

THE JOINS OUTS OF COMPLIANCE OUTSOURCING

BY RAFFI FESTEKJIAN

SUCCESSFULLY COMPLYING with the barrage of disparate regulatory requirements—Sarbanes-Oxley, the USA PATRIOT Act, Basel II, Bank Secrecy Act (BSA), anti-money laundering (AML), Community Reinvestment Act (CRA), Home Mortgage Disclosure Act (HMDA), Fair Lending, and the Gramm-Leach Bliley Act (GLBA), to name a few—can be costly and time consuming. As a result, many financial institutions are turning to outside experts for help ensuring that their compliance programs are running at peak efficiency, as well as for assistance with specific tasks, from regression analysis to regulatory exam preparation. For many lenders, outsourcing's perceived threat to security is waning as third-party providers develop the necessary tools and technology to address security and data integrity concerns.



Some of the Biggest Reasons to Use External Experts

- Supplementary regulatory expertise
- Advisory and technical support
- Evaluation of internal compliance procedures
- Best practices determination and enforcement
- Creation of formal compliance policies and procedures
- Compliance training/mentoring
- Usage review of automated solutions
- Process assessment and re-engineering

FWA WALIDOKKI/ISTOCKPHOTO.COM

The Big Picture: Going Outside for Help

Outsourcing is the concept of paying an external firm to manage non-core company functions in order to save money, freeing internal resources for other activities and potentially improving quality. First utilized in the data-processing world and universally accepted for IT, accounting, customer service and manufacturing functions, outsourcing is a fairly new concept among compliance professionals. But it is becoming more established as organizations confront the daunting challenge of complying with an increasing and changing array of municipal, state, federal, and global regulations.

Maintaining compliance requires making accurate decisions from relevant information gathered through effective, documented processes—a tall order for a compliance department short on resources. Yet recent headlines clearly show that institutions running at less than their best may be putting themselves at great risk:

- A Chicago bank paid a \$2 million penalty for improperly exempting two money services businesses from currency transaction reporting and for structuring currency transactions by a former president and director of the bank.

Ultimately, the need to outsource should be driven by what's right for the enterprise, and an institution needs to have total confidence in any provider with whom it chooses to partner.

- A recent complaint alleged that another Illinois bank avoided serving the lending and credit needs of predominantly minority neighborhoods. The proposed consent order required the bank to invest a minimum of \$3.5 million in a special financing program for residential and CRA small business loans.

- The Justice Department announced that an Indiana bank will invest more than \$4.3 million and open new branches in minority neighborhoods in the northwestern portion of the state to resolve allegations that it engaged in a pattern of discrimination on the basis of race and national origin.

- The Financial Crimes Enforcement Network, Federal Deposit Insurance Corporation, and New York State Banking Department assessed civil money penalties of \$12 million against a New York financial institution for violations of federal and state anti-money laundering laws and regulations.

- The Department of Justice filed its third lawsuit in three years contending that a lender violated the Fair Housing Act and the Equal Credit Opportunity Act by failing to offer loan products.

These real-world examples demonstrate that compliance departments are more overworked and under-trained than ever. Outsourcing can be a smart business decision for lenders who feel comfortable offloading specific non-core compliance processes outside the organization, enabling staff members to focus on strategic, value-generating competencies that enhance the lenders' overall business.

As a practical matter, compliance outsourcing is business process outsourcing (BPO) with a compliance twist. By outsourcing the compliance process, the organization expects the BPO provider to manage the compliance function in a cost-effective and efficient manner by leveraging its specific expertise. The ideal partner delivers a level of experience and proven processes that the organization does not possess. Most compliance process outsourcing focuses on the operational aspects of lending compliance—the resource-intensive data management, production, scrubbing, and research aspects of compliance—allowing the management team to focus on programs and process while proactively managing risk.

Overburdened compliance officers are increasingly realizing they need to reach out to third-party experts for brawn, brainpower, and guidance. Many are recognizing the value of bringing in a trusted partner, a team of reliable experts who can assume responsibility for data processing and report generation, a statistical wiz to perform any number of highly technical, data-intensive tasks, or an adviser who's appropriately educated and well versed in the glut of regulations facing compliance teams. No matter what the specific needs, the ideal collaborator will help an organization allocate internal resources efficiently, improve performance, and better serve its own customers and communities. The ultimate partner provides access to best practices and improves relationships with regulators, often leveraging an organization's existing technology for such tasks as preparing for exams more thoroughly.

Still, there are many executives who fear that by relying on third parties they will loosen their grip on the entire organization, and in turn, lose their competitive advantage because of the time and attention required to move operations to an outsourcer. Ultimately, the need to outsource should be driven by what's right for the enterprise, and an institution needs to have total confidence in any provider with whom it chooses to partner.

