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Compliance as a safeguard of ethical and image standards in banks

Abstract

The main purpose of this article is to present compliance risk and its place in the banking sector. The intensification of internal controls in banks, caused by the growing number of regulations, provided the premise for writing this paper, which is divided into five chapters. Chapter 1 includes basic information about the theory of compliance. Chapter 2 defines the essence of ethical standards in the banking sector. Chapter 3 describes the role of a compliance specialist, including risks associated with this job. Chapter 4focuses on the contemporary trends of ethical operations in the financial industry in the context of banks. Chapter 5 contains an overview of the considerations, providing a synthetic summary of the issues raised throughout the article.

Key words: compliance risk, compliance department, compliance, ethical standards in banks, bank image, misselling, whistle blowing.

JEL CODE: G20, G21, G41.

Introduction

Financial entities in Poland, and in particular banks, are facing new challenges as financial markets witness changes in the scope of services offered by financial institutions. According to a 2017 report by the World Economic Forum, the FinTech industry – known for implementing innovative methods of quick payments androbo-advisors - is growing rapidly. In addition, the recent EU regulation on the protection of personal data imposes further legal requirements on institutions. A dynamic expansion of the activities of banking entities may, however, entail additional risks. One such risk is compliance risk, which has gained a lot of significance in the last ten years, becoming an integral element of internal control systems. In the literature, this trend is said to originate not only from banks' efforts to meet regulatory requirements imposed upon them (Łosiewicz-Dniestrzańska2014), but also from the pursuit of compliance with ethical standards (Barcik 2016). In this article, a hypothesis is examined that proper compliance risk management is very important in the correct functioning of a bank. To this end, the method of critical literature review was used, allowing to verify the

research hypothesis. Literature items in the field of economics (also in English) and regulations applicable in the Polish and European legislation provided the main source of research material.

Compliance risk – a conceptual overview

A universal definition for compliance risk has yet to be adopted. Compliance risk is usually defined separately, depending on the regulator. The division of this concept is presented in (Łosiewicz-Dniestrzańska 2014), in which classification by source of the legal act, or its content, was opted for. The legal definitions of compliance risk can be found, among others, in Resolution of the Polish Financial Supervision Authority (PFSA 2011), Recommendations H (2011) and M (2013) of the same, or the MiFiD Directive (2006). Guidelines are also laid down in Standard (ISO 19600). Compliance itself is called the art of observing rules, emphasizing the synthesis of law with ethics and market rules (Grynfelder 2012). For the purpose of this article, the most general definition of compliance risk was adopted, derived from the Act (Banking Law 1997), which specifically accentuates the compliance of a bank's activities with legal provisions and internal regulations. A safeguard against this relatively new risk category in banking operations is to ensure compliance at the level of legislation, corporate order andethics (Włodarczyk 2014). In internal bank documents (Materiały wewnętrzne Banku Spółdzielczego w Końskich 2014), records can be found that compliance is also aimed at keeping a bank's good image or, more importantly, reputation. Another source complements the objective of compliance by referring to the protection of client interests (Materiały wewnętrzne Banku Spółdzielczego w Wąsewie2015).

Compliance risk is often equated with operational or legal risk. And while these concepts overlap, they are not identical and should not be confused. Legal risk is prompted by external factors, such as a dispute with the client, whereas compliance concerns internal factors - regulations adopted in a bank's structure (Mórawski 2016). Operational risk, meanwhile, admits the occurrence of losses arising from both internal and external factors (PFSA 2013), and unlike compliance risk, it can be measured. Client trust and good bank reputation are undoubtedly the assets of a well-functioning compliance department. A high level of monitoring this risk is also a sign of discipline and awareness on the part of managing entities (Grynfelder 2012). It should be pointed out that money invested in creating a separate compliance unit will be a warrant of avoiding future penalties arising from breaches and violations (Kowalczyk-Borek 2016). Last but not least, the following actions may prove decisive in the area of ethics: creating a list of entities with whom the bank will not cooperate

(PFSA 2013), whistle blowing, introducing a new product to the market (risk of misselling), market abuses, wrong marketing, and more.

