



Conservative compliance behaviour

Drivers of conservative compliance responses in the
South African financial services industry

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Foreword

The quest for inclusive financial markets is challenging both business and regulatory models as it requires new and largely unknown portions of the market to be served.

FinMark Trust commissioned this study to investigate the reasons for the apparent lack of universal response by financial institutions to the flexibility allowed by South Africa's anti-money laundering (AML) and combating of terrorist financing (CFT) regulatory requirements in relation to low-risk clients. Further perspectives are gleaned from experiences relating to similar reticence in the context of the Financial Advisory and Intermediary Services (FAIS) Act and the insurance sector's withdrawal of advice-based intermediation from the lower-income segment of the market.

These responses raise larger questions about the appropriate regulatory approaches to support innovation and financial inclusion internationally. In striving to extend inclusion, regulators are faced with fast-changing markets characterised by new players and new products. In a number of cases inclusion innovation occurs in spaces that are not yet covered by regulation. It is difficult under such circumstances for regulation to keep pace with these developments. In an attempt to create an appropriate regulatory space, regulators in some cases employ open-ended and flexible regulation that allows the financial institutions to innovate and exercise their discretion when complying with legislation. This speaks to the heart of the debate about balancing regulation with development.

The analysis presented in this document suggests that such regulation may not have the desired impact in all cases. Some financial institutions may ignore or may tend to respond in an overly conservative manner to the scope for discretion. In order to create regulatory frameworks that support financial inclusion we need to gain a better understanding of the dynamics that shape compliance behaviour. This study takes a first step in this direction. It outlines major drivers of overly conservative compliance responses and also identifies key factors that determine the nature of a company's response to a particular legal requirement. The study also proposes a number of preliminary guidelines for regulators who wish to avoid an overly conservative response to AML/CFT customer identification and verification requirements. While the study is focused on the South African environment, certain issues raised are relevant to an international audience as well.

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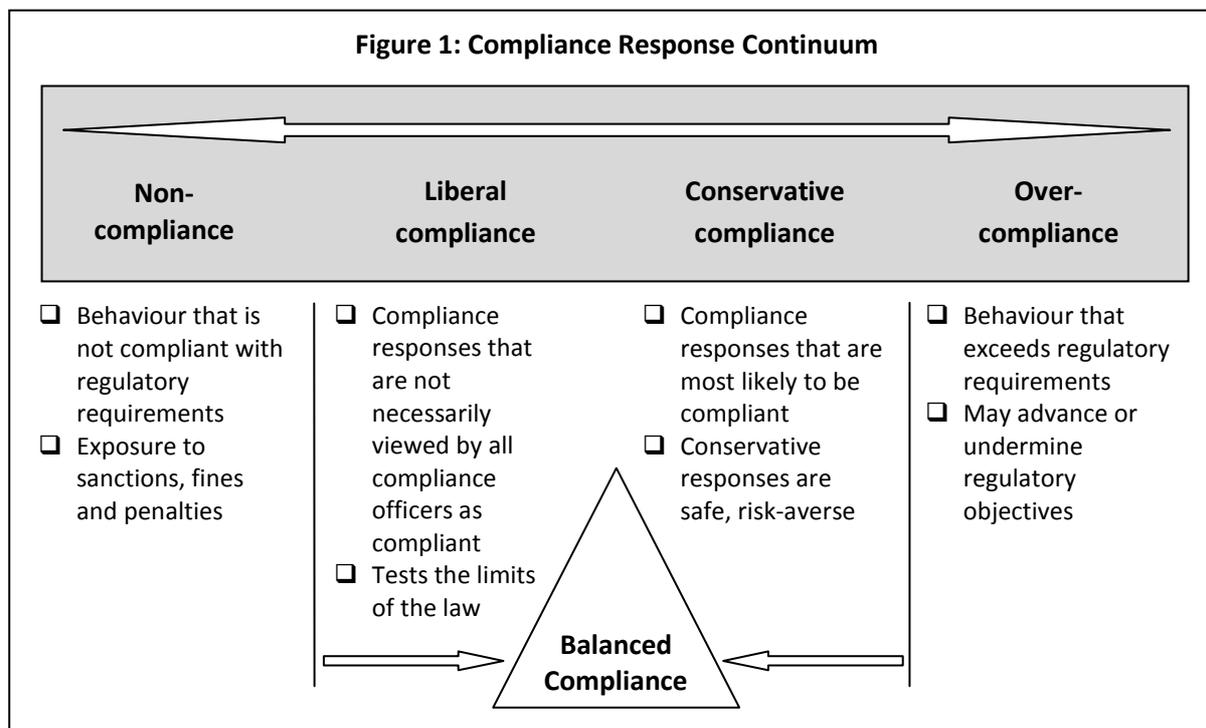
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Overview and recommendations

