Addressing Compliance Challenges: Regulatory Risk in Practice

By Daniel Schmand, Global Head of Trade Finance, Deutsche Bank

Managing risk and uncertainty—whether created by market volatility, geopolitical events, regulatory change or lack of economic confidence—dominated 2016, with 2017 looking set to deliver more of the same. With diverse pressures and potentially competing priorities, how can treasurers make sense of the diverse set of issues that they are forced to contend with? Deutsche Bank recently commissioned the Economist Intelligence Unit (EIU) to produce a comprehensive whitepaper, Managing Risk in Challenging Economic Times, to understand treasurers’ issues in more detail. In a series of articles that will follow in TMI, experts from Deutsche Bank explore some of the concerns and priorities that arose from the study in more detail, and illustrate how leading companies are overcoming them. In the first of these articles, Daniel Schmand, Global Head of Trade Finance, Deutsche Bank, discusses regulatory risk, which has emerged strongly as a key priority over the past year.
In September 2016, the Economist Intelligence Unit (EIU) published its whitepaper, Managing Risk in Challenging Economic Times which was commissioned by Deutsche Bank. The report was based on a survey of 150 senior corporate treasury executives and 150 CFOs from around the world, representing companies of above $2bn in turnover, to find out how they are managing risk in challenging economic times.

Key findings included:

- Uncertainty about economic growth is treasurers’ top concern worldwide;
- Low or even negative interest rates are triggering significant policy changes in cash management; however, respondents continue to maintain large surplus cash balances;
- Regulatory developments continue to be a priority – and significant overhead – for treasurers;
- Treasurers recognise the importance of technology innovation, but adoption can be more challenging;
- Treasury functions continue to expand their range of responsibilities, particularly in the areas of risk management and capital allocation.

The report can be accessed at http://tiny.cc/ntcdly

A growing regulatory burden

Managing the impact of regulatory change is not a new phenomenon for treasurers, but over the past eighteen months, the burden of compliance has grown, with this set to continue or even increase in the future. Indeed, according to the EIU study, treasurers now identify regulatory and tax risk as the second most significant risk after global economic growth. There are a variety of reasons for this:

Firstly, as corporations of all sizes expand internationally, they are subject to domestic financial regulations in a larger number of jurisdictions, as well as global regulations.

Secondly, corporate treasurers are not only subject to regulations that are directly targeted at their activities, but there are also indirect consequences of regulations to consider. Basel III, for example, aims to build resilience and transparency in the banking sector, but as banks adapt their capital structures and liquidity ratios to comply with these requirements, their corporate clients are inevitably affected as the solutions and pricing that banks are able to offer will change. Some treasurers are also concerned that banks may become more selective in their corporate relationships.

Thirdly, in the case of requirements such as know your customer (KYC), as most corporations operating internationally work with multiple banks, their compliance obligations are replicated across banks. Although banks are subject to the same regulations, their interpretation may differ slightly:

consequently, while their policies and procedures may be similar, they are not identical, which inevitably adds to corporate clients’ compliance burden. Similarly, KYC requirements in each country will often differ, further exacerbating the compliance burden.

Sanctions screening is another area fraught with complexity. For example, while sanctions may have been eased on business with counterparties in Iran, volumes remain low as there is still a high degree of scrutiny and the rules that apply can be complex, so banks tend to take a conservative view.

Addressing compliance risk

Managing regulatory risk requires a very different approach to managing financial and credit risks. For example, treasurers can hedge FX and interest rate risk, and insure for, and limit credit risk according to a counterparty’s risk profile. Regulation cannot be avoided or hedged: the focus is therefore on ensuring compliance to reduce the risk of financial and reputational damage. The regulatory burden can therefore only be reduced by simplifying and streamlining the compliance process. Consequently, treasurers are looking to their banks to standardise KYC procedures across both banks and markets as far as possible. This is challenging in practice, not least as banks are ultimately responsible for their own compliance, so they are unlikely to be willing to cede control over the process.

Secondly, as documentation requirements can differ across jurisdictions, it is difficult to know which to use as a template. In reality, the tightest would have to apply, which inevitably creates additional, unnecessary compliance requirements in some situations, whether markets or products.

Despite the challenges, it is in everybody’s interests to ease the compliance burden, and compliance offers no competitive advantage to banks. In fact,
as the EIU study reveals, an overly onerous compliance process can damage bank–corporate relationships. At Deutsche Bank, for example, we have compiled a detailed, 105-point questionnaire to cover the large majority of information requests and documentation requirements. We prefill this questionnaire as completely as possible, using publicly available information or data we already hold. We then only need to ask our clients to validate the majority of the questionnaire, and provide limited data for the information we don’t have internally. For example, the bank cannot make assumptions about the amount of business a company does in a particular market, so we need a discussion about these issues.

Identifying compliance opportunities

One of the contributors to the study, François Masquelier, Head of Corporate Finance and Treasury at RTL Group, noted that regulatory compliance should not always be considered negatively: rather, it is an opportunity to review policies, processes and controls. For example, if a treasurer lacks oversight of cash, counterparty risk and controls in a high-risk jurisdiction, there needs to be a strategic decision made about whether there is sufficient value of working in that market. We are also seeing far more awareness and action on issues such as bribery which in turn drives policies, processes and behaviours. Advising on best practices, enforcement and reporting is a key area in which a bank such as Deutsche Bank can add value; similarly, we help treasurers and finance managers to develop procedures to help avoid and highlight problem counterparties.

Compliance innovation

Over the coming months, as the compliance burden for banks and corporates alike continues to grow, we would expect to see further innovations to help alleviate this burden through greater automation and better, more consistent use of data. For example, we are warmly supportive of SWIFT’s KYC Registry which provides banks with an efficient, shared platform for managing and exchanging standardised, SWIFT-validated KYC data on their correspondent banking relationships globally. We would also welcome a similar registry for corporate information, but this needs to be driven by the corporate community, just as SWIFT’s registry was motivated by banks. The use of the LEI (legal entity identifier) is also a valuable way of validating a counterparty to a transaction, including their business activities and ultimate ownership. We expect this concept to extend further with a significant impact on automating the validation of trading counterparties and streamlining commercial and financial flows.

KYC and KY3P (know your third party) are only two of the areas of regulation with which banks and corporations need to comply: FATCA requirements also create a substantial documentary burden, for example. Similarly, treasurers are tasked with a wide range of accounting, tax and reporting obligations that add complexity and put pressure on processes. Working with a bank that has the depth of knowledge of both domestic and international regulations, and can share best practices of working with global corporations can be a valuable way of prioritising compliance tasks and refining processes and reporting. Compliance obligations cannot be avoided or mitigated, and treasurers are often understandably frustrated that dedicating additional resources and implementing new technologies may not deliver tangible benefits. However, by collaborating to share best practices and common platforms, there is the potential to reduce the burden and ultimately increase transparency and trust between financial and commercial counterparties, and facilitate global relationships.

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