

THE COST OF COMPLIANCE: THE CASE OF SOUTH AFRICAN BANKS

Johan Marx*, Ronald H Mynhardt**

Abstract

Compliance cost is expenditure of time or money in conforming to government requirements such as regulation or legislation. In the press it is stated that the cost of compliance is much too high in South Africa. Some South African regulatory authorities agreed with this opinion. To this end, research was conducted in South Africa to establish whether these opinions are accurate. The study found that the cost of compliance with regulations was unacceptably high for South African banks. The study concluded that banks needed assistance to reduce the cost of compliance. Following the recommendations of the study, calculations indicated that the implementation of these recommendations could reduce the cost of compliance by as much as 40 per cent.

Keywords: Banking Supervision, Banks Act of 1990, as amended, Basel II, Compliance risk, Cost of compliance, Regulatory Compliance, Regulatory risk, Risk Management

*Department of Finance, Risk Management and Banking, University of South Africa

**Department of Finance, Risk Management and Banking, University of South Africa, PO Box 392, Unisa 0003

Tel: +27 12 429 4927

Fax: +27 86 640 0793

Email: mynhardt@unisa.ac.za

Introduction

In October 2003, the Basel Committee on Banking Supervision ("the Committee") issued a discussion paper on compliance risk and the compliance function in banks (BIS, 2003:1). The purpose of this paper was to stimulate debate on the introduction of principles that could promote sound practices in banks and banking groups. In April 2005, after lengthy discussions and much debate with banks and regulators around the world, the Basel Committee issued their paper entitled "Compliance and the compliance function in banks". The paper provided detailed compliance principles banks are expected to adhere to. The Committee's paper (BIS, 2005:7) stipulated specifically that the board of directors of a bank was ultimately responsible for their particular bank's compliance with all relevant Acts and regulations. It further stipulated that compliance should become part of the culture of a bank (BIS, 2005:7) and that the bank's compliance function should be adequately resourced (BIS, 2005:8).

Resourcing such a function implies additional costs in the form of compliance cost. Compliance cost is an expenditure of time or money in conforming to government requirements such as regulation or legislation. In the push to meet initial compliance deadlines many banks focus on implementing the minimum technology systems needed to achieve a passing grade from regulators. Compliance, however, is an ongoing process that goes beyond the testing and

evaluation of internal controls to ensuring security and system integrity as well as managing changes. Banks are focusing their technology efforts on enhancing or implementing systems to ensure sustained compliance in the years to come.

In the financial sector of the United States of America (USA), new legislation such as the Sarbanes-Oxley ("SOX") Act was enacted in response to the Enron and WorldCom financial scandals to protect shareholders and the general public from accounting errors and fraudulent practices in the enterprise. Three years after the United States Congress had passed the Sarbanes-Oxley Act public companies experienced a profound escalation in operating costs. Foley and Lardner, a law firm in the United States of America, discovered that Section 404, the internal controls provision of SOX, had the biggest impact on companies (Foley and Lardner, 2006). The results were based on responses from 147 public companies, as well as proxy statements of more than 700 public companies, obtained by Standard and Poor's. One of the more interesting findings was that the percentage increases in fees paid to outside auditors is disproportionately greater for smaller public companies than that of larger companies. These costs mainly resulted from companies' compliance with the internal control provisions of SOX.

South African banks did not escape either as media reports, as far back as 2005, stated that the cost of compliance was already much too high in South Africa (Makuna, 2005:1). Some South African

regulatory authorities agreed and acknowledged that there was a definite need to reduce the cost of compliance (Kieswetter & Gordhan, 2005:2).

Makuna (2005:1), however, mentioned that, although the cost of compliance might have been too high, there was still a definite need for regulatory authorities and supervisory activities in South Africa. Makuna (2005:1) further concluded that the challenge to banks in South Africa was to ensure compliance with Acts and regulations in their organisations at an acceptable cost.