Ethical standards in relation to bank activities

In banking, entities must comply with certain orders and prohibitions that define the purpose and manner in which they should do business. A set of such norms in the banking sector, established by the Polish Bank Association, is a code of ethics dating back to 2001, entitled "*Zasady dobrej praktyki bankowej*" [lit. "The Principles of Good Banking Practice"] (2013). It consists of seven chapters (including rules of conduct for clients, other banks and employees) and an attachment (Regulations of the Banking Ethics Committee). It follows from these provisions that every bank client should be treated with the same diligence and should always be informed about additional benefits that can be obtained by using a given service. Bank employees, meanwhile, should be loyal to the bank and take care of its good reputation. The bank, on the other hand, is supposed to provide the employee with career growth opportunities. The right attitude of a bank employee towards a client further provides an opportunity to better identify the client's needs and expectations, which leads to a reduction of uncertainty and increased trust when establishing a mutual relationship (Danielak 2015, pp. 72-73).

Organizational culture in a bank is a long-term process, which is nevertheless highly conducive to employee behavior. It is defined as a set of standards (e.g. moral) and beliefs that are passed on to members in a given organization (Gostomski 2017). Organizational culture can contribute to better performance, as employees who demonstrate commitment to mutual cooperation generate positive results in building trust in the bank (Thakor 2016). A certain incentive to comply with ethical principles for financial institutions may have been intensified in recent years by the activity of nationwide ethics competitions and a number of relevant prizes and honors (Charuba-Chadryś 2016).Practice, however, indicates a certain deficiency in this area. In 2012, online surveys were conducted in the United States and Great Britain, in which 500 randomly selected people working in finance participated. As many as 39% of respondents (195 people) indicated that their superiors are likely to be involved in illegal activities connected with the better performance of their business. Approximately 30% of respondents (150 people) stated that their bonus depends on the degree of violation of law or ethical standards (Wehinger 2012). Similar research was carried out in 2015, in which almost one in three respondents (391 out of 1223 respondents working in finance) stated that bonus schemes are designed in a way that encourages employees to violate the adopted ethical

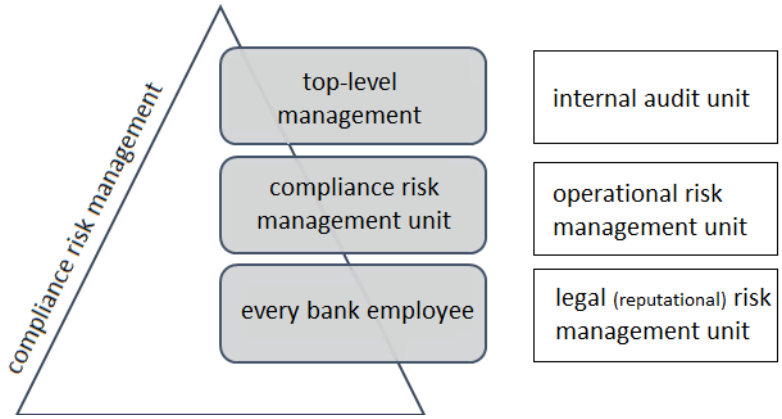
standards (Labaton Sucharow 2015). Inventive systems in banks cannot be omitted here, since many scholars (Davydenko, Kaźmierczyk, Romashkina, Żelichowska 2017, p.116) (Kaźmierczyk, Żelichowska 2017, p. 59) point out that motivation of employees is an important factor in an organization's financial success. On the other hand, the same authors also indicate barriers that threaten the adoption of good and effective incentives referring to limitations such as: know-how, experience in building incentive systems held primarily by foreign banks).

