practices, while not a direct trigger for the financial crisis, were closely associated with it and so were a key contributory factor. International regulatory bodies recognized that the risk management and internal control frameworks are effective internal governance arrangements, but were often not sufficiently integrated within institutions or groups. A uniform methodology and terminology was missing, so that a holistic view on all risks did not exist. An institution should have an appropriate Internal Control framework to develop and maintain systems that ensure effective and efficient operations; adequate control of risks; prudent conduct of business; reliability of financial and non-financial information reported or disclosed (both internally and externally); and compliance with laws, regulations, supervisory requirements and the institution's internal policies and procedures.

Latvia implemented Internal Control framework (FCMC, 2007c) that includes compliance in 2007, while in other countries a specific regulatory requirement for Compliance Function (or analogous) had been already introduced. For example, in Belgium the *Commission Bancaire et Financière* has established the need for a Compliance Function in 2001; in Germany this function has been required in 1994; in the UK the appointment for a compliance officer within financial services firms has been prescribed since 1980s; in the USA the vast majority of legislation on such issues is dated even from the 1930s and 1940s (PwC, 2003). In Italy like in Latvia changes regarding status of the compliance function have been introduced in 2007. In 2008 research regarding Italian bank compliance practices was done. It confirmed several hypotheses among them: since foreign regulators have generally begun to pay attention to the compliance issue earlier, there is concern that local banks are behind the global compliance development (Birindelli, 2008). The similar hypotheses can be relevant to the Latvian banking sector. This stimulates to organize an academic study on compliance risk management practices in Latvia's banking sector that wasn't done before. The objectives of study are to identify possible gaps and to contribute to the debate on the compliance risk management in Latvia's banking sector.

The purpose of this paper is to make a systemic investigation of available sources of literature on interrelation between corporate governance in banking and compliance function, and compare with the situation in Latvia.

The Basel Committee on Banking Supervision (BCBS, 2010) has issued a new set of principles for enhancing sound corporate governance practices at banking organizations and the principle No.3 covers: "The importance of a risk management function, a compliance function and an internal audit function, each with sufficient authority, stature, independence, resources and access to the board." The presented analysis of the survey review the compliance function's access to the board and interrelation, and is one of the steps for compliance academic study (Lagzdins, 2011a, 2011b, 2012c, 2012d; Lagzdins and Sloka 2011a, 2012b; 2012d; Lagzdins et al. 2011). The study aims updating the recent academic findings, and evaluating the current situation in the field of preparing reasonable fundament to develop a theoretical concept of the compliance risk management in Latvia.

Against the above-mentioned background it is important to review if and how the banking boards in Latvia perform compliance function's oversight.

**Research object** is the banking boards and compliance function in Latvia. **The aim** of the article is to evaluate the interrelation between banking boards and compliance function. **The research tasks** are the following:

- Systemize knowledge around corporate governance in banking;
- Evaluate Latvia's compliance legal framework and status;
- Trough the specially organized survey to find a practical application of interrelation between compliance function and banking boards in commercial banks;

**The research methods** involve analysis of the documents of the International regulatory bodies; Latvian laws and regulations related to the Internal control; compliance and corporate governance literature review; the empirical study consisted of survey;

**The research novelty** is investigation of Latvia's legislative documents and practice related to the organization of the compliance function in commercial banks.

## 2. THEORETICAL FRAMEWORK

### 2.1 Discussion and literature review

#### 2.1.1 Compliance function

The compliance literature (Bryant, 2004; Haynes, 2005; Apreda, 2006; Bauer, 2007; Mills, 2008; Birindelli, 2008) and surveys (Basel Committee, 2008; European Commission, 2009) maintains compliance function as the function that should facilitate the implementation and maintenance of the compliance culture, arrange for or provide compliance framing, advise on regulatory matters, conduct monitoring, maintain lines of communication with the regulator, handle regulatory issues, conduct reviews, provide reports and guidance to management, assist in identifying, assessing and managing regulatory risk, manage internal, external and inter-relationships, and turn regulatory burden into competitive advantage (e.g. such as

recommending IT solutions, regulation and guidance). In general terms, the inter-relationships for the Compliance function are: the Board of Directors has the responsibility for overseeing the management of the compliance function; Senior Management is responsible for establishing a compliance policy and a permanent and effective Compliance function. Some regulators (Basel Committee, 2008) promote two levels of compliance function: 1) operational and 2) oversight that is independent from business.

In Latvia, the bank regulator is the Financial and Capital Market Commission (FCMC). Similar to other bank regulators, it must decide on compliance regulatory framework. The analysis of the FCMC requirements confirmed that such framework is defined in two laws, three regulations and non-binding guidance-handbook (FCMC 2008a, 2003b, 2007c, 2009d, 2006e, 2007f). Author finds that FCMC requirements regarding the compliance function are similar to Basel Committee recommendations and reflect to the wording and spirit in compliance literature. A risk management framework in Latvia consists of at a minimum the following three internal control functions: Internal Audit, Risk Management, and Compliance. The roles of each of the respective functions along with the Board of Directors, Senior Management, Compliance Staff and Business Unit personnel, all have a part to play in contributing to the overall success of the three internal control functions as they form an effective risk management framework. Latvian regulator FCMC doesn't distinguish levels of compliance function.