The cost of compliance can be divided into two broad categories, namely the cost associated with reaching compliance, i.e. operational cost, and the cost of non-compliance. The operational cost of compliance is a cost that a bank has to incur given the specific regulatory requirements. This operational cost could differ from bank to bank, as the banks' activities could be different. The cost of non-compliance can be severe to a bank (Sinha, 2006). Makuna (2005:1) is, however, of the opinion that the cost of performing compliance is in most instances lower than the cost of non-compliance.

As a result of media reports and the introduction of the Basel II Capital Accord in South Africa in 2008 (Nedbank, 2009:1), a study was conducted among 12 banks in South Africa with the main objective to ascertain whether the cost of compliance is in fact a problem to and a burden for the country's banks.

The second objective was to use the specific results obtained from the research and to suggest recommendations that could possibly ease the burden of the cost of compliance to banks.

Where did Compliance start for Banks in South Africa?

Compliance is either a state of being in accordance with established guidelines, specifications, or legislation, or the process of becoming so. Compliance in a regulatory context is an important business concern, because of an ever-increasing number of regulations and the widespread lack of understanding about what is required of a bank to be in compliance with new legislation.

The Banking Supervision Department of the South African Reserve Bank ("SARB") expressed its dissatisfaction with the apparent culture of non-compliance by some of the banks in South Africa (SARB, 2005b:11). In order to solve this apparent problem, the SARB expanded its annual supervisory process by also focusing on the banks' compliance functions in terms of Regulation 49 of the Regulations relating to Banks (SARB, 2005b:43). Regulation 49(1) of the Regulations relating to the Banks Act ("the regulations"), Act 94 of 1990 (SARB, 2008:740), states that:

"a bank shall establish an independent compliance function as part of its risk management framework, in order to ensure

that the bank continuously manages its regulatory risk; that is, the risk that the bank does not comply with applicable laws and regulations or supervisory requirements".

The regulations also require that a compliance officer of the bank should head the independent compliance function of that bank, and that the compliance function shall have adequate resources (SARB, 2008:740). The SARB further announced the commencement of a review process to assess compliance with corporate government principles on banking institutions in South Africa (SARB, 2004a).

This review process was completed during 2005, and the results were published by the SARB (SARB, 2005a). In the report, it was specifically mentioned that the compliance function of the banks in South Africa was not fully functional yet and that adequate resources were a problem (SARB, 2005a :61).

The South African regulatory environment, as that of the rest of the world, is constantly changing. Among these changes is the introduction of the new Basel II Accord for banks in 2008 (Nedbank, 2009), which created an additional burden on the banks in South Africa. Compliance costs are already estimated to be significant and it is often the case that compliance costs are more severe on the small banks as on large banks as these small banks have to comply with the same requirements as the large banks (Davie, 2004:1).

Research Methodology

The research on which this article is reporting was aimed at obtaining information about the cost of compliance and related information regarding compliance in South African banks.

The target population included 12 banks in South Africa licensed by the SARB. The banks interviewed included South African-owned banks, foreign-owned banks and branches of foreign banks. The banks interviewed own 80 per cent of the total banking capital in the South African banking industry, making the sample representative of the banking sector in South Africa.

The research focused mainly on the following:

- Firstly, a review of the international perspective on regulatory compliance was performed and attention was paid to supervisory structures and current trends in regulatory compliance in the G10 countries.
- Secondly, the cost of non-compliance for the relevant banks in South Africa was investigated by identifying the direct cost of non-compliance with the applicable Acts in South Africa. To achieve this goal the regulatory universe in South Africa was reviewed in order to identify the sections in the different Acts where non-compliance with that section is a criminal offence. The penalties attached to these offences

were identified, whether they were prison sentences, fines, or a combination thereof.

- Thirdly, the banks were asked how they calculated the cost of their actual compliance with all the Acts and regulations.