Characteristics of a compliance department

Chief compliance officer, compliance officer, compliance supervisor and compliance advisor –these terms are used to describe the increasingly important position of a person responsible for managing the bank's compliance department (Cichy 2015). Practice indicates that persons responsible for compliance in banks are to monitor ongoing activities, evaluate the risk of introducing a new product on the market and solving conflicts of interest (Olędzki 2014). A document issued by the Polish Financial Supervision Authority (PFSA 2013) outlines that compliance managers should have appropriate qualifications and experience that will allow them to perform their duties properly. They should also have access to necessary information and be able to cooperate with other departments to ensure efficiency. A separate compliance department (cell, unit) is most often established in large banks, as it is associated with the creation of additional structures which would be difficult to implement for smaller banks (e.g. cooperative banks). As pointed out by W. Żółtkowski (Szelągowska 2012), compliance issues should be resolved in particular by the bank supervisory board, possibly upon previous legal consultations. Arguably, having a compliance specialist employed at the bank could reduce the risk of failure associated with introducing a new product on the market. That person (usually a lawyer) will have better knowledge to determine compliance between internal (individual banking procedures) and external regulations (including acts, resolutions and recommendations) (Łosiewicz-Dniestrzańska 2016). A separate compliance department at the bank, by creating pressure (by testing compliance with internal regulations), may also have an impact on compliance on the part of employees (Baldwin, Hutter, Rothstein 2000). In addition, the department will have the opportunity to manage any arising risk independently, which will ensure meeting the conditions consistent with Recommendation M (p. 14.2.) issued by the Polish Financial Supervision Authority (PFSA 2013).

Fig. 1 shows a compliance risk management model based on ISO 19600, constituting an attempt to systematize the issue of compliance management. It is worth noting that the compliance department is in this case an independent entity, similarly to risk division, which may be a confirmation of the previous claims about differences between the two. This model shows that not only top-tier management are responsible for compliance risk management and that the most effective solution is to manage compliance at all levels of the organization.

Figure 1. A compliance risk management model



Source: own study based on (Włodarczyk 2014).

The notion of compliance risk in the context of banking ethics is also closely linked to misselling, referred to as the bad and dishonest sale of products or services. In relation to the bank's activities, misselling concerns a marketing operation consisting ina bank employee deliberately offering a misleading product to the client (e.g. by omitting relevant information) (Office for Competition and Consumer Protection- UOKiK 2017). This behavior is unacceptable especially in banks, which are institutions operating on human trust, and as such, they should “play fair”, in particular: act in accordance with the law, respect mutual interests, and represent a high level of integrity and professionalism (Lipiński 2008). Clearly, the work of a compliance specialist - a person responsible for consistent, reliable and ethical conduct – is worth exploring. At this point, it might also be reasonable to try and explain the concept of whistle blowing, which is a social phenomenon consisting in an employee (whistleblower) confidentially exposing non-compliance with the law, procedures and standards in force at the bank he or she works for. This is described as a national obligation in (§6 of Chapter 1 of the Corporate Governance Rules for Supervised Institutions) of the Polish Financial Supervision Authority (2014) and the 2013 Directive of the European Parliament and of the European Council (2013), as well as in the Code of Banking Ethics in Chapter II part A (2013). This provision entitles employees to anonymously report unethical behavior

(discrimination, repression), inconsistent with the adopted code of ethics or organizational culture, to members of a Board of Directors or a Supervisory Board without further consequences (for both the whistleblower and the person who has allegedly committed a crime). As can be expected, it is recommended that the procedure of anonymously reporting wrongdoing at the bank be handled by a risk compliance department (Okońska 2017). Okońska argues that, while whistle blowing is not commonly abused and does not interfere with the principles of mutual cooperation, it may prove to be an effective form of fight against corruption and actions that could be considered abusive, additionally protecting the bank's reputation and eliminating potential costs (e.g. payment of compensation to clients). Nevertheless, it should be pointed out that a good atmosphere at work, coupled with mutual trust of the team, will contribute to the strengthening of ties, thus creating a synergy effect (Kromer, Jackiewicz 2015).

Corporate social responsibility as a form of implementing ethical and image standards – determining the scope of compliance

Ethics lies at the core of responsibility, and therefore, when analyzing ethical standards in banks – institutions dealing with public trust (although profit-driven at the same time), responsibility should be distinguished as an immanent part of ethics (Kubik 2016), given that the two concepts overlap to some extent . What they have in common is organizational order, thanks to which, within a given structure, employees are expected to be responsible for acts towards other colleagues, and ethical principles are expected to be respected (Responsible Business Forum 2015). The idea of corporate social responsibility, in addition to ecological responsibility and concern for the interest of the community, also assumes activity that takes into account the safety of employees. One of the concepts of development of this activity is the pursuit of enterprises to increase competitiveness conditioned by trust (Labocha 2012). Institutions implement these tasks with the help of promotional, marketing or training instruments (e.g. developing entrepreneurial attitudes and promoting knowledge) (Jóźwiakowski 2016, pp. 72 -74).

