

## BANKS, KNOWLEDGE AND COMPLIANCE: CHALLENGES FOR LATVIAN EDUCATIONAL SYSTEM

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### **Abstract**

Compliance in general terms is the adherence to existing rules and regulations laid down by those in authority. In the new regulatory environment, knowledge of compliance is becoming increasingly important across all areas of business. But according to EU Commission, present sanctioning regimes are often weak and quite heterogeneous. In addition, research studies and review of Latvia's laws that regulate banking industry confirm very low level of sanctions in Latvia. These above-mentioned findings should urge Latvia's banking sector to pay greater attention to the issues of compliance risk management. To ensure compliance knowledge, an appropriate specialised department should be organised in commercial banks and staff of such department should have respective knowledge.

**Keywords:** compliance, banks, knowledge, educational system, Latvia.

### **Introduction**

Over the last five years compliance function has changed and its role has increased significantly. Until 2003 the interpretation of compliance function was different, then Basel Committee introduced several documents to ensure compliance function inclusion into business processes. Latvia faced with compliance function in 2007, when banking regulator (The Financial and Capital Market Commission, Republic of Latvia) published banks' internal control rules where Basel Committee's recommendations and definitions of compliance were used. Issues of compliance in commercial banks are also on the agenda of academic research: Verhage (2009), Ludwick (2006), Carreta *et al.* (2010), Birindelli (2008), Biegelman (2008) have examined different aspects of compliance. In Latvia there is still not enough academic research done on compliance problems. Besides it is noticed that practical work in commercial banks of Latvia is not very much concerned about the issues of compliance; not enough attention is paid to these issues in educational establishments preparing bank specialists.

**The aim of the paper** is to analyse if compliance knowledge needed for banking sector could be ensured by higher education in Latvia.

#### **The research tasks:**

- systemise research findings around compliance in commercial banks;
- evaluate practical importance of compliance knowledge;
- evaluate level of compliance knowledge provided by Latvia's higher education establishments and the accredited study programs in law and finance.

**The research methods** involve analysis of the research results of studies on compliance issues, analysis of EU policy documents and research of Latvia's accredited study programmes in law and finance using content analysis.

### **Compliance knowledge and theoretical background**

Compliance is a core to operation and well-being of the financial services sector and the consumer. Compliance includes concepts of obedience, observance, deference, governable, amenable, passive, non-resistance and submission. Aspects of duty that include doing what ought to be done, moral obligation,

accountability, propriety, fitness, to be on one's good behaviour, answerable, to act morally and ethically are closely linked to the issue. A difficulty of defining compliance with any real precision is noted by Parker [7].

Compliance is defined as a state of being in accordance with established legislation, guidelines, standards or specifications [2]. Regulators for financial services have framed compliance within a number of terms and concepts. The key regulatory concepts that comprise compliance are defined by Mills (2008) as:

- compliance risk;
- reputational risk;
- regulatory sanctions;
- compliance laws, rules and standards;
- compliance function;
- compliance universe;
- compliance department;
- compliance officer;
- compliance culture;
- cost of compliance [12].

In a globalised financial services industry, the regulations driving compliance include those regulations that are imposed at the international level and at the EU level. Basel Committee on Banking Supervision is the leading international institution setting up high-level compliance principles on bank's management of compliance risk [5]. In 2005 Basel Committee provided definition of **compliance risk**, which is defined as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank 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 banking activities (together, "*compliance laws, rules and standard*") [16].

In 2008 Basel Committee organised a survey "Implementation of the compliance principles". Eight Committee member countries and 16 countries that are not members of the Committee participated in the survey. Respondents from 21 jurisdictions underlined two major issues they had to face when implementing compliance framework. One of these issues, which relates to small and medium-size institutions in particular, was how banks should organise their compliance function. This includes, for instance, the determination of what are appropriate resources for compliance function in relation to the size, complexity and nature of the business; the relationship between internal audit and compliance; the independence of the compliance function. Another issue was the scope of compliance function [9].

Basel Committee urged also other countries to assess implementation of compliance principles. Latvia implemented Basel Committee principles and introduced the definition of compliance risk in May, 2007 [18]. Birindelli (2008) confirmed hypothesis about greater development of compliance risk management in foreign banks as in domestic banks [3]. Sathye (2008) found empirical evidence suggesting that owing to scale economies in regulatory compliance, the burden has fallen more heavily on smaller financial institutions [14].