Potential compliance responses to regulatory requirements (whether through action or inaction) range from non-compliant to over-compliant with balanced compliance often viewed as the ideal response by a financial institution. The range of responses can be depicted as a compliance response continuum:



In certain cases financial institutions adopt processes and procedures that go beyond what is required by applicable regulatory requirements. For example, regulators that allowed financial institutions to adopt simplified customer due diligence measures in respect of low risk customers and products to support greater financial inclusion found that some financial institutions continued to apply more comprehensive measures. Over-reporting of suspicious transactions provides a further example. The Financial Intelligence Centre Act 38 of 2001 requires certain suspicious transactions to be reported. Institutions engage in “defensive reporting” when they also report transactions that may actually not be reportable. This generally happens when they have difficulty determining whether particular transactions are reportable or not. They then elect to rather over-report than run the risk of penalties for non-reporting. Over-reporting adds to the costs of compliance without proportionally advancing the objectives of the suspicious transaction reporting scheme.

Conservative responses were also evident in relation to the requirement that certain financial service providers must register with the Financial Services Board. Businesses that were not required to register, did in fact do so.

These examples provide an illustration of overly-conservative or over-compliant responses to the regulatory requirements in question.

Over-compliance may be positive from a regulator’s perspective, for instance where the text of the regulatory provision is flawed but the compliance response furthers the objectives of the provision in a balanced and appropriate manner. In some cases, however, an over-

compliant response may be inefficient and may even undermine the regulatory objectives. This is a real risk in relation to simplified customer due diligence measures that were designed to support greater financial inclusion. If institutions continue to apply more stringent measures, many potential customers who are unable to meet those requirements will continue to be excluded from formal financial services.

This limited study of over-compliance was undertaken by Cenfri to identify the main drivers of over-compliant customer due diligence responses by financial institutions in South Africa and to consider the need for further research in this field. Data was gathered by means of interviews with compliance officers and business representatives of such institutions as well as with regulators.

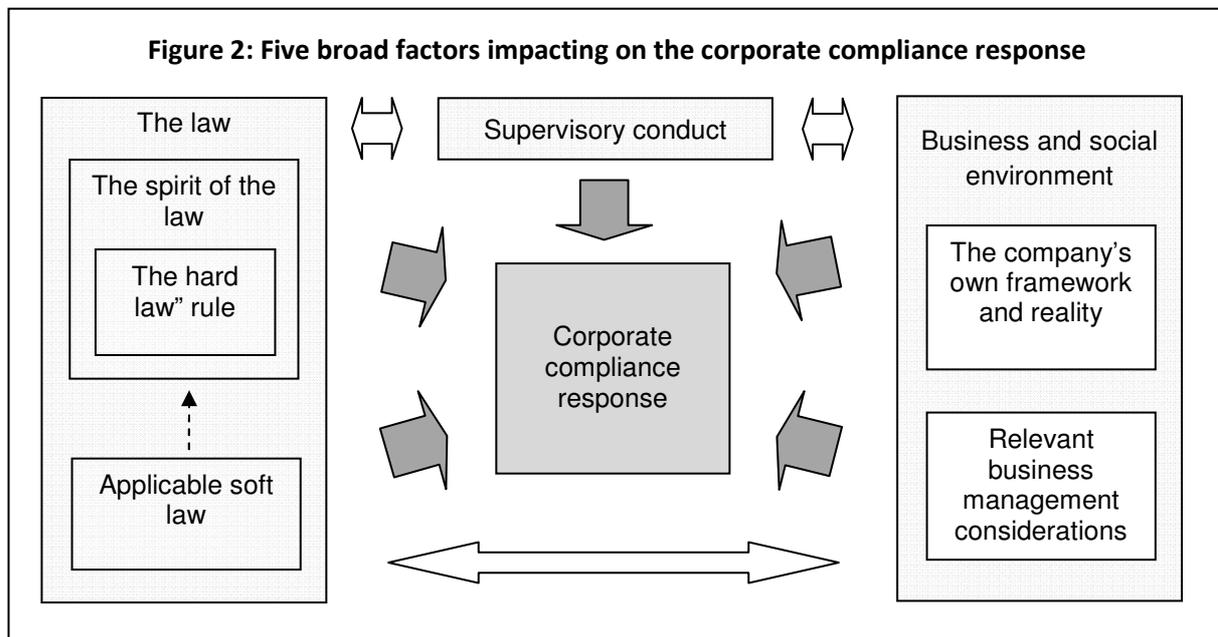
During the interviews it became clear that regulators generally viewed over-compliance in a positive light and was concerned that so little of it was evident. In fact, according to their view, regulated institutions were generally to be found on the left of the compliance continuum. As a result key regulators recently increased their enforcement powers. Institutions on the other hand generally viewed themselves as inclining towards the right of the continuum. These views were noted but the study was conducted around clear cases and examples of over-compliance to avoid the impact of overly-subjective views.