Ever since the 2007-2008 financial crisis, trust has played an overarching role in the activities of financial institutions, as found in (TNS 2013), in which trust is identified as one of the most valuable factors in the opinion of clients, hence the importance of social banks is increasingly the subject of research and analysis. The term "social bank" refers to a bank’s active presence in social media, and the resulting increase in developing a more profound

relationship between the borrower (bank) and the lender (client), offering services in the area of micro and small-sized enterprises, or building the image of "positive business" through ethical and sustainable actions (Weber, Remer 2011). Nowadays, social banks have grown to value responsibility (by caring mutual responsibility, they expect borrowers to be responsible for the money they are entrusted, excluding risky investments), transparency (observing the positive impact of granted loans), and sustainable development (apart from short-term profits, they try to care for the environment and nurture community spirit) (Benedikter 2011). Client trust is highly correlated with the quality of services provided by the bank, and these in turn affect customer loyalty. Currently, in the market of highly competitive banking services, the issue quality of services is becoming an increasingly common problem (Zabrocki, Suszek-Namroży 2015, pp. 121-122).

In Poland, there is an open register of prohibited acts (Register of Abusive Clauses). The list includes institutions that committed acts deemed unlawful and were convicted by a judgment of the Court of Competition and Consumer Protection (Węglarz 2012). The number of entries in this register in recent years has increased significantly (UOKiK 2017). Examples include financial penalties imposed because of advertising misleading, affiliation to cartels regarding bank agreements on the pricing of issued Visa and Mastercard cards, or Swiss-franc mortgages which, in the opinion of the UOKiK President, violate the collective interest of clients (UOKiK 2016). The above violations may indicate certain oversight on the part of compliance specialists, so this still remains a challenge for the department investigating the compliance risk at the bank. The global trend related to the promotion of responsible business forces institutions to adapt to these conditions, which also translates into an increased scope of duties for compliance departments. An example of this is the modern creation of advertisements for banking products - it turns out that this is not just a task for a marketing and promotion department – advertising, by law, cannot mislead the customer –as compliance with ethical principles is the responsibility of a compliance department.

Conclusions

The purpose of this article was to present the issue of compliance in banks, as well as to demonstrate its relationship with ethical standards. Western standards (and increasingly also Polish law) force financial institutions to conduct their business activities in a responsible way. The review of Polish and foreign literature, followed by an assessment of current

information from the world of finance, did not challenge the research hypothesis formulated at the outset of this paper. The unique (because referring to ethics) presentation of the problem of compliance risk in banks provided a fresh perspective on the problem in question, and as such, it should be considered a scientific contribution. At the same time, the author entertains the idea of conducting surveys with the participation of employees of smaller banks (e.g. cooperative banks) regarding the introduction of whistleblowing.

The dynamic advancement of modern technologies, the expansion of new banking products, higher customer requirements and the pursuit of competitiveness, may be tricky from the point of view of compliance and lead to loss of trust. Through the prism of emerging problems of banks related, among other things, to misleading customers, there are still discrepancies between what a financial institution declares and how it operates. Good reputation, a positive image and the rank of an ethical institution all require, first of all, responsibility for one's actions, which seems to remain the greatest challenge of compliance in the context of ethics, image and trust. It can also be concluded that ethical action pays off because a good compliance program can mean the opposite of penalty. Equally important is the idea that ethics allows to find a way out of a crisis, since the client trusting in the bank will know that their deposits are safe with the institution they entrusted them to. Ultimately, the decisive factor is the presence of a broad range of codes and regulations regarding ethical behavior in financial institutions. In the opinion of some, these rules act the same as money during a rising inflation, that is, they lose validity. However, a contrasting view suggests that the more standards and principles of banking ethics are in force, the better they will be absorbed and translated into practice.

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