### **2.1.2 Corporate governance and compliance responsibilities of the banking boards**

The compliance function starts at the top. How banking boards can fulfill compliance oversight function and what kind of framework they can use for that? The general understanding of corporate governance is needed before to look for answers to this question. Corporate governance is a very general phrase and refers to the process and structure used to direct and manage the business. Cadbury Report (1992) says: "the system by which companies are directed and controlled". Hardoiun (2009) emphasizes that the governance of the financial sector goes through two channels. One is the general organization and regulation of the sector. Governance depends first from the framework defined by the regulator (Basel Committee, 2005). The other channel is corporate responsibility.

After the recent financial crisis, Basel Committee on Banking Supervision and European Banking Authority have called attention to the need to improve corporate governance of financial entities and issued new guidelines (BCBS 2010; EBA 2011) endorsed by local regulators. Now regulators more than ever believe an efficient compliance function is a prerequisite for good corporate governance that should restore trust, integrity, and responsibility in the banks. They believe that compliance is key facet of governance because it shows how actually bank meets corporate responsibilities. Regulators especially advocate a governance structure composed of Board of directors and senior management that are responsible for overseeing the management of the bank's compliance risk and effective compliance function. The BCBS is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. The notions of the board of directors (some countries including Latvia supervisory board) are used not to identify legal constructs but rather to label two decision-making function within bank.

Several scholars (Handley-Schachler et.al 2007; de Andres and Vallelado, 2008) in their extensive banking corporate governance literature reviews found that there are many studies on corporate governance, but only few papers focus on bank's corporate governance (Ciancanelli and Reyes, Macey and O'Hara, Levine, Adams and Mehran, Caprio et al.). The literature emphasizes that regulation distinguishes the banking industry from other industries and presents several challenges in the field of corporate governance. Regulation can be considered an additional mechanism of corporate governance, but in most situations it reduces the effectiveness of other mechanisms in coping with corporate governance problems. The main aim of the regulator, which is to reduce systemic risk, might come into conflict the main goal of shareholders, which is profit. Corporate governance in banks plays a special role due to the uniqueness of the organizations. Studies above acknowledge the existence of difficulties, such as complexity and intense regulation, in the corporate governance of the banks. The reasons stated consider that bank board becomes a key mechanism to monitor managers' behaviour and to advise them. McIntyre (2009) suggests that regulators can expect more from banking boards.

Recent corporate governance empirical literature beyond traditional topics such as: board size and composition, performance and compensation, has focused on effectiveness of the banking boards. Belkhir (2009) using panel data set of nearly 170 banks found that there is no evidence in banking organizations that smaller boards are more effective, and induce an increase in performance. De Andres (2008) indicated that

board members' specific knowledge of the complexity of the banking business enables them to monitor and advise managers efficiently. Careta and Farina (2010) offers a model to assess the effectiveness and compliance of bank boards. He concluded that regulatory recommendations alone are not sufficient to guarantee board and director effectiveness and focused on two major drivers of board effectiveness. Board level drivers refer to size, composition, duality, committees, meetings, incentive schemes and management information reporting systems. Individual drivers refer to competencies and commitment of directors, who should develop and maintain appropriate level of expertise as the bank grows in size and complexity. Regarding compliance Corporate governance regulatory arrangements require from the boards two major things: 1) establishment of the compliance function and 2) oversight of the management of the bank's compliance risk. According risk regulations there should be a compliance framework and a common language to discuss risk issues.

The most significant law in Latvia regarding compliance and board relations - the Law On the Prevention of Laundering of Proceeds Derived from Criminal Activity was enacted in December 1997 and became effective in June 1998. The Law has been amended a number of times in order to comply with all the international requirements. In some instances the law went beyond what international standards required. Articles 7 and 8 of the above mentioned law obliges financial institutions to establish Internal Control System and Improving the Internal Control System on ongoing bases. Article 10 requires credit and financial institution appoint a board member who shall be responsible for the prevention of money laundering and of terrorist financing in the respective credit or financial institution. The analysis of the legal and regulatory requirements confirmed that Latvian regulator FCMC obliges the banking boards to perform compliance risk oversight by approving compliance risk management policy and at least once a year to assess the effectiveness of the compliance risk management. Regulator doesn't offer particular oversight framework or mechanism. Compliance officer should help Board to offer oversight mechanism and therefore author aims to design board compliance empirical corporate governance oversight model based on theory and best practises.

### 2.1.3 Latvia's financial market

Bank based system still dominates in most of continental Europe (Girardone et al. 2009). Latvia is among those countries that have developed financial sector as a bank based model (Clarkson, 2009) where banks have 92.4% of total financial sector assets (FCMC 2011g). Banking sector in Latvia is presented only by commercial banks and two other types namely savings and co-operatives don't exist (LCBA 2012). At the end of 3rd quarter of 2011, 22 banks operated and 9 branches of foreign banks were registered in Latvia. All banks are accepting deposits, grants commercial and industrial loans and provides other banking services for the public. They are called commercial or full-service banks. The bank assets form the greatest share of the total assets in the financial and capital market of Latvia (Ministry of Economics, 2011). At the end of the 3st quarter of 2011, the total amount of the bank assets reached LVL 20.7 or EUR 29.5 billion and account for over 92% of all financial assets. Three banks are owned by large Nordic banking groups (SEB, Swedbank, DnB), representing 45% of the total banking system assets. Two banks owned by top-tier banks from the Russian Federation (MDM bank, the Bank of Moscow) and two by large Ukrainian private banks (Privatbank, Pivdenny), and altogether they account for 3% of the total banking system assets. There is one bank owned by Austrian banking group (UniCredit Bank) accounting for 3.5% of the total banking system assets. One bank is a 100% state-owned (LHZZB), accounting for 4.5% of the total banking system assets. The number of clients who have opened accounts at Banks in Latvia were 2.9 million as of December 2009 (FCMC 2010). On June 1st 2010, the market capitalization was LVL 600.4 million and the total amount of gross premiums signed in the insurance market reached LVL 223.3 million of 2009. The research confirms that capital markets in all CEE countries including Latvia are more underdeveloped than banking sectors (Dinger and Hagen, 2009). Various international institutions (US Department of State, 2010, International Monetary Fund, 2007) are noting the importance of banking sector by recognizing Latvia as a growing regional financial centre with sizeable non-resident deposit base.