Size Can Influence the Decision to Outsource

Without question, banks of all sizes face rising costs and increasing complexity related to regulatory compliance and due diligence. Regional and community banks tend to outsource more because they are more likely than larger banks to have limited financial and personnel resources. Outside providers can offer these smaller institutions instant access to a deep pool of industry knowledge covering a broad range of regulatory compliance matters—and the bank

most likely saves money because it is spared the cost of hiring a team of individual subject matter experts on a full-time, long-term basis. In addition, providers can pass on to the institution gains made by economies of scale, possibly resulting in further savings. Outsourcing new programs or tasks can also be the perfect solution for smaller banks because it buys management time to get staff members educated and up to speed. After employees receive proper training and feel comfortable assuming responsibility for the initiative, it can then be brought back in-house.

When a bank passes the \$200 million mark, various federal and state regulations typically kick in, resulting in increased compliance responsibility and often the hiring of one or more dedicated compliance officers. Because larger banks are more likely to have the money to hire and train the needed personnel in-house, they may be less likely to outsource. In addition, many larger institutions shy away from outsourcing because the perceived security risk is too great. When the largest lenders in the United States do decide to outsource, they pick their partners carefully and focus heavily on solving operational headaches. That said, there's no magic formula to knowing which organizations are more or less likely to outsource.

A Flexible BSP Approach Served to Clients a la Carte

Some providers follow a business services provider (BSP) framework, integrating process, people, product, and platform expertise to build an outsourced compliance department that can effectively perform any or all of the needed compliance activities on behalf of its customers. This model incorporates best practices and strategies to offer financial institutions an alternative to managing compliance programs internally.

It's important for decision-makers to remember that they have a great deal of flexibility in choosing just how much and to whom they'd like to outsource. For instance, one company may feel comfortable outsourcing all of its compliance needs to a single provider (i.e., the one-stop-shopping approach), while another may choose to use the software from one provider and partner with another vendor to fulfill its personnel needs.

Regulators Intensify Consumer Compliance Scrutiny

Given recent developments in the United States and Washington, D.C., in particular, it's clear the compliance landscape is again changing. Because state and federal regulators are more closely scrutinizing BSA, CRA, HMDA, and fair lending practices, many institutions may now be feeling the need to outsource more as they look for help navigating the regulatory minefield. With the elevation of consumer compliance to new importance, lenders must start devoting resources to

The Upsides and Downsides of Going Outside: Is Outsourcing Worth It?

THE FOLLOWING RESULTS ARE BASED ON A SURVEY performed by Deloitte Consulting. The study, "Calling a Change in the Outsourcing Market," asked senior executives at 25 large companies to cite their main reasons for outsourcing, and was reported by Linda Tucci in a May 11, 2005 SearchCio.com article.

70% of respondents cited cost savings as a key driver for outsourcing, but 38 percent said they ended up paying hidden or added costs they thought were included in the contracts

57% cited quality and innovation, but 31 percent said vendors became complacent after contracts were in place

35% cited flexibility and capacity, but comments revealed that contracts are binding and vendors are refusing to accommodate last-minute changes

22% cited access to high-caliber labor, but one in five experienced greater employee turnover and realized the intellectual capital they had paid for was fleeting

22% cited transfer of risk to vendors, but they said vendors were unable to fully absorb the costs of business losses, leaving the company to pay the bill

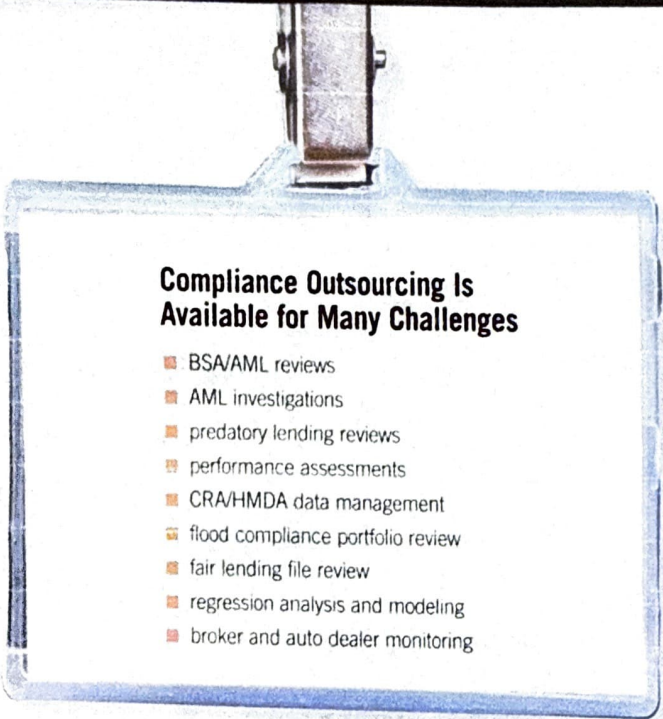
16% said they outsourced because they lacked in-house expertise, but 44 percent found their vendors couldn't deliver on the quality and cost savings and they decided to bring the operations back in-house

being compliant if they are not currently doing so. Many organizations may receive help by outsourcing a range of compliance-related responsibilities to one or more providers who can offer concentrated expertise and knowledge.