Drivers of conservative compliance responses

The following potential drivers of conservative corporate responses were identified:

- An institutional compliance culture that encourages conservative compliance responses;
- A conservative approach to risk in the industry;
- A need for uniformity in business management processes;
- Lack of compliance management expertise;
- Application of foreign compliance requirements, especially by local subsidiaries of foreign companies, may result in a compliance response that exceeds local requirements;
- Foreign compliance examples that inform local compliance responses;
- Concern about expenditure to upgrade or change compliance processes tend to encourage compliance responses that anticipate future requirements;
- Corporate processes to manage compliance with discretionary requirements;
- Concern about penalties and sanctions;
- The desire to maintain a good relationship with regulators and supervisors;
- A belief that the supervisor is intolerant of compliance errors;
- When the law is uncertain, compliance officers and legal advisors tend to advise that conservative compliance practices should be adopted;
- Appropriate management of other risks may require a conservative approach; and;
- Business information systems may dictate a more conservative response.

The drivers of behaviour that are listed above will not necessarily, in themselves, result in overly conservative compliance responses. The drivers function within a framework created by broad, interlinked, but also contending, factors that influence the corporate compliance response. This study identified five factors, as modelled in Figure 2:



- The **“hard law” (binding and enforceable regulatory requirements)**, interpreted in accordance with the spirit of the law and in view of the potential enforcement impact of a breach or contravention.
- **Applicable “soft law” (not binding through state action and not enforceable by the state)**, such as codes of conduct, corporate governance codes, international, national and industry standards and non-binding regulatory guidance. Although these requirements do not have the force of hard law, they tend to influence companies to interpret their hard law obligations broadly and to adopt practises that go beyond the text of the regulatory requirement itself. Soft law is often used as a guide by compliance officers to determine the so called “spirit of the law”, thereby impacting on their interpretation of the companies’ hard law obligations. Some companies voluntarily subject themselves to a particular set of soft law requirements, thereby elevating the status of these requirements in relation to the company and, in particular, their impact on their compliance responses.
- **Supervisory conduct**, that ranges from formal guidance and enforcement action to informal guidance and even agreements with senior managements of financial institutions. The majority of financial institutions in South Africa appear respectful of the power of the financial industry supervisors. Interventions may draw on hard law but may also go beyond. Interviewees cited examples where the management of larger institutions agreed to comply with soft law requirements because they were requested by the supervisor to do so.
- **Relevant (general) business management considerations**, for instance for the business to be profitable, for its systems, risks and opportunities to be managed well and for the business to be sustainable, which would include being viewed as compliant with industry standards and meeting the approval of the supervisor.

- The **company's own framework and reality**, for example its ethics, compliance culture, business context and human resources. The response may also be linked to, and sometimes embedded in, the management of other risks (for instance fraud risk, and consumer protection risk) and business opportunities by the company (for example, the company's marketing and customer service strategy).

Responses to the drivers of conservative or over-compliant behaviour are generally linked to one or more of these factors and in particular the way in which they operate internally and mutually. The complexity of their mutual operation was not further explored in this preliminary study.

In the context of this study, however, various aspects of the key drivers referred to above can be identified in relation to conservative compliance responses to various South African regulatory requirements. For example, the following illustrates factors that are relevant in respect of AML/CFT customer due diligence requirements:

- The hard law obligations in relation to customer due diligence, as specified in the Financial Intelligence Centre Act 38 of 2001 and regulations relating thereto, are enforced by onerous penalties, some of which compliance officers believe will be levied on them personally in future if their institutions are non-compliant. Compliance officers furthermore believe that customer due diligence measures will become more onerous and comprehensive in future.
- Soft law requirements such as the FATF Recommendations and the Basel guidance on Customer Due Diligence envisage comprehensive customer due diligence measures, especially in relation to high risk customers, but provide limited guidance in relation to low risk customers.
- Supervisors have undertaken various audits in relation to compliance with customer due diligence measures and institutions that were held not to be fully compliant had to incur costs to ensure that their processes are deemed compliant by the relevant supervisory body.
- Business management considerations such as pressures from international business counterparts, especially in relation to correspondent banking relationships, and concerns about identity fraud and reputational risk tend to influence management of financial institutions to support more extensive customer due diligence procedures.