Figure 1 provides with a comparison of neighbouring countries. Latvia is a regional financial centre of some significance and acts as an important trade and financial gateway between CIS countries (mainly Russia) and Western countries. The high volume of throughput of transactions in accounts in Latvian banks shows, in part, the financing of trade, but also contains a substantial component related to capital flows and transactions designed to minimize the impact of tax and currency control requirements in the originating countries, mainly in the CIS.

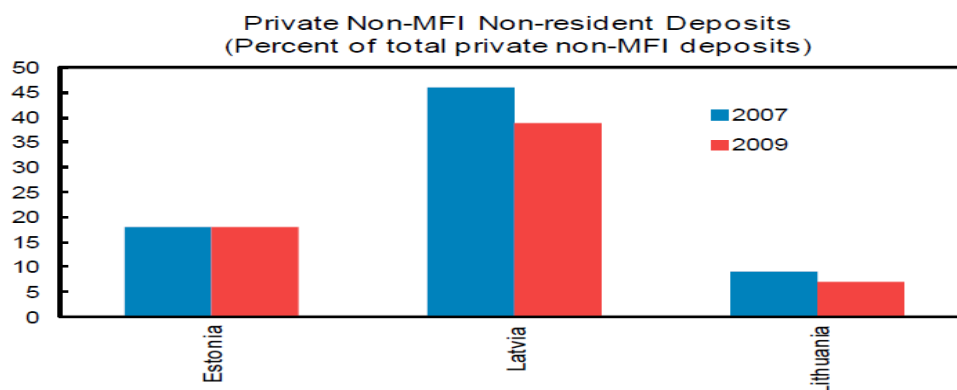


Figure 1. Non-resident deposits

Source: Purfield, C., Rosenberg, C. B. (2010): *Haver; IFS; BIS, Locational Banking Statistics; and EBRD*

When the size of the banking sector is measured relatively to financial wealth, the gap between the developed EU banking systems and those of the CEE countries is not as severe as argued in studies based on the traditional approach of measuring the size of the banking system with respect to GDP (Dinger, Hagen, 2009). It is important to confirm that not only the size, but also other areas (including corporate governance and compliance) of Latvian commercial banking are in line with developing trends.

### 3. RESEARCH METHODOLOGY

The empirical study consisted of survey that was accepted by Latvian Commercial Banking Association's (LKBA) Compliance Committee. To carry out the empirical research, a web-based survey was conducted from December 2011 through January 2012 to collect information about compliance officers and the compliance function practices at their banks in Latvia. The goal of the survey was to identify how compliance function is organized and managed in Latvia's banking sector. The survey questionnaire was prepared by author and included also some similar questions from 2009 Bank Compliance Officers Survey organized by American Banking Association (<http://www.aba.com/Members+Only/Regulatory/2009BCOSurvey.htm>) allowing to benchmark views against those of compliance peers in USA. The measures and the wording of each question were based on earlier qualitative and documentary research on compliance risk management as well as the theoretical considerations and the scholarly literature. A great variety of regulatory documents including Basel Committee and surveys of audit companies (PwC, KPMG) were also read. The survey questionnaire contains 65 questions. The major topics include the following:

- Information about bank's most senior compliance manager
- Information about bank's compliance structure
- Education and training
- **Compliance and the bank's Board**

The Bank's most senior persons responsible for compliance function were invited to participate in the survey through an email. Follow-up emails and announcements were used to encourage participation. By the response cutoff date, 19 commercial banks (members of LKBA) participated in the survey. The Association had 22 members. Therefore response rate 86% compares well with the 40% response rate for similar survey in Italy.

The questionnaire was confidential: all survey results will be used only in updated version and will assist for the basis for real and practical recommendations regarding the necessary improvements in compliance risk management in the commercial banks. It took around 20 minutes to fill in the form.

Due to the limitation of the paper, only the main results related to the compliance and bank's board are described in this paper.

The majority of the banks established independent compliance department or similar unit. The figures in Table 1 confirm that only 15.8% or 3 banks don't have separate compliance unit. Vast majority of compliance units has been established after 2007.

#### 4. ANALYSIS OF RESEARCH RESULTS

European Commission (2011) published impact assessment accompanying the initiative for the reform of corporate governance in credit institutions. The EU paper provides the framework for assessment of the effectiveness of risk oversight by Boards. Such framework is contributing efforts to find an answer to the question - how the banking boards in Latvia perform compliance function's oversight? The other comparison is done by using survey results from American banking association. Latvia have two-tier board structure and therefore author analyzes refer to the management board, which have a similar function compare with US unitary board structure.

Table 1 shows that the boards in most of banks in Latvia have appropriate time commitment and Board members spend sufficient time to exercise their duties. The 81.3 percent of responders indicated, that the board meets weekly, while in the USA the most often boards of banks use to meet monthly (84.6%). This might indicate the benefits of Latvian banks governance structure that could be more reactive to the changes in business and regulatory environment, and furthermore this means that decisions in Latvian banks' boards can be made faster.