In October 2010 Basel Committee issued Principles for enhancing corporate governance. The bank should maintain sound control functions, including an effective compliance function that, among other things, routinely monitor compliance with laws, corporate governance rules, regulations, codes and policies to which the bank is subject and ensure that deviations are reported to an appropriate level of management and, in case of material deviations, to the board. Committee noted that in some cases, banks' compliance functions have been designed to address only anti-money laundering issues, which is inconsistent with Basel Committee guidance. The compliance function should have a broader scope and address the areas indicated in this document and in the Basel Committee guidance [16].

Compliance 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 laws, rules and standards have various sources, including primary legislation, rules and standards issued by legislators and supervisors, market conventions, codes of practice promoted by industry associations, and internal codes of conduct applicable to the staff members of the bank. For the reasons mentioned above, these are likely to go beyond what is legally binding and embrace broader standards of integrity and ethical conduct. In a context of EU some particularly important FSAP (Financial Sector Assessment Program) measures (the Selected Directives) that are making compliance landscape:

- the Prospectus Directive;
- the Financial Conglomerates Directive;
- the Capital Requirements Directives (the CRDs);

- the Transparency Directive; the Markets in Financial Instruments Directive (MiFID);
- the Third Anti-Money Laundering Directive (3AMLD) [15].

It is important to review EU regulation for financial sector alongside with the abovementioned background. FSAP was endorsed at Lisbon European Council of 2000, and has laid the legislative foundations for the EU financial services industry: banking, insurance, securities and asset management. It detailed 42 measures of four types: directives, regulations, communications and recommendations. In 2001 and 2002 FSAP was added with Lamfalussy Process covering securities market, banking and insurance. The Lamfalussy Process involves a four – level approach to the implementation of EU financial services legislation:

- Level 1 – The European Commission and the European Council agree on basic framework of the legislation being considered.
- Level 2 – The European Commission specifies the technical details of the framework agreed at Level 1.
- Level 3 – Each member state implements the measures taken at Level 1 and 2. Guidelines and best practice standards are issued in order to bring about uniform implementation.
- Level 4 – this will involve the European Commission checking member states' compliance with the FSAP measures, with the threat of enforcement action for any that are “under-performing” [12].

At present, sanctioning regimes are often weak and quite heterogeneous. Legal framework covering sanctions provided in the national legislation for the violations of EU financial services rules - including: type (administrative and criminal, pecuniary and non-pecuniary) and level of sanctions, addressees of sanctions, factors to be taken into account in the application of sanctions - and actual enforcement of sanctions.

In the light of this review, Commission will make proposals on how Member State sanctions should be strengthened and adequately enforced.

Based on research studies, on the level of fines and its relation to the level of enforcement, the EU commission made an impact assessment that defines the problem and explains the need for and the objectives of EU level action in the field of sanctioning regimes. It also provides an analysis of rationale, the alternative and the impact of the Commission proposals on how sanctioning regimes may be approximated at the EU level, which are presented in the Communication on sanctions [4].

The specific problems can result in wider problems, in a lack of compliance with EU financial services rules, such as prudential rules, conduct of business obligations, transparency obligations, etc. For example, when the maximum amount of the pecuniary sanctions is very low, even for the most serious infringements, there is a high risk that sanctions will not have a sufficiently dissuasive effect, as the perceived reward from such behaviour will far outweigh the real risk.

Those divergences and weaknesses of sanctioning regimes can also have a negative impact on the trust between national supervisors and, hence, on cross-border financial supervision.

Levels of administrative pecuniary sanctions (fines) vary widely across Member States and seem insufficient, or too low, in some Member States, including the same type of infringement. For instance, regarding the level of administrative pecuniary sanctions, the maximum levels provided for in the national legislations diverge very widely; in the banking sector, the maximum amount of fines provided for in case of violation is unlimited or variable in 5 Member States, more than 1 million EUR in 9 Member States, less than 150 000 EUR in 7 Member States [16].

Figure Nr. 1, compiled from data of the Member States, gives an overview of the amount of administrative financial sanctions imposed in the banking sector (compared with the range of sanctions that is the minimum and maximum levels provided for in the legislation). The figure demonstrates that the majority of Member States imposed little or no sanctions during that period. It also shows that in most cases, where a wide range of sanctions are allowed in the statute book, including very high sanctions, that range of sanctions is not effectively imposed. Only in three Member States significant amount of sanctions can be observed, which totalled over 1 million EUR, imposed in the banking sector during that period.