Outsourcing can come in handy for a variety of time-consuming, labor-intensive tasks, including the complicated statistical demands of fair lending regression analysis. Many lenders are realizing the value of regression analysis, typically the only way to identify disparate impact. But that raises the question of whether to use in-house statisticians or outsource to professionals. Because the results from regression can be confusing, outsourcing may be the best choice. With the newly aggressive stance of federal regulators, there may also be other reasons to outsource.

BSA/AML Initiatives May Precipitate the Greatest Need to Outsource

According to results from the American Bankers Association's (ABA's) 2006 Community Bank Competitiveness Survey, 87 percent of respondents mentioned BSA as the regulation causing them the most headaches, greater even than Sarbanes-Oxley. Adding to the palpable stress already felt by institutions



Compliance Outsourcing Is Available for Many Challenges

- BSA/AML reviews
- AML investigations
- predatory lending reviews
- performance assessments
- CRA/HMDA data management
- flood compliance portfolio review
- fair lending file review
- regression analysis and modeling
- broker and auto dealer monitoring

trying to deal with BSA in a post-9/11 world are a variety of factors, including a surge in terrorist financing concerns, an intensified exam process, the zero-tolerance policies of overzealous regulators, the increasing complexity of technology-driven schemes, and an increase in fines for companies failing to implement controls to detect or report suspicious activity. Although software is more readily available to help institutions filter out routine, nonsuspicious transactions, people still need to look at and analyze the data.

"BSA requirements have acted as an accelerant for global, enterprise-wide compliance that pose many challenges, including, for example, country specific information sharing restrictions," writes Ann F. Jaedicke, deputy comptroller for compliance policy in the Office of the Comptroller of the Currency (OCC), in the May 30, 2006, issue of the *Goodwin Procter LLP Financial Services Alert*. "Ensuring compliance with BSA requirements is especially important because the reputational risks associated with a failure in BSA compliance are particularly damaging."

Many institutions do not have the internal expertise and investigative know-how to anticipate threats or detect and prevent money laundering. One of the biggest challenges currently facing organizations is the enhanced Bank Secrecy Act-targeted examination, which focuses primarily on transaction monitoring and the implementation of "know your customer" procedures. A key tool to help banks—large and small—with this process is a transaction monitoring system. But in order to use this tool effectively, banks must first identify their needs and then determine how the system integrates within their current IT environment. This is not easily achieved, and institutions need skilled teams of IT, business, and compliance professionals to make this determination. Quite often the best team can be assembled only using outside resources. Still, many firms prefer to keep AML programs in-house—especially larger institutions that can better afford to maintain the necessary technology.

A Good Compliance Expert Is Hard to Find—and Harder to Keep

Due to the unprecedented demand for highly proficient and trained compliance professionals, it's not uncommon for an institution to offer a competitive salary to attract top-notch talent and then spend additional money training and retention, only to have the recent hire take all that knowledge and skill to a competitor after as little as six months to a year on the job. Not only has the original organization lost that brainpower, but it also has to start from scratch, searching anew for the next expert and hoping this one will stick around longer and provide a return on the lender's investment. And when a lender loses an experienced compliance professional, it can be very challenging to find a suitable replacement.

The bank would likely save money in the long run because it won't incur the expense of committed internal resources, benefits, and support systems, to say nothing of the cost of finding and hiring qualified personnel. It may make sense to complement internal staff on an outsourced basis, using the always-available and at-hand personnel of third party providers in a variety of roles, whether to update and train employees on new initiatives, periodically review and evaluate internal procedures, or offer a fresh unbiased view on organization-wide regulatory compliance issues.

One of the greatest opportunities for providers to augment internal staff can be found in perhaps the most time-consuming and labor-intensive tasks facing compliance departments: the preparation and submission of CRA/HMDA data. By outsourcing these redundant, tedious operational tasks, employees are able to focus on essential analytic and strategic responsibilities.