However, whether an institution implements a relatively conservative approach also depends on factors relating to the particular institution, for instance its interpretation of the legal obligation; the cost and market impact of compliant procedures; how it perceives its broader corporate citizenship obligations and whether it can strengthen other business strategies, for instance marketing and improved customer service, by adopting a more conservative position.

Recommendations to avoid over-compliant responses

Over-compliant responses to regulatory requirements may advance regulatory objectives or may undermine them. In the light of the findings of this study, the following guidelines are proposed for regulators who wish to avoid over-compliant corporate responses:

Consult with regulated institutions when drafting new laws to ascertain potential compliance responses: A regulator that understands the most significant factors that may impact on corporate compliance decisions is in a strong position to manage and guide compliance responses. Valuable though the consultation will be, it also has its limits and challenges. Companies may display a broad range of responses because different factors

may be at play in different companies. Furthermore, the responses may be limited because companies tend to rely on past experiences and current knowledge that may or may not be totally apposite to the proposed new law. Consultation that is undertaken in a manner that recognises the strengths and the weaknesses of the consultation process will assist in addressing development imperatives.

Effective consultation requires active participation by the regulated institutions in discussions during the drafting stage of the law. During interviews of representatives of the regulators a number of examples were mentioned where the business community remained disengaged until the legislation took effect.

Address policy and policy conflicts expressly: A regulator that wishes to advance financial inclusion should adopt a clear policy in that regard. The policy document should emphasise the social and economic developmental objectives of financial inclusion and should address the interplay and possible conflict between the inclusion policy and other policies, for instance law and order and consumer protection. Policy statements will assist in clarifying the spirit of the law, which will also assist in interpretation of compliance obligations, especially from a corporate governance perspective.

Clarify legal obligations and ensure that they support financial inclusion: Regulatory objectives can best be met by clear regulatory requirements. The main regulatory instrument, whether it is an act or a regulation, should be clear and preferably sufficiently flexible to allow its objectives to be met in different ways in different contexts. Regulated institutions should be clear on the leeway they have to tailor their responses to their unique business contexts and risks. Financial inclusion imperatives and local context issues should be explicitly addressed to ensure that appropriate measures are adopted.

Allow adequate time for the implementation of regulatory requirements: Where regulatory requirements are brought into effect before organisations are ready to comply with them, organisations may respond with compliance behaviour that does not support the objectives of the regulatory requirements. Regulators expressed frustration with regulated entities that leave compliance “to the last minute” while business representatives often blamed a slow response on a lack of clarity. This issue can be managed through appropriate industry communication and timely regulatory and supervisory intervention.

Identify and manage interaction between hard and soft law requirements: A regulatory intervention may not be completely successful when contradictory or broader soft law principles apply. A more relaxed statutory regime may for example be undermined by more stringent soft law standards. It is important to identify applicable soft law requirements, including those issued by the regulator, and to consider ways to counteract their potential impact, if required. That may be done, for instance, by clear regulatory requirements that override soft law principles. Soft law can however also be utilised to strengthen the desired behaviour. Where corporate governance standards are relevant, the regulator could outline the importance of the social impact of the new rules and link compliance with those rules with the principles of responsible corporate citizenship.

Regulate for the long term: Institutions are concerned about the impact of future changes to client identification and verification requirements on existing customers. If they believe that the requirements will change in the near future, they may attempt to anticipate those changes in their current procedures. This is more likely to happen when the requirements are expensive to meet, or or disruptive to business activities, should they be implemented in an incremental manner.

Address key pressures that may prevent the implementation of simplified customer identification and verification measures Regulators are not necessarily in a position to

counter all the pressures and drivers but may still attempt to shape and guide the compliance response. They could, for instance, compel institutions to implement simplified customer due diligence measures in respect of very low risk customers and transactions, and provide them with regulatory protection should any of the related risks (for example credit risk or reputational risk) eventuate. By means of an appropriate guidance note the regulator can clarify its understanding of reasonable and justifiable AML/CFT controls or other measures. It may assist banks to respond to pressures arising from correspondent relationships and foreign shareholding, by emphasising financial inclusion as corporate social responsibility. In many cases it could point out that financial inclusion products hold no risk for correspondents and that foreign shareholders will support good governance by facilitating financial inclusion measures. It may undertake studies of the fraud risk related to financial inclusion products and ensure that the industry is sufficiently informed about the correct level of risk posed by the relevant products.