Questionnaires were completed during personal interviews with the chief compliance officers of the relevant banks. The questionnaire was designed to obtain specific information pertaining to the cost of compliance including the different types of costs. It also tested the participants' views on specific aspects of regulation in South Africa. The interviews conducted were strictly confidential and, at their

request, none of the banks or compliance officers interviewed was named.

The questionnaire consisted of specific questions divided into the following segments: bank demographics, compliance structure, compliance responsibilities, cost of compliance, regular submissions, other submissions, outsource agreements, and supplementary information.

The table below provides more detail on the questionnaire used:

Table 1. Questions to Bank Participants

Topic	Rationale
Bank demographics	<ul style="list-style-type: none"> - Ascertaining the South African-regulated banks' geographical presence; - identifying the business sectors in which the banks operate; - establishing the banks' compliance staff complement; and - identifying the different regulators.
Compliance structure	<ul style="list-style-type: none"> - Identifying the compliance structures in each bank; and - identifying the interaction between the role-players.
Compliance responsibilities	<ul style="list-style-type: none"> - Identifying the compliance responsibilities in each bank.
Cost of compliance	<ul style="list-style-type: none"> - Establishing the cost of compliance in each bank in terms of staff-related costs, legal costs and out-of-pocket expenses.
Regular submissions	<ul style="list-style-type: none"> - Establishing the extent of regular submissions.
Other submissions	<ul style="list-style-type: none"> - Establishing the extent of other submissions.
Outsource agreements	<ul style="list-style-type: none"> - Establishing the extent of outsource agreements.
Supplementary information	<ul style="list-style-type: none"> - Obtaining other relevant supplementary information.

An International Perspective on the Cost of Compliance

An international perspective on regulatory compliance was researched with the purpose of identifying international trends in regulatory activities and structures, which could possibly be used in South Africa. In order to achieve this goal, a high-level review of the supervisory and regulatory frameworks was conducted in each of the G10 countries as well as a review of trends in the regulatory compliance in said countries.

Internationally, it was observed that regulation, on the one hand, involves providing input into developing and interpreting legislation and regulations, issuing guidelines, and approving requests from regulated financial institutions as required. Supervision, on the other hand, involves assessing the safety and soundness of regulated financial institutions, providing feedback to institutions, and using supervisory powers to intervene in a timely manner when necessary.

Internationally, the responsibility for banking supervision rests with the central bank, while supervision over other financial institutions is

typically vested in other regulatory agencies. There are, however, several countries that are departing from this model, rather adopting the model of a single financial regulator. The reason for favouring this kind of model is that, since the boundaries between different kinds of financial institutions are becoming blurred, it makes sense to integrate the supervision of all financial institutions into a single agency.

The management of risk in the majority of international banks consists of three elements, namely accurate measurement and monitoring of risk, controlling and pricing exposures, and holding of adequate capital and reserves to meet unexpected losses. Instead of reviewing regulatory returns, supervisors have been focusing on these risk aspects lately.

The most important trend observed in the financial markets was that regulators are departing from traditional regulations regarding supervision. This constitutes a move aimed at the assessment of whether the overall management of a financial institution's business is being prudently conducted. There is a strong tendency towards the introduction of action plans and additional supervisory activities by

supervisors to review and fully understand all aspects of a financial institution's business.

Supervisors are paying attention to the efficiency and stability of their country's financial sector as it was found that any financial sector's efficiency and stability depend on the robustness of the financial infrastructure which consists of the legal framework, accounting standards used to value financial assets, availability of relevant statistics, payment and settlement system, and principles of corporate governance.

Numerous methods used by the different banks to calculate the indirect cost of non-compliance were identified during the study. Some banks use changes in certain indicators to estimate and/or to calculate the indirect cost of non-compliance. These indicators include loss of current and future customers, loss of employees, reduction in current or future business partners, increased costs of financial funding, and increased costs due to tighter supervision by the regulator.