Table 1

##### The comparison of distribution of answers to question "How often does your organization's board meet?" in Latvia and USA

	LV	USA	LV vs USA difference, in percent points
Weekly	81,3%	2,3%	79,0%
Quarterly	12,5%	8,7%	3,8%
Monthly	-	84,6%	-
Six times a year	-	4,5%	-
Other:	6,3%	-	-
Two times in month	6,3%	-	-
Missing	-	-	-

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19, and American banking association's compliance survey in 2009

The boards in banks have a lot of various duties and areas of decision making, and the compliance is one of the areas. Compliance starts at the top and the Basel Committee suggested mechanisms of internal coordination between Compliance Officer and top management. To verify if the banks understood these indications, this research investigated the interrelation between the compliance reporting and Board.

The boards' attitude to the importance of compliance functions is characterized in table 2. As the survey results show, the compliance officer in USA banks is a frequent participator of board meetings: 33.7% of responders in USA attend meetings of board of directors every meeting and 24.5% attend quarterly, while in Latvia the most often there are no persistent participation of compliance officer: 26.3% respondents specified that they only report the examination results, and 26.3% - at the board request only. This means that in Latvia compliance is not yet treated as the function that must be performed continuously, and the boards of banks in most cases ignore periodical assessment of compliance management results.

In this case the USA practice can be treated as the example that should be followed, because it allows more comprehensive performance of compliance in banking, having in mind that compliance must cover nearly all banking procedures and is supposed to be controlled directly by board of the bank (the strategic and independent performance is a key factor for efficient compliance management).

The banking Boards in Latvia should improve priority given by Boards to compliance risk issues and invite more frequently compliance officer at the Board meetings. The establishment of the Compliance Committee at Board level could be used as a structure to discuss compliance risk issues.

As seen in table 3 in Latvia banks' boards directly review the compliance budget more often than in USA (respectively 50.0% and 23.7%) and in the context of previously discussed boards' attention to continuous compliance management, this can be treated in two ways.

Firstly, the stronger regard to compliance budget shows a serious involvement to the organization and control of compliance and this is not always can be treated as a positive factor. The strong attitude to the

financial aspect of compliance function together with the week control of the results create the background for formal compliance realization, which in most cases is far away from real compliance management.

Table 2

**The comparison of distribution of answers to question “How often do you (or another compliance representative) attend meetings of your board of directors?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Every meeting	10,5%	33,7%	-23,2%
At the board's request only	26,3%	10,0%	16,3%
Only when the organization is facing a major new compliance duty	10,5%	1,7%	8,8%
Quarterly	10,5%	24,5%	-14,0%
Only when new compliance duties face the board directly	5,3%	5,8%	-0,5%
Only to report examination results	26,3%	2,6%	23,7%
Never	10,5%	7,3%	3,2%
Other:	15,8%	14,3%	1,5%
Half a year	5,3%	-	-
Monthly and when compliance related issues are discussed	5,3%	-	-
On average 1 per month (quarterly + ad hoc issues)	5,3%	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

Secondly, the focus of board on compliance budget instead of compliance results in Latvia raises a question whether boards of Latvian banks properly conceive the role of compliance management in banking. The formation of budget automatically creates the boundaries for compliance function realization, and in this case it is very important than those boundaries should be loose enough to guarantee the efficient compliance management in all banking areas and sectors. The direct review of compliance budget creates the possibility to control compliance management actions, but have a limited impact on the final results of compliance efficiency.

Table 3

**The comparison of distribution of answers to question “Does your organization's board directly review the compliance budget?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	50,0%	23,7%	26,3%
No	50,0%	76,3%	-26,3%
Missing	-	-	-
<i>If NO - please, evaluate</i>			
1	60,0%	-	-
3	20,0%	-	-
4	20,0%	-	-
Missing	-	-	-
<i>If YES, is the head of compliance function ever permitted to defend or explain items in that budget?</i>			
Yes	66,7%	58,3%	8,4%
No	33,3%	41,7%	-8,4%
Other:	10,5%	-	-
In LV compliance, oprisk, security budget is common	5,3%	-	-
There is no separate budget for compliance	5,3%	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

Despite the quite low involvement of boards of Latvian banks in compliance management, there can be seen a strong support for the compliance function realization in practice – table 4 shows that 88.9%

respondents in Latvia receive the support the compliance function requires from the board, and this match the situation in USA, where 92.9% respondents confirmed the provision of consistent support from the board.

The support from the board in compliance management area can be treated as crucial factor for efficient realization of compliance function (it is difficult to perform most of compliance functions in different units of the bank without the direct support of governing body), so the consistent support of the board a necessity in compliance management. On the other hand, the support from the board is stimulated by banking supervision institutions, which in overall treat the coordination of compliance management as one of primary functions of the board in the context of banking risk management.

The same situation in the support can be stated in the context of CEO role in compliance management (table 5): 94.7% responders in Latvia and 88.6% in USA confirm the consistent provision of the support the compliance function requires. The bigger number in Latvia may be related with the size of banks in Latvia and USA. In Latvia banks in general are much smaller than in USA and this means the closer relations between CEO and other officers, including compliance officer.