Recent observations [2; 4; 6; 10; 18] suggest that in the new regulatory environment knowledge of compliance was becoming increasingly important across all areas of business. Bank regulation models and supervisory approaches have changed significantly. The new role of the supervisory bodies requires significant consistency between the knowledge bases and supervised entities [4].

The compliance departments should not ring-fence knowledge and operate more as internal consultants [11]. Holland (2010) noted that the lack of basic knowledge of banking risks and value drivers by the board

and senior managers was implicated in the banking crises. He concluded that by ensuring greater bank learning, knowledge creation, and knowledge use, governments and regulators could help to reduce individual bank risk and the likelihood of future crises. At the same time, he admitted that, given the history of bank learning, incentives to learn and implement knowledge effectively are only to arise at the top of banks with clear regulation and *tough sanctions* [8].

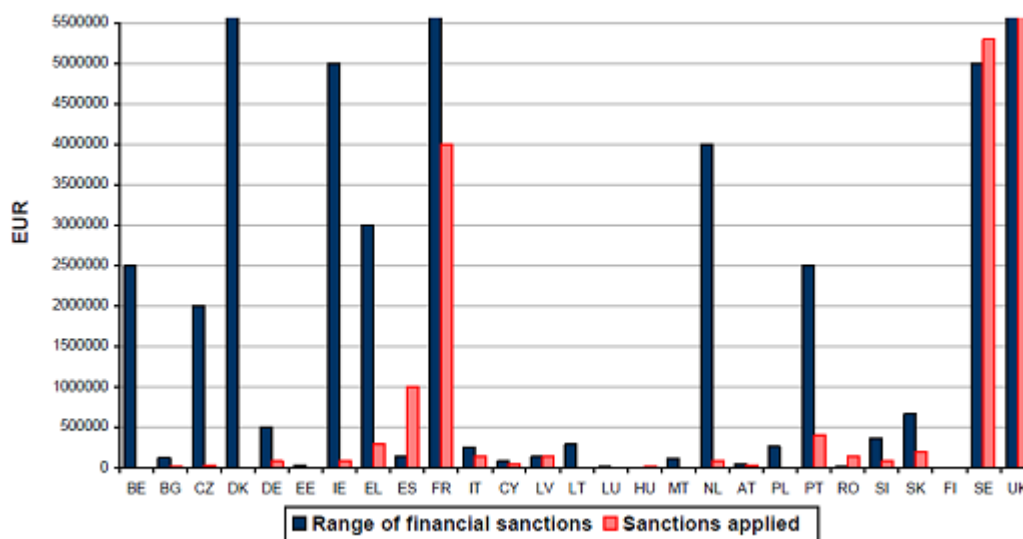


Figure 1. Range of (financial) administrative sanctions against legal persons, and sanctions applied from 2005 to 2007 (in EUR)

Source: *The future of compliance – best practice and delivering value* On-line <http://www.ilaw.com/ilaw/doc/view.htm?id=131975> – viewed on 16.02.2011.

In Latvia, like in Belgium, certification of compliance profession is still under discussion [18]. Birindelli (2008) suggested that highly skilled resources, competences and experiences are the essentials to discharge compliance liabilities effectively [3].

Edwards (2006) has established a compliance competence partnership model where the regulator and regulated need to work together in a proactive partnership in order to achieve compliance competent organisation [7]. The appropriate specialised department is the main element of Compliance Risk Management [13]. Obviously, an effective compliance department has to feature quality and quantity of HR and material structure (including IT support) corresponding to the size and complexity of the bank, whereas “quality” refers to a personality profile of an ideal compliance officer (and a manager of department, in particular) with extensive knowledge.

Aligned with this background, further research and discussion would be needed regarding education, professional examination and certification for the compliance specialists in Latvia. Interviews with experts from commercial banks and Latvian Commercial Banking Association have confirmed the need for that. In order to prepare more detailed training program on compliance issues in commercial banks, the authors of this article and management of the Latvian Commercial Banking Association have decided to conduct a survey to evaluate the real situation and needs for training on compliance issues. The survey topics for compliance issues investigations in commercial banks in Latvia have been negotiated with Latvian Commercial Banking Association – survey is at the preparation stage. First drafts of questionnaire are accepted by Latvian Commercial Banking Association. In this paper, education on compliance issues is observed and evaluated.