Some banks in the study have also developed statistical and other models to predict how changes in the indicators, such as those mentioned above, will influence, among others, the bank's revenue streams, deposits on hand and profitability.

A number of banks in the study measure reputational losses by examining the reaction of their share prices to an announcement of a major loss event. If the bank's market value declines by more than the announced loss amount, it is interpreted as a reputational loss. Research undertaken by some of the banks has shown that the market value of shares fall by a ratio of one for one with losses caused by external events, but fall by a ratio of more than twice the loss percentage in cases involving internal fraud.

Another method identified and used by banks to calculate the impact of indirect non-compliance, is to rate the reputational damage into risk categories of high, medium and low impact on the bank. This damage can be caused by negative publicity and comments on business governance, compliance, integrity, performance or customer relationships.

The effect of non-compliance on the bank's market share can also be categorised as being of high, medium or low impact. Impact will be high if there is a loss of a major client or group of clients or when the bank is not achieving the desired outcomes relative to those of competitors by a large margin. The effect will be of medium impact if there is a loss of any clients or if the bank is not achieving the desired outcomes relative to those of competitors. The impact will be low if there is a possible loss of a few clients.

The conclusion drawn from this section of the study was that calculating the indirect cost of non-compliance was difficult but there were, nonetheless, statistical methods available to estimate such cost. There was, however, no doubt that if a bank is deliberately non-compliant it will almost certainly be forced from the market (Deffree, 2005:2).

The regulatory compliance, it was observed, also extends beyond the compliance department, and it was clear that regulatory compliance affected each employee of a bank. Carlson and Fernandez (2006:3) held the same view and stated that depending on the structure of a bank, the compliance functions could reside in several areas within the bank in addition to the compliance department. Such areas could include the risk management department, treasury department, internal audit department, the branch network and the human resources department.

Calculating the Cost of Compliance

The banks in the study acknowledged the various costs associated with compliance, but similarly have difficulty in calculating such costs accurately. Due to frequent changes to regulations, the distinction between start-up and ongoing costs is not clear, causing banks to incur both types of costs on a continuous basis.

Staff-related costs encompass fixed and variable compensation, including salaries; bonuses, medical aid contributions and leave pay. Banks mentioned that these costs are easily quantifiable for certain functions in banks, such as the compliance and legal department. It could however be more difficult to calculate cost of compliance for business areas where staff members spend only some of their time performing compliance duties.

The banks further mentioned that experienced compliance staff was in short supply and that higher salaries have to be paid in order to attract such staff. Another contributing factor mentioned was that the pace of regulatory change has necessitated a premium to be paid in terms of higher compensation.

The banks in the study reported that they are experiencing difficulty in expanding internal compliance support rapidly enough to meet the sharply increasing regulatory and supervisory demand. Internal resources have become so overloaded that the use of external sources is the only way to meet the deadlines.

The banks mentioned that opportunity costs are incurred whenever an employee spends additional time on compliance-related activities instead of developing business for the bank. In addition, when multiple regulators request the same information, the time spent on this duplication represents an opportunity cost.

Clients are also impacted, as banks tend to spend more and more money on compliance-related activities. Clients are therefore limited regarding the choice of products on offer or in the selection of a financial advisor.

An important aspect highlighted by the study that needs mentioning was that substantial portions of compliance costs are avoidable, reflecting deficiencies in the way that banks currently calculate compliance.

Additional Compliance-Related Information Obtained from the Banks

The following additional compliance-related information was also obtained from banks.

The majority of banks in South Africa have a presence (branch or office) in Europe, Africa and Australasia, implying that they have to meet the regulatory requirements of the different regulators in those countries.

The majority of banks in South Africa are active in the country's economy in the commercial, investment, treasury, retail and merchant banking sectors. The result is that the banks have to meet the requirements of different regulators and not just that of the banking regulator. In South Africa, other regulators could, among others, be the Financial Services Board ("FSB"), the Johannesburg Stock Exchange and the Bond Exchange of South Africa.