Table 4

**The comparison of distribution of answers to question “Does your board consistently provide the support the compliance function requires?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	88,9%	92,9%	-4,0%
No	5,6%	7,1%	-1,5%
Other	5,6%	-	-
No need so far for additional support	5,6%	-	-
Missing	-	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

While CEO is supposed to be less supportive in case of compliance politics and performance boundaries, the role of CEO in supporting the compliance function can also be crucial. CEO in this case can be treated as the direct provider of resources needed for efficient compliance functions realization, so the support from CEO means the access to the resources that are necessary to form the continuous and reliable compliance management system, including various software, human resources and financial resources on time.

Table 5

**The comparison of distribution of answers to question “Does your CEO consistently provide the support the compliance function requires?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	94,7%	88,6%	6,1%
No	5,3%	11,4%	-6,1%

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

The differences in the size of the banks in Latvia and USA may be reason for the different practice of reporting to the board. As seen in table 6, the dominant reporting form in Latvia is a direct reporting (89.5%), which means the close compliance officer's contact with the board, while in USA the most common forms are reporting through the audit committee (40.8%) and direct reporting (32.5%).

The presented results are a little bit confronting the previous results, where the compliance officers' attending board's meetings were discussed. As in Latvia the attending of boards meetings is not regular and mostly happens only if the need appears, it can be presumed that the direct reporting to the board is not very often. In this case the further presumption appears that the reporting to the board in Latvia is quite rare, and mostly is realized directly to the board only if board expresses the need for it.

Meanwhile in the USA the reporting is probably the more frequent and is performed using periodical reports for several governing bodies, such as audit committee, board, etc. In such case where is guaranteed

more detailed information from the compliance officer, and this information is distributed for different governing bodies in respect to their interest.

Table 6

**The comparison of distribution of answers to question “Through what avenue does your compliance function report to the board?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Direct	89,5%	32,5%	57,0%
Audit committee	-	40,8%	-
In-House	-	0,4%	-
Compliance committee	15,8%	11,1%	4,7%
Risk management committee	15,8%	2,6%	13,2%
CEO	21,1%	7,4%	13,7%
Other:	10,5%	5,3%	5,2%
Directly to LV board to Group management through Group org.	5,3%	-	-
Several committies in different areas	5,3%	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

The role of board and other governing bodies in compliance management strongly depends on their competence level in this area. For this reason one of compliance officer's duties is the education of governing bodies' members. While these education possibilities depend on the conditions the compliance officer receives from the governing bodies, the results of education and the level of competence is strongly dependent on the methods and forms used for that.

Table 7 shows that in Latvian banks the main forms of board education about compliance issues are formal presentation (78.9%), one-on-one meetings (52.6%) and background memos (47.4%). In the USA banks the dominant forms of education are also a formal presentation (82.1%) and background memos (36.0%), but the one-on-one meetings are much less popular (9.8%) than in Latvia. Instead of that, compliance officers in USA use a bigger diverse of education tools, such as videos, specialized newsletters and booklets. These differences may be related with the differences in banks size: in Latvia board members have a more close non-formal contact with bank's officers, so the one-on-one meetings are a popular form of education. Meanwhile in the USA the banks are much bigger, with much more complicated organizational structure, so the compliance officers must use more creative tools for indirect education of board members.

Table 7

**The comparison of distribution of answers to question “What steps have you taken to educate the board about compliance issues?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Formal presentations	78,9%	82,1%	-3,2%
One-on-One meeting	52,6%	9,8%	42,8%
Informal presentations at board retreats	10,5%	6,9%	3,6%
Background memos	47,4%	36,0%	11,4%
News clippings	5,3%	10,8%	-5,5%
Videos	-	12,1%	-
Specialized newsletters	-	10,0%	-
Booklets	-	15,8%	-
Special class	5,3%	9,8%	-4,5%
Other:	5,3%	10,6%	-5,3%
E-Learning mandatory training	5,3%	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

The education of board members in compliance area is a popular activity in both Latvia and USA: the results of the survey presented in table 8 show that 78.9% in Latvia and 93.6% in USA compliance officers have taken steps to educate the board about compliance issues. It is important to notice that in Latvia the percentage of compliance officers that educate board members is high, but not high enough in comparison with USA. Knowing that compliance management in Latvia is not as much developed as it is supposed to be in the context of USA experience, it is important to reach the high intensity of education of banks' governing bodies in compliance area.

The debatable results are shown in figure 1. It is already clear that in USA banks the compliance management is a widely developed function in banking sector, with strong attitude from both commercial banks and supervision institutions. In Latvia the compliance management is still considered as the new function in banking. The earlier studies of compliance management in Latvia, based on the results of the same survey which is discussed in this article, confirmed that the practical experience in compliance management is much bigger in USA than in Latvia, mostly because the compliance management function in USA is treated as one of core functions in banking risk management from quite a long time ago, while in Latvia (as in most of EU countries) compliance management function is only starting to become an important part of bank's risk management.

Table 8

**The comparison of distribution of answers to question "Have you taken any steps to educate the board about compliance issues?" in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	78,9%	93,6%	-14,7%
No	10,5%	6,4%	4,1%
Other	10,5%	-	-
Please see answer No. 52	5,3%	-	-
Special Compliance training programs	5,3%	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

Despite the above mention facts, the comparison of distribution of answers to question "How would you rate your board of directors' understanding of the compliance risk facing your institution?" in Latvia and USA (figure 1) shows that compliance officers in Latvia considers that their banks' boards members have an enough deep understanding (72.2% of respondents rated it from 8 to 10 in 10-points scale). But in the USA the compliance officers ratings differ significantly: 31.9% rated the understating of boards members as 5 (in 10-points scale), 21.7% as 6 and 20.0% as 4.