Provide certainty about regulator’s approach to compliance and enforcement:

Compliance officers and other stakeholders find it difficult to exercise their discretion if they believe that any error could be visited by regulatory enforcement action. It is therefore important that the regulator clarifies its approach and its views in this regard. A zero tolerance approach will encourage conservative compliance responses.

Cooperate with the industry to increase compliance expertise: Compliance officers with the necessary expertise and understanding of the regulatory framework appear better able to exercise their judgement appropriately than compliance officers lacking expertise. It is therefore important to cooperate with the industry to increase compliance resources and expertise.

Build mutual trust: Risk-based client identification and verification procedures are best shaped in the context of mutual trust. Mutual trust supports communication and will enable parties to jointly identify drivers of over-compliant behaviour and the effective ways to neutralise them. Institutions and compliance officers must therefore act in ways that strengthen the trust that the regulator places in them while the regulator should act in a manner that builds the trust of stakeholders. To this end regulations should be sensible and clear and regulatory action should be predictable, transparent and fair.

1 Introduction

Financial services industry regulators and firms are increasingly sensitive to the potential negative impact of financial regulation on financial inclusion.

The potential impact was recognised in South Africa specifically – though not exclusively – in respect of anti-money laundering (AML) and combating of financing of terror (CFT) controls,¹ which compel financial institutions to identify and verify their customers. If, for example, potential customers are required to present identification documents that a large number of persons do not possess, they will effectively be barred from accessing the services offered by institutions. As a consequence the South African regulator allowed and guided financial institutions to employ pragmatic verification measures in respect of low risk customers. However, institutions did not generally respond uniformly and positively by imposing less requirements on these clients. A number persisted in requiring low risk customers to produce the same documents that they required of higher risk customers. They therefore continued to employ procedures and controls that were more rigid and conservative than actually required by law. This was not done to create barriers that would keep undesirable clients out as there were particular incentives to serve that part of the market.

While these institutions complied with the law, they employed compliance practices that can be classified as “overly conservative”. In the context of environmental compliance such practices are labelled as “over-compliant”. In this study, “overly conservative compliance” and “over-compliance” are used interchangeably. In the case of AML/CFT verification practices the over-compliant response impacted negatively on the regulator’s objective to facilitate financial inclusion innovation and market development.

Against this backdrop, FinMark Trust thought it appropriate to undertake a preliminary investigation of the phenomenon of over-compliant behaviour and especially the drivers thereof in relation to financial inclusion. The research is intended to identify guidance for financial industry stakeholders who might wish to limit this form of response and to identify further areas where research may be needed.

Cenfri, as FinMark Trust theme manager for insurance and retail payment systems, engaged the services of John Symington of Compliance & Risk Resources, South Africa, and Louis de Koker of Deakin University, Australia, to undertake the study.² The study was designed with input from financial services industry stakeholders including regulators and financial institutions. In the course of the study various interviews with compliance and business representatives from various financial institutions were conducted. A workshop with representatives of the institutions and regulators was also held. This paper reflects the general views expressed by the various participants but does not necessarily represent the views of any particular regulator or institution.

The document consists of two parts. Part A introduces key terms that are used in the study and provides background perspectives on compliance and relevant laws. The methodology of the study and its findings are discussed in Part B.

1 See for instance Bester *et al* (2003); Bester *et al* (2004); De Koker (2005); Isern *et al* (2005); De Koker (2006); Chatain *et al* (2008); Chatain *et al* (2011); Bester *et al* (2008); Isern & de Koker (2009).

2 This study that has been undertaken with the contribution and support of numerous contributors, which includes regulators, supervisors as well as compliance officers and business representatives of financial services organisations. Their input and insights have been invaluable.

PART A: Conservative compliance behaviour: The theoretical framework and terminology

2 Terminology

Regulators and supervisors often hold the view that regulated entities will tend to remain non-compliant unless their behaviour is closely supervised and the law is enforced. Where there is effective enforcement entities will tend to comply with the minimum required to avoid sanctions, fines or penalties. However, some institutions will not achieve the minimum level of compliance. These entities may remain non-compliant until this is exposed through supervision and appropriate penalties are imposed. The mountain of evidence of rampant corporate delinquency in certain financial institutions tends to support these views.