All banks in the study have either a centralised model or a combination of a centralised and decentralised business model for compliance, where "centralised" means that the head office of the bank is dictating compliance activities and "decentralised" means that business units manage their own other activities.

The majority of banks deploy permanent compliance staff on a decentralised basis by placing them in the bank's different business units. The banks taking part in the study, however, indicated that this deployment of staff could and often does lead to the duplication of compliance work performed, thereby adding to the cost of compliance.

The lead regulators for banks in South Africa are the South African Reserve Bank ("SARB"), through its Bank Supervision Department, and the Financial Intelligence Centre. The banks also interact with other regulators but on a less frequent basis.

In the study it was established that the lead foreign regulator for South African banks is based in the United Kingdom, namely the Financial Services Authority ("FSA"), with the other regulators with whom they interact based in Africa, the United States of America, Hong Kong, Brazil and India.

Compliance with the requirements of the Financial Intelligence Act (Act 38 of 2001) and the Financial Intelligence Centre Act (Act 38 of 2001) are managed by all the banks on a centralised basis whilst fewer banks manage the Banks Act (Act 94 of 1990), Financial Advisory and Intermediary Act (Act 37 of 2002) and Occupational Health and Safety Act (Act 85 of 1993) on a centralised basis.

All the banks in the study indicated that they perform the basic compliance activities which include advisory duties, developing compliance/regulatory policies and procedures, education and training of compliance and other staff, monitoring the level of

compliance, performing compliance reviews, performing compliance-related investigations and liaison with the different regulators.

The majority of regular submissions to local regulators are made to the SARB followed by submissions to FSB and the National Credit Regulator (NCR). In addition, the banks indicated that the SARB's reporting requirements were more onerous when compared to those of the other regulators in South Africa resulting in high resource allocation and costs.

The majority of regular submissions to foreign regulators are made to regulators in Africa followed by the United Kingdom, the USA and Hong Kong.

Despite not being able to calculate such costs accurately, the banks were unanimous that the cost of compliance has definitely increased over the past couple of years as a result of additional people who had to be employed in order to keep up with regulatory changes.

The banks were divided about whether the regulatory regime in South Africa was too onerous on banks in South Africa, about the influence of the current regulatory regime on competition in the industry and whether there are too many regulators in South Africa, or not.

In addition, the idea that the financial market in South Africa should regulate itself was tested. Some banks favoured self-regulation while others were totally opposed to it. The majority of the banks in the study were however of the opinion that self-regulation was currently not the answer for South Africa.