These differences may be related with two main factors. Firstly, the cultural peculiarities in Latvia and USA may form an inadequate assessment of boards' members' competence in Latvia, where in exist closer non-formal relations between compliance officers and board members. Secondly, the high assessment of boards' members' competence in Latvia may be related with the lower competence level of compliance officers themselves. In USA compliance officers have much more practical experience and deeper knowledge in compliance management: previous studies showed that:

- Education of compliance managers in USA is mostly based on specialized education and this can be treated as a weak side in Latvia, where no specialized education possibilities exist;
- In Latvia, most of compliance managers perform in compliance management 1 to 5 years (66.7%) and only 22.2% have experience in this field for more than 5 years. In USA there are 24.1% compliance managers with the experience in compliance management 6 to 10 years and 45.1% have more than 10 years of experience.

The lower competence of compliance officers in Latvia may mean the inadequate understating about the competence requirements for the board members, and this conditions the high ratings, which are given for lower competence level.

Despite the fact, that compliance officers in Latvia consider that board members have enough understanding of the compliance risk, 31.1% of them have faced the fact that examiners have been encouraging more involvement from the board in compliance issues (table 9). Even higher percentage of compliance officers faces this fact in USA (48.2%). This shows that examiners, who are considered to be the

professionals in compliance management field, use to notice the lack of competence and attitude of boards members in compliance management area. This means the need to intensify the participation of board members in compliance management including the performing in this area and the deepening of their knowledge in theoretical and practical level.

Although examiners see the need to stimulate the involvement of board's members in compliance management field, only few of them have ever specifically criticized the perceived level of any banks' boards' understanding of compliance issues. As seen in table 10, in Latvia where were 5.6% respondents who faced this, and in USA where were 12.8% respondents. Such the results may be treated in two ways.

On the one hand, examiners often are dependent financially (or in some other form) on board's decision, and this means they tend not to criticize the board member. On the other hand it may mean that examiners have no clear view whether the board members have some specific misunderstanding about compliance.

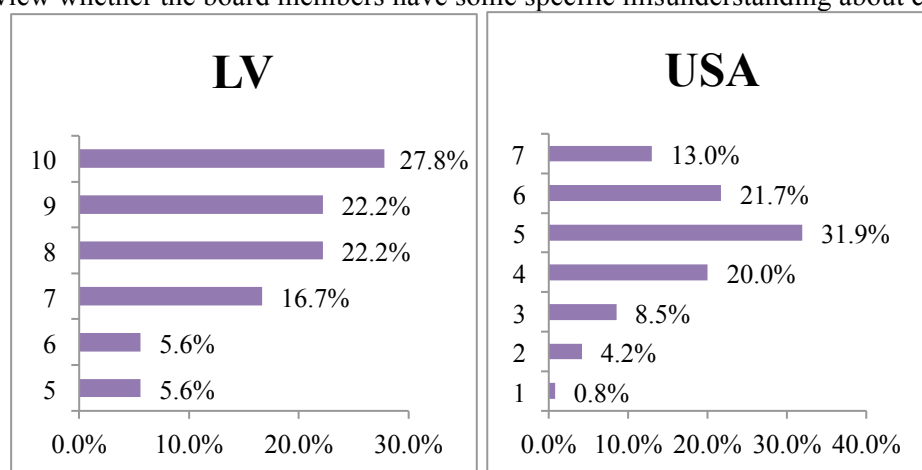


Figure 1. The comparison of distribution of answers to question "How would you rate your board of directors' understanding of the compliance risk facing your institution?" in Latvia and USA

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012 and American banking association's compliance survey in 2009

In other words, the presumption may be made that examiners notice the not high enough level of board members' competence in compliance management, but they cannot accentuate any specific area where board members' competence is critically low.

Table 9

**The comparison of distribution of answers to question "Have examiners been encouraging more involvement from your board in compliance issues?" in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	31,3%	48,2%	-17,0%
No	62,5%	51,8%	10,7%
Other:	6,3%	-	-
No examiners so far	6,3%	-	-
Missing	-	-	-

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009

The results presented in table 11 allow identifying the main topics of compliance officers, which are presented to boards. In the USA the dominant topic (mentioned by 84.1% of respondents) is anti-money laundering (AML), because it is one of the main areas in compliance risk management from the perspective of banking supervision institutions, which form the compliance management practice in banks. Other popular topic in USA presented to the board is fair lending (50.2%), which is more relevant for the banks themselves, as this is one of the tools for income generation and competitiveness control.

In Latvia there are two main topics for boards from compliance officers: AML and MiFID. These two topics are mostly initiated by Latvian banking supervision institution, which follows the guidelines from banking supervision authorities in European Union level. In addition to those two above mentioned topics,

the compliance officers in Latvia use to present additional topics for board, such as personal data protection, consumer's rights, progress reports on audit recommendation implementation, general compliance issues, risk management or upcoming compliance issues.