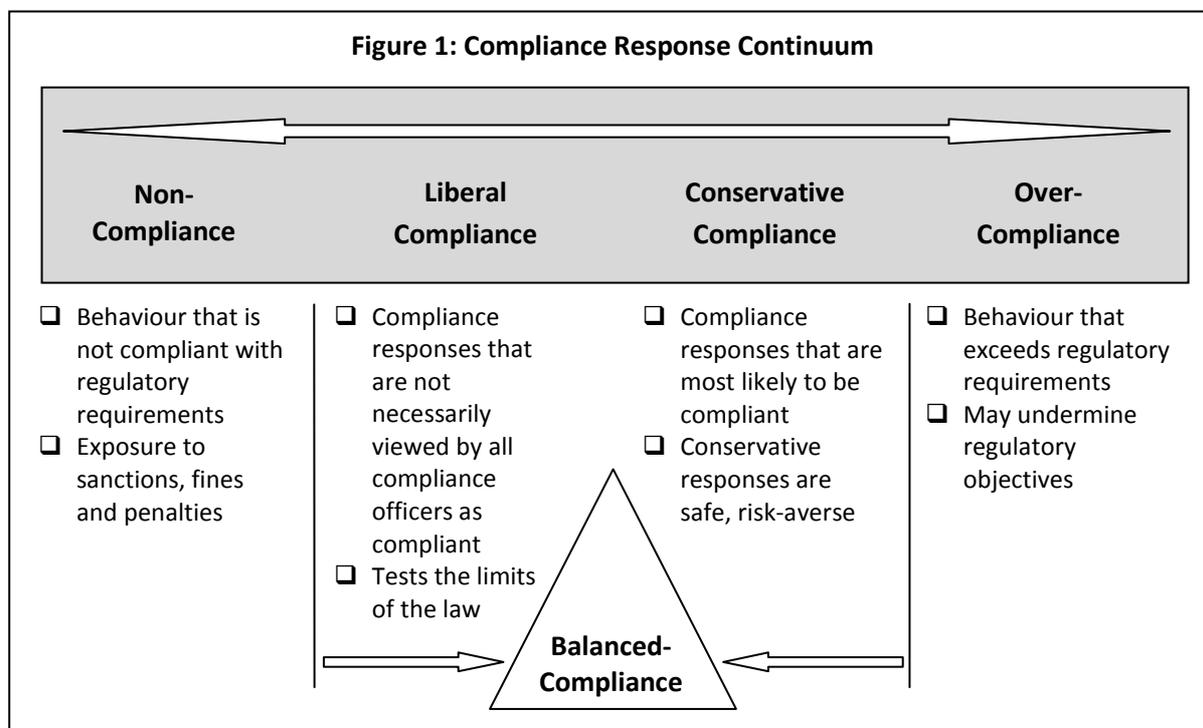
However, counter to the aforementioned, there are examples where entities comply without intervention by supervisors. In these instances they readily embrace the new regulatory requirements that are imposed. They may even have lobbied the regulators and government for the particular set of regulations. This may occur where the particular regulations serve the financial interests of the institution, for example when they create conditions that enables it to maintain or grow its market share, for instance by creating a level regulatory playing field,³ or when it provides the institution with a competitive advantage. This behaviour may also be driven by considerations that are not explicitly financial in nature, for instance when the management team of the institution embraces compliance with the regulation because it corresponds with its governance and ethical views.

In some instances, institutions do not merely comply with the basic requirements of a requirement but go beyond the law or “overcomplies”. It is this behaviour that forms the subject of the study.

3 Institutions may adopt different compliance practices for a variety of reasons. Where regulations are not clear, institutions may respond differently. Those who interpret the law as requiring a conservative response may feel disadvantaged compared to institutions who adopt a liberal approach. An institution may also adopt conservative compliance practices when it forms part of an international group that has a policy requiring its subsidiaries to adhere to the higher of the host or home country regulations. In the absence of host country regulations, the institution may feel itself disadvantaged by having to implement home country procedures that its host country competitors do not need to adopt. Institutions such as these would often lobby the government for clear regulations that would set compliance requirements for the industry and ensure competition on a level regulatory playing field.