### Compliance issues in accredited higher education study programmes in Latvia

The aim of empirical research was to estimate if compliance knowledge needed for banking sector could be ensured by the higher education in Latvia. The research was performed in February 2011: 33 accredited finance and law study programmes were studied (by degree – Bachelor Studies, Professional Bachelor Studies, Master Studies, Professional Master Studies, Doctoral Studies, 1<sup>st</sup> Level Higher Professional Education Studies, and Professional Studies). The information source was Higher Education Quality Evaluation Centre of the Republic of Latvia, where information on all accredited study programs: self-

evaluation reports, expert evaluations and decision on accreditation are published (available on <http://www.aiknc.lv/>). The research was made in all 33 accredited finance and law programmes. The key words were *compliance*, *money laundering*, *consumer protection*. The results of the respective investigation are included in Table 1.

Table 1

**The Inclusion of *Compliance* concept in Accredited Study Programmes in Latvia  
(as of February 2011)**

University	Study programme	Accredited	Accreditation period ends	Study course	Keyword
University of Latvia	Law science 43380 (bachelor studies, 180 ECTS)	30.06.2010	31.12.2016	Rights of consumer protection (3 ECTS)	Consumer protection
University of Latvia	Finance management 42343 (professional bachelor studies, 240 ECTS)	16.06.2010	31.12.2016	Economic rights (6 ECTS)	Consumer protection
Riga Graduate School of Law	Law and finance 45380 (master studies, 72 ECTS)	10.12.2008	31.12.2014	Investment Firms & Regulatory Compliance (3 ECTS)	Compliance
BA School of Business and Finance	Finance 4634300 (professional master studies, 240 ECTS)	08.06.2005	31.12.2011	Tax economics (1.5 ECTS)	Compliance

*Source: Accredited Study Programmes of higher education establishments in Latvia, by degree. Available at: [http://www.aiknc.lv/en/prog\\_grads.php](http://www.aiknc.lv/en/prog_grads.php) - visited 15.02.2011.*

The data in Table 1 indicates there are only 4 accredited programmes in Latvia's higher education establishments where the *compliance* concept is mentioned: two study programs of University of Latvia – Law Studies (bachelor) and Finance Management programmes (professional bachelor), in Riga Graduate School of Law – Law and Finance programme (master) and in BA - School of Business and Finance – Finance programme (professional master). Interviews of representatives from the commercial banks in Latvia as well as Latvian Commercial Banking Association have emphasised that specialists familiar with compliance issues are in shortage in Latvia, therefore it would be necessary to strengthen existing accredited study programmes with compliance topics as well as organise training on compliance issues for specialists in commercial banks. Since there are several higher education establishments in Latvia providing education in finances and law, we would recommend BA School of Business and Finance to develop training courses together with Latvian Commercial Banking Association and offer them to specialists from commercial banks in Latvia. First steps in this direction are already negotiated and suggested.

Out of 33 accredited study programmes including around 1085 study courses, only in 4 study programmes (4 courses) *compliance* or *consumer protection*, which corresponds to 13.5 ECTS or 9 credit points, was mentioned. It indicates that in higher education establishments not enough attention is paid to *compliance issues* and some steps to improve the situation have to be taken. It means that professional organisations related to commercial bank operations have to require higher education study programs to include *compliance* issues – the professional standards have to be updated. It is recommended to discuss theoretical findings as well as practical experience of commercial banks in *compliance* on a regular basis, for example, to host international conferences.

### Conclusions and suggestions

1. In the new regulatory environment knowledge of compliance is becoming increasingly important across all areas of business.
2. The new regulatory environment will require original ideas, new methods and approaches to the knowledge concerning the compliance risk management.
3. Latvia's banking sector has to pay greater attention to the issues of compliance risk management.
4. Appropriate specialised department should be integrated into commercial banks as a main element for *Compliance Risk Management*.

5. A survey of Latvian Commercial Banking Association (LCBA) members should be conducted with the goal to understand how compliance function is set up and how many banks have an independent compliance department.
6. The staff of such department should have an appropriate education and knowledge. The abovementioned survey could also provide information regarding a bank's top compliance manager.
7. There are no accredited study programmes in Latvia that ensure *compliance* knowledge on internationally required level.
8. As the *compliance* role in financial sector is increasing, the employers (banks, insurance companies and asset management companies) and their associations could urge to include *compliance* knowledge and skills development of study programmes related to the financial services, as well as to evaluate the possibility to organise special study courses on compliance issues.
9. Compliance Competence Centre could be developed in a partnership between LCBA and BA School of Business and Finance, to encourage discussions about compliance knowledge.
10. At least once a year discussions about compliance knowledge in Latvia and Baltic States, gathering experts from Nordic Countries and other countries present in the Latvian banking sector, must be organised. This would promote coordination in using common terms at least in Baltic States.

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