Table 10

**The comparison of distribution of answers to question "Have examiners ever specifically criticized the perceived level of your board's understanding of compliance issues?" in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	5,6%	12,8%	-7,2%
No	83,3%	87,2%	-3,9%
Other:	11,1%	-	-
Compliance reports/risk assessments	5,6%	-	-
No examiners so far	5,6%	-	-
Missing	-	-	-

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009

Table 11

**The comparison of distribution of answers to question "What topics do you regularly present to your board?" in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
AML	52,6%	84,1%	-31,5%
MiFID	52,6%	-	-
Fair lending	-	50,2%	-
Other:	52,6%	49,6%	3,0%
All compliance responsibility areas	5,3%	-	-
Ongoing important activities	5,3%	-	-
None	5,3%	-	-
Personal data protection, consumer's rights	5,3%	-	-
Progress report on audit recommendation implementation	5,3%	-	-
Regularly are presented reports on general compliance issues	5,3%	-	-
Regulatory compliance, privacy, complaints, etc.	5,3%	-	-
Risk management	5,3%	-	-
Summary (no specific reports for separate topics)	5,3%	-	-
Upcoming compliance issues	5,3%	-	-

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009

Significant differences in compliance management realization in Latvia and USA is noticed in case of compliance functions allocation. In USA 80.0% respondents indicated that their bank hold non-management employees outside of the compliance function responsible for their performance of compliance duties in connection with their own jobs, while in Latvia there were only 26.3% respondents (table 12). This means that in USA exists much higher level of compliance management functions allocation between bank's employees, and the separate compliance functions are matched to the other functions in banking, which may be performed by other employees who are not directly related to compliance management.

In Latvia such the function allocation is rather unusual practice and this may be related with the fact that compliance management in Latvia is not widely developed; it has less interests' area than in USA banks, so there are smaller need to incorporate compliance functions into the functions of other employees.

Bearing in mind that compliance management in USA is supposed to be treated for Latvian banks as a guideline in compliance management improvement, it can be presumed that function allocation will be more

and more common thing in Latvian banks, and more employees will be involved in compliance management area. This process might be strongly fastened by banking supervision institutions through the changes in supervisions standards and requirements for banking.

Though compliance officers in Latvia indicate that their bank rarely hold non-management employees outside of the compliance function responsible for their performance of compliance duties in connection with their own jobs, but most of them (77.8%) accent that compliance duties are explicitly included in employee job descriptions. In this case the Latvian banks are even stricter than USA banks where only 63.4% of respondents see the explicit inclusion of compliance duties in employee job descriptions.

Table 12

**The comparison of distribution of answers to question “Overall, does your bank hold non-management employees outside of the compliance function responsible for their performance of compliance duties in connection with their own jobs?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	26,3%	80,0%	-53,7%
No	73,7%	20,0%	53,7%
Other	-	-	-
Managers of units	-	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

Such the differences in research results presume the fact that compliance officers in Latvia differently understand employees functions worth to be treated as compliance duties. Other important notice in this case is that there may be the practice for employees in Latvia to pay less attention to their formal duties in job descriptions, and for this reason their actual performance not always matches the formal duties.

In USA the formal duties are expected to be more significant in case of employee's results assessment, so the compliance duties are included in job descriptions only then they are really needed and agreed between the employee and manager.

Table 13

**The comparison of distribution of answers to question “Are compliance duties explicitly included in employee job descriptions?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes, in most employees' job descriptions	77,8%	63,4%	14,4%
No, we have job descriptions, but compliance isn't included	22,2%	22,4%	-0,2%
No, because our organization doesn't use written job descriptions	-	14,2%	-
Missing	-	-	-

*Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009*

The survey results in table 14 show that in Latvia an employee's compliance record individually tracked and recorded in any way more often than in USA (respectively 73.7% and 44.2%). This allows stating that compliance management in Latvian banks is more related to employees' performance control rather than financial flow and performance efficiency control. This might be one of the most important differences in compliance management between Latvia and USA. In USA the more attention is paid to compliance risk management and the individual employee's performance record is treated as less important. Such the difference, once again, may be related to the different size of banks in Latvia and USA: in USA banks the average number of employees is much bigger than in Latvia and this means that individual employee has less importance in compliance risk than in Latvia.

The same difference, which may be related with the difference in size of banks, is noticed in case of employee's compliance record usage (table 15). In Latvia the dominant usage of employee's compliance record is the course of formal annual employee review (this reason was mentioned by 63.2% respondents in Latvia and 48.1% in USA).

Such the situation may allow stating that in Latvia the bigger part of bank's employees face the compliance management area and have some practical and/or theoretical competence in this field. But this presumption is contrary to the above mentioned fact that in Latvia only about ¼ respondents mentioned that their bank hold non-management employees outside of the compliance function responsible for their performance of compliance duties in connection with their own jobs.

Table 14

**The comparison of distribution of answers to question “Is an employee’s compliance record individually tracked and recorded in any way?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	73,7%	44,2%	29,5%
No	26,3%	55,8%	-29,5%
Other:	-	-	-
About serious breaches	-	-	-

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009

The comparison of different results creates the need to pay more attention at this area of compliance management practice in Latvia, because it may be a significant vulnerability for compliance management development in Latvian banks. The big attention to compliance management issues in formal employees' annual reviews and minimal performance of employees in day-to-day compliance management realization create the functional incompatibility and this may condition the misunderstanding of general compliance risk management matter and compliance management's position in bank's organizational structure.