2.1 Range of compliance responses

A regulated institution's compliance response can vary from non-compliance to over-compliance. This can be presented as follows:



“Conservative” in this context is used to label compliance responses that are most obviously compliant with the particular requirement while “liberal” refers to responses that may not necessarily be interpreted by all reasonable compliance officers in that industry as compliant. Liberal responses test the limits of the regulatory requirements while conservative responses are safe, risk-averse responses. Over-compliant responses on the other hand are compliance responses that go further than required by the regulatory requirements.

Compliance officers would generally argue that the ideal approach (the “balanced” approach) would lie on the continuum between liberal and conservative responses. Some interviewees indicated that they believed it would lie just to the right of midpoint on that continuum.

Institutions may adopt a predominant compliance response, for instance, those who have a corporate culture that emphasise compliance will tend to display responses that range towards the right of the continuum. However, even such institutions may be non-compliant with aspects of specific laws and regulations, for instance because a relevant regulatory requirement was misinterpreted. The classification of the institutional response may therefore differ from one regulatory requirement to another.

During the interviews it became clear that regulators generally viewed over-compliance in a positive light and was concerned that so little of it was evident. In fact, according to their view, regulated institutions were generally to be found on the left of the compliance continuum. As a result key regulators recently increased their enforcement powers. Institutions, on the other hand, generally viewed themselves as inclining towards the right. The tension between these views of corporate compliance responses was noted, but the

study was designed to focus on clear cases of over-compliance to avoid the impact of purely subjective views.

2.2 Differentiating between non-compliant, compliant and over-compliant responses

While the general distinction between non-compliant, compliant and over-compliant behaviour is relatively clear in theory, it is not always easy to gain consensus regarding the correct classification of a particular response. Differences of opinion often arise when the regulatory requirement is unclear or open to a measure of interpretation. The impact of other regulatory measures, especially so-called “soft law”, must also be considered.

2.3 Regulatory clarity

A lack of consensus regarding the classification of a compliance response can often be attributed to a lack of clarity and precision of the regulatory requirement in question.

It is easier to identify over-compliant behaviour when the regulatory requirement is precise, for instance where it sets a purity level for water or an emissions level to ensure air quality. Manufacturing plants that exceed the allowed emissions levels are non-compliant, while those that remain within the set limits are compliant. Although factual disputes may arise, these types of regulatory requirements are fairly clear and it is generally easy to classify the conduct as either compliant or non-compliant. When an institution’s emissions are well below the stipulated levels, its compliance with that particular regulation could be classified as conservative. When it is significantly below the stipulated levels - and “significance” in this context involves a value judgement - it can be classified as over-compliant.

A similar level of clarity is often elusive in financial services regulation. Given the subject matter and context, many requirements cannot be set with the precision attainable in food, pharmaceutical or environmental regulation. Many financial services requirements, for example, use terms that require a value judgment, for example when words such as “reasonable” or “appropriate” is used.⁴ Disputes may arise when the regulator does not agree with the judgement call made by the institution and therefore does not regard its compliance practice as reasonable or appropriate.

Factual disputes may also arise, even in the context of a requirement that appears fairly clear, for example that a person may not provide financial advice or intermediary services without the appropriate license. Persons may, for instance, deny that their services can be classified as “financial advice” or “intermediary services” or deny that their actions amount to the provision of such advice or services.

If the regulatory requirement is not objectively clear and beyond dispute, regulated institutions may have very different views regarding their obligations and may contest the application of labels of “liberal” or “over-compliant” to their particular response.

2.4 Hard and soft law

In some cases, usually due to a flawed law-making process, two or more requirements may give rise to overlapping or even contradictory compliance obligations. This is a relatively

4 A number of provisions that are relevant to this study, for instance the FICA address verification regulations, use words such as “reasonable” and “practical”. These words introduce a measure of flexibility. Such flexibility was introduced in a few cases to support financial inclusion.

uncommon phenomenon, particularly where both the regulatory requirements in question are “hard law” requirements. Far more common is an overlap between soft law principles and hard law requirements.

“Hard law” refers to binding regulatory requirements while “soft law” refers to non-legislative requirements and principles that are not enforceable by the state.⁵ Soft law includes guidance and interpretations given by the regulator, standards formulated by international or national industry bodies and codes of conduct that may apply to the company or its business. Although soft law is not binding by force of law, it may acquire some quasi-binding effect, especially from a compliance perspective. A company can for instance unilaterally or by agreement commit itself voluntarily to observing a set of soft law requirements. Such requirements may also acquire higher status through social or peer pressure or even indirectly through hard law, for instance where adherence may be considered by a court of law as indicative of reasonable conduct when applying a regulatory provision that requires reasonable behaviour.