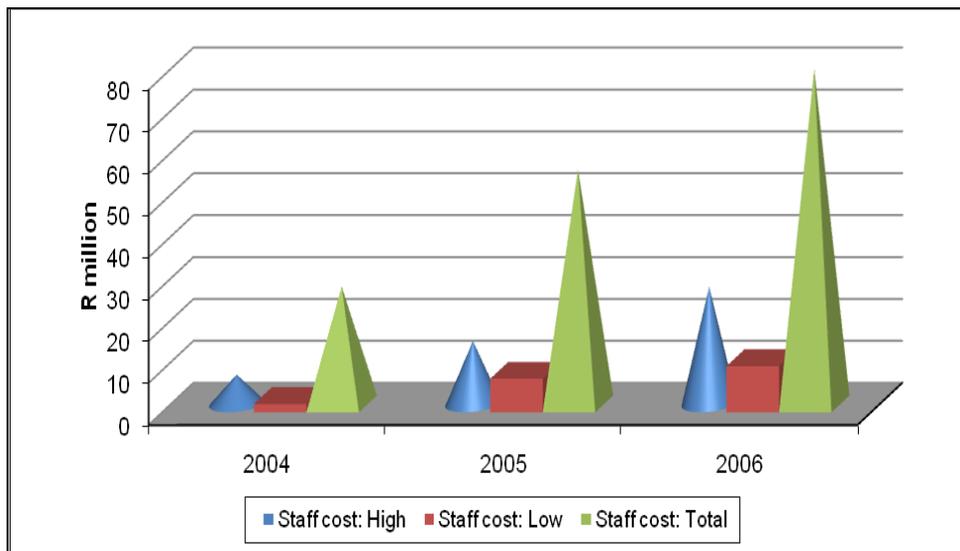
Summary of Main Findings

The main objective of the study being reported here was to determine whether the cost of compliance with regulations and other applicable Acts was onerous for banks in South Africa. The findings confirmed that banks are struggling to calculate the cost of regulatory compliance accurately. At best, they can estimate the cost of regulatory compliance only. The cost of compliance has increased and there are definite reasons for these increases.

The Cost of Compliance

The figure below provides the estimated compliance costs as furnished by the banks taking part in the study. The figure provides information on the combined total compliance cost of the banks and the highest as well as the lowest compliance costs in the banks. It must be noted that these estimates only pertain to those banks that were able to estimate costs and not the banking industry as a whole.

Figure 1. Cost of Compliance



In analysing the information obtained in the study, it was calculated that the total cost of compliance to the banks has increased by nearly 300 per cent from 2007 to 2009 as it has risen from an estimated R28 million in 2007 to R80 million in 2009.

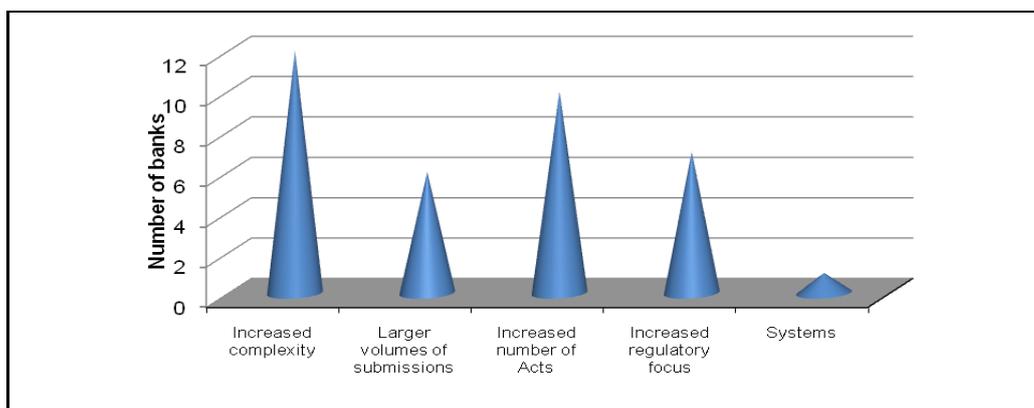
The banks cited the main reasons for the increase in the cost of compliance as the increased complexity of the regulatory regime, larger volumes of submissions, an increased number of Acts,

increased regulatory focus and the implementation of new systems.

Reasons for the Increase in the Cost of Compliance

The figure below indicates the banks' opinion of these reasons.

Figure 2. Possible Reasons for the Increase in the Cost of Compliance



The information in this figure indicates that the banks were of the opinion that the complexity of the regulatory regime, the increased number of Acts and increased regulatory focus were the main reasons for the increase in the cost of compliance.

The conclusion was that South African banks need assistance not only in calculating the cost of compliance but also in reducing the actual cost of compliance.

Recommendations

In order to enable banks to possibly reduce the cost of compliance as well as the complexity of the current regulatory regime, the following changes to the current legislation in South Africa were recommended:

- a single financial services regulator;
- tax rebates;
- capital reductions;

- outsourcing of the compliance function; and
- changes to Section 60 of The Banks Act (Act 94 of 1990).