Table 15

**The comparison of distribution of answers to question “Is an employee’s compliance record weighed in the course of formal annual employee reviews?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
Yes	63,2%	48,1%	15,1%
No, we have formal reviews, but compliance is not included	10,5%	44,4%	-33,9%
No, because our organization does not conduct formal reviews	10,5%	7,8%	2,7%
Other:	10,5%	-	-
Currently it has limited/formal impact	5,3%	-	-
With few exemptions, compliance is not included in the annual rev.	5,3%	-	-

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009

Table 16

**The comparison of distribution of answers to question “When an employee has routinely mishandled compliance tasks, what response has your organization taken?” in Latvia and USA**

	LV	USA	LV vs USA difference, in percent points
A supervisor has informally retrained the employee	31,6%	67,2%	-35,6%
The employee has been reassigned to an area with fewer compliance burdens	-	9,8%	-
The employee has been given a verbal warning	78,9%	54,4%	24,5%
The employee has been terminated	36,8%	23,8%	13,0%
The employee has received formal compliance training	68,4%	69,9%	-1,5%
The employee has been penalized financially	21,1%	7,6%	13,5%
Other:	5,3%	-	-
Several options depending on case	5,3%	-	-

Source: Survey results of Latvia's commercial banks in December, 2011 and January 2012, n=19 and American banking association's compliance survey in 2009

As seen in table 16, the consequences of inappropriate performance in compliance management are the same in Latvia and USA, and are common to other banking areas: the main forms of response are a verbal warning (78.9% in Latvia and 54.4% in USA), formal compliance training (68.4% in Latvia and 69.9% in USA) and informal retraining of employee (31.6% in Latvia and 67.2% in USA). This means that in compliance management area the reaction to inappropriate performance is similar to the forms used in other fields and has no specific peculiarities.

## 5. CONCLUSIONS

Recent corporate governance empirical literature beyond traditional topics such as: board size and composition, performance and compensation, has focused on effectiveness of the banking boards. Regulatory recommendations alone are not sufficient to guarantee board and director effectiveness and banks should focus on two major drivers of board effectiveness. Board level drivers refer to size, composition, duality, committees, meetings, incentive schemes and management information reporting systems. Individual drivers refer to competencies and commitment of directors, who should develop and maintain appropriate level of expertise as the bank grows in size and complexity. Regarding compliance Corporate governance regulatory arrangements require from the boards two major things: 1) establishment of the compliance function and 2) oversight of the management of the bank's compliance risk. According risk regulations there should be a compliance framework and a common language to discuss risk issues. There is no evidence in literature that smaller boards in banks are more effective, and induce an increase in performance.

The analysis of the legal and regulatory requirements confirmed that Latvian regulator obliges the banking boards to perform compliance risk oversight by approving compliance risk management policy and at least once a year to assess the effectiveness of the compliance risk management. Regulator doesn't offer particular oversight framework or mechanism that would support implementation of the Board's operational objectives: improve challenge by Board decisions, improve ownership by Board of risk strategy, improve priority given by board to risk issues and improve the information flows to Board on risks

The empirical study confirmed that in general, banking boards in Latvia spend sufficient time to exercise their duties. 81.3 percent of responders indicated that the board meets weekly. Concerning the compliance risk oversight results are mixed. In Latvia the dominant compliance reporting form to the Board is a direct reporting (89.5%), which well respond to the Basel Committee recommendations. In USA the most common forms are reporting through the audit committee (40.8%) and direct reporting (32.5%). The reporting methods, frequency, format and content are not clearly defined and Boards in Latvia should consider how to improve the information flows to the Board on compliance risk. To improve ownership by Board of compliance risk strategy there should be on an annual basis compliance risk statement.

The compliance officer in USA banks is a more frequent participator of board meetings: 33.7% of responders in USA attend meetings of board of directors every meeting and 24.5% attend quarterly, while in Latvia the most often there are no persistent participation of compliance officer: 26.3% respondents specified that they only report the examination results, and 26.3% - at the board request only. The compliance officer in Latvia has a lower opportunity to interact with Board members. The establishment of Compliance Committee or sub-Committee at the Board level could serve as an additional alternative for the discussion of new or potential changes in the regulatory environment, and existing or potential compliance issues within Bank. The further research is needed regarding the role of the compliance committees in Latvian banking sector.

Banks' boards in Latvia directly review the compliance budget more often than in USA (respectively 50.0% and 23.7%). This can be treated in two ways: 1) positively-more serious involvement from board; 2) negatively-the focus on budget instead of results and organization.

Latvian banking Boards positively respond to the need of improvement of the Board members expertise in area of compliance risk management. The main forms of board education about compliance issues are formal presentation (78.9%), one-on-one meetings (52.6%) and background memos (47.4%). In the USA banks the dominant forms of education are also a formal presentation (82.1%) and background memos (36.0%), but the one-on-one meetings are much less popular (9.8%) than in Latvia. Instead of that, compliance officers in USA use a bigger diverse of education tools, such as videos, specialized newsletters and booklets.

Good understanding of the compliance risk by the Chairman of the Board (CEO) is promoting support to the compliance function in Latvia. 94.7 percent of responders confirm the consistent support from CEO. This is higher compare with US (88.6%).

Significant differences in compliance management in Latvia and USA is found in compliance function's allocation. In USA 80.0% respondents indicated that their bank hold non-management employees outside of the compliance function responsible for their performance of compliance duties in connection with their own jobs, while in Latvia there were only 26.3% respondents. This means that in USA exists much higher level of compliance management functions allocation between bank's employees, and the separate compliance functions are matched to the other functions in banking, which may be performed by other employees who are not directly related to compliance management.

Considering that compliance management in USA is supposed to be treated for Latvian banks as a benchmark, it can be presumed that further discussion regarding the differences found is needed among compliance officers and board members in Latvian banking sector. There is a room for the improvement in compliance risk oversight in banking boards in Latvia. Author offers systemic approach to compliance risk management and oversight that has been tested for more then ten years in different banks. Compliance management system and compliance program as compliance risk oversight tools are analyzed and described in the author's research papers (2012).

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