Weighing the Real and Perceived Risks

While outsourcing all or part of an organization's compliance efforts can cut costs and in many cases improve internal processes, there are risks related to BPO, including privacy; intellectual property rights; the security of data, computer networks and systems; and corporate accountability. Nevertheless, it's wrong for organizations to assume that outsourcing equates to substandard protection of data or any threat to privacy. In fact, shifting oversight to a provider that specializes in those areas may actually reduce an institution's overall vulnerability.

"For certain servicing-related tasks, outsourcing can actually reduce a company's exposure to some forms of risk," reports Jeff Mouhalis in the November 13, 2006, online issue of *Mortgage Banking*. "This is largely because BPO providers are focused on very specific processes or tasks that are supported by specialized technology and highly customized training. That combination enables a level of expertise and operational consistency that is hard for any

servicer to duplicate while managing very diverse functions across the enterprise."

With good reason, information security is on the radar screens of corporate executives everywhere. Many institutions have concerns about outsource providers' accessing critical data and processes, yet it's a risk that can largely be solved with the appropriate technology, including locked data facilities, data encryption, and close monitoring. In the current environment, organizations and outsourced providers can manage the risk.

"A common concern expressed by executives is that BPO could expose their companies to increased risk with regard to matters of security and data integrity," Mouhalis notes in the same article. "However, most major players in outsourcing today—particularly those who operate in the American financial services sector—understand these concerns and place the utmost importance on security and regulatory compliance."

Does Reputational Risk Trump Other Risk Factors?

Although security remains a concern for many firms considering outsourcing, the risk may be outweighed by the possible reputational damage done to a company that does nothing and lacks in-house talent to effectively manage all its compliance efforts. With the sharing of data a paramount concern one breach of data security could tarnish an institution's reputation as well. Either way, a company's reputation is at risk.

In fact, reputational risk is one of the greatest dangers for today's lenders. Regulatory risk is also important, but it's secondary. Lenders should keep this in mind when deciding whether to outsource key compliance functions that might otherwise be left unaddressed.

For many financial institutions, the real issue seems to be evaluating how much risk they are willing to assume, and what kind. "It's less an issue of eliminating risk, because there will always be some level of risk for lenders whether it's reputational or security," says Richard Riese, director of the ABA's Center for Regulatory Compliance. "Instead, it's deciding which type of risk an institution feels it can successfully manage."

Certainly, security and cost are two main reasons why some companies remain reluctant to outsource. One way to minimize the overall cost of outsourcing is for an organization's compliance group to be better prepared from the start. For example, if a company is hiring a provider to help with data scrubbing, it behooves that company to spend the time up front ensuring its data is entered accurately. There is HMDA data collection software available with built-in alerts that signal if any errors are made while addresses are being entered. With this capability lenders spend less time correcting and cleaning data, which saves


money and time in the long run. By embedding tools within the process up front, providers can minimize lenders' outsourcing costs.

Conclusion

While saving money remains one of the main reasons financial institutions decide to outsource, many organizations want tailored outsourcing solutions, which can hinder the provider's ability to deliver savings based on economies of scale.

In addition to cost, however, there are almost always going to be extenuating circumstances impacting the final decision whether to outsource or not. "While there may be very sound reasons against outsourcing certain functions for your organization, it makes all the sense in the world to examine your operations, run the numbers, and determine for yourself whether BPO has a role to play in your organization," Mouhalis notes. "Regardless of your conclusion, you must continue to reevaluate your position as your company, the market, technology, and the availability of reputable BPO providers evolve."

If a recent Dun & Bradstreet survey is any indicator, outsourcing is to be pursued cautiously and only after careful research and consideration. The survey showed that 20 percent of outsourcing relationships fail in the first two years, and 50 percent within five years. But whether an organization decides to outsource all or part of its compliance program, it's important to take an enterprise-wide approach to the matter. Regulatory compliance ideally should be the concern of all within a financial institution, not the exclusive responsibility of the compliance officer or management. Furthermore, a company must embed compliance in its business units in order to be proactive and take a strategic view.

In the end, no matter how much of its compliance efforts an organization decides to outsource, it is essential for the lender to remain an active player throughout the entire compliance process. "Having systems in place with reliable providers and being able to monitor the systems they are using is critical to successful outsourcing," explains Riese. "A lender must remain actively involved with its compliance programs, keeping close watch over all activities undertaken by the provider. This includes routine monitoring, spot checks, and overall stringent oversight." 

ABOUT THE AUTHOR

Raffi Festekjian is president and CEO of PCI, a part of Wolters Kluwer Financial Services. PCI offers software and professional services to monitor, detect, analyze, and resolve compliance demands throughout the entire lending process. Mr. Festekjian may be reached at raffi.festekjian@wolterskluwer.com.