A Single Financial Services Regulator

South Africa requires only one financial service regulator, similar to the regulators in the UK and Australia. This regulator should be responsible for the prudential supervision of all financial institutions including banks and non-banks such as insurance companies. Such a measure could ensure the necessary consistency and uniformity of the currently fragmented South African regulatory structure. One financial service regulator is justifiable by the continued blurring of institutional and product boundaries, as well as growth in financial conglomerates.

The main advantages of such a single financial regulator would be the following:

- maintenance of confidence in South Africa's financial system;
- promotion of greater public understanding of the risks, rewards and other key features of the financial system;
- maintenance of adequate security and protection for consumers of financial products and services, reflecting the different levels of risks, tastes and sophistication possessed by various types of investors; and
- reduction of criminal activity of a financial nature among regulated institutions.

Ultimately, it should ease the complexity of the current regulatory regime in South Africa.

Tax Rebates

Banks should be permitted to determine their direct cost of compliance once a year, have it audited by the external auditors and then be allowed a tax rebate.

The cost of non-compliance should not be tax-deductible as an expense on the bank's income statement. The bank shall therefore carry the full cost, penalties and fines of its non-compliance and these costs could be as high as R10 million per incident.

The introduction of tax rebates could possibly ease the cost of regulatory compliance by rewarding the banks for effective compliance structures and procedures.

Capital Reductions

Banks should be rewarded for effective compliance risk management. It is suggested that compliance risk and the management thereof be assessed as part of the operational risk assessment under pillar two of the Basel II Accord. The external auditors should also audit a bank's compliance function once a year and

report the findings to both the bank's board and the Registrar of Banks. The result of this will be that the capital charge for operational risk could be reduced or increased according to the findings of the assessments and the external audit.

Outsourcing of the Compliance Function

The Registrar of Banks and auditors should allow the outsourcing of a bank's compliance activities subject to strict conditions and oversight. The decision as to whether to outsource compliance activities to independent third parties should be left to the bank in question.

Should the bank choose to outsource its compliance activities, it was suggested that the regulations be amended to include the following conditions to allow outsourcing:

- the existence of a legally binding agreement between the bank and the compliance services provider ("CSP") detailing the exact terms of the agreement;
- the CSP is only responsible for the monitoring of compliance and not for performing compliance in the bank;
- the CSP shall be totally independent from the bank and appointed on an annual basis;
- the appointment of the CSP shall also be subject to the Registrar of Bank's approval based on specific criteria set by the Registrar;
- there shall be regular, formal meetings between the Registrar of Banks and the CSP;
- the work of the CSP shall be subject to an audit by the bank's external auditors on at least an annual basis;
- the CSP shall report its findings to the bank's board of directors and make all the reports available to the Registrar of Banks; and
- the CSP shall be responsible for the training of bank staff with regard to compliance.

The permission to outsource compliance activities could possibly ease the cost of regulatory compliance to the banks.

Changes to Section 60A of the Banks Act

It was recommended that Section 60A of the Banks Act (Act 94 of 1990) be changed to enable banks to implement the compliance framework. In the main, the changes pertaining to permission for outsourcing, to allow capital reductions and to allow tax rebates could possibly ease the cost of regulatory compliance to the banks.

The implementation of the above-mentioned recommendations is estimated to reduce the cost of compliance to the banks in South Africa by as much as 40 per cent.

Conclusion

Suggestions were investigated that the cost of compliance with regulations and other applicable Acts was unacceptably high for banks in South Africa. The subsequent research findings showed that there was evidence to support these suggestions. Banks are however struggling to calculate the cost of regulatory compliance accurately. At best, the banks in South Africa can only estimate the cost of regulatory compliance. The study concluded that the banks need help not only in calculating the cost of compliance but also in reducing such cost.

In order to enable banks to possibly reduce the cost of compliance, changes to the current legislation in South Africa were recommended. These included a single financial regulator in South Africa, allowing the direct compliance cost to be a tax rebate, making provision for compliance cost as a capital reduction, and allowing the outsourcing of the compliance function by banks in South Africa under certain conditions.