The FATF Recommendations, the Basel guidance on Customer Due Diligence,⁶ the King III Code of Corporate Governance and the guidance notes issued by the Financial Intelligence Centre are examples of soft law that are relevant to this study.⁷

Financial supervisors expect financial institutions to comply with hard law and with soft law. This is recognised for instance in the Basel Committee’s 2005 paper *Compliance and the Compliance Function in Banks*:⁸

“3. The expression “compliance risk” is defined in this paper 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 standards”). ...

5. 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.”

Where both soft law and hard law impact on a particular compliance obligation, it is more difficult to classify the nature of the response. The response may for instance exceed the hard law requirement but comply with the soft law requirement. As a consequence, the researchers adopted the approach below to view such compliance responses where necessary from the perspective of each set of requirements.

2.5 The yardstick used for data gathering

Preliminary research showed that compliance officers found it difficult to identify drivers of over-compliant behaviour if questions regarding soft law are introduced too early in the discussion. For purposes of the interviews it was therefore decided to use the hard law as the yardstick to differentiate between non-compliant, compliant and over-compliant

5 Hard and soft law is discussed in greater detail in 7.2 below. These terms are used primarily in international law but the distinction is also relevant to financial regulation.

6 Basel Committee on Banking Supervision (2001).

7 It must further be noted that companies may take different views on soft law that they regard as applicable to them.

8 Basel Committee on Banking Supervision (2005) 7.

compliance responses. However, once examples of over-compliant behaviour were identified, they would be analysed to identify the role, if any, that soft law may have had on that conduct. If soft law required the company to exceed the hard law requirements, the conduct would not be classified as over-compliant in general but specifically as over-compliant with the hard law requirement and compliant with the soft law in question.

The requirements of the hard law and soft law can only be determined through interpretation. In this regard, it was decided to apply the purposive or contextual approach to interpretation of statutes. In the past some courts followed a literal approach to interpretation, focusing on the language in the law to find the intention behind the law. This approach gave rise to tension between the letter of the law (in other words the language of the text) and the spirit of the law (or the objective with and intention behind the law). Current principles of statutory interpretation however lead lawyers to interpret the language of a provision in view of the context of that provision and its purpose. The aim is therefore to view the words that are used in a broader context that reflects the “spirit” of the law. It was decided to apply the contextual approach when differences regarding interpretation of a specific provision were raised.

3 Corporate compliance

As this study focuses on compliance practices in the financial services industry, it is important to provide relevant perspectives regarding the management of compliance practices in financial institutions.

Towards the end of the 20th century most large financial institutions tended to have a compliance function to assist the management of the company and its board of directors to ensure that the company is meeting its regulatory requirements.⁹ Compliance officers play an essential role in this regard. Various standards and practices have been developed to shape and guide the management of corporate compliance obligations.¹⁰ These standards and practices are mirrored in South African principles, standards and guidance developed by the Compliance Institute of South Africa. The development of a more professional approach to corporate compliance management in South Africa also found support in the various corporate governance codes (King I, II and III) that were adopted in South Africa since 1994, especially in the context of professional risk management and good corporate citizenship.

3.1 The role of the compliance officer

The board of directors of a company is responsible for compliance by their institutions. Compliance officers are appointed to assist management and the board to discharge their obligations. These officers generally:¹¹

1. Design and assist in implementing and maintain a compliance risk management framework;
2. Define, maintain and advise on the regulatory universe;
3. Develop, facilitate compilation of and review compliance risk management plans;

⁹ Organisation for Economic Co-operation and Development (2000); Parker (1999).

¹⁰ AS 3806-1998 Compliance programs (revised and issued as AS 3806-2006); Basel Committee on Banking Supervision (2005); International Committee of the International Organization of Securities Commissions (2006). For recent research on the impact of these functions, see Parker & Lehmann Nielsen (2009).

¹¹ These are the tasks identified in terms the compliance practitioner curriculum development process that has been undertaken in South Africa with a view to developing the compliance professionalism framework.

4. Conduct compliance monitoring;
5. Compile and submit internal and external compliance reports; and
6. Interact with industry regulators, supervisors and stakeholders.

In addition, they often assist in designing and offering training regarding compliance obligations and processes, although the main responsibility for training normally resides with other corporate officers.

When performing these duties, a compliance officer assists in fostering a sound corporate compliance culture that engenders an awareness of compliance requirements. Compliance officers support management and the board through the implementation of a compliance process that consists of a number of phases, namely compliance risk identification, risk assessment, risk management, and monitoring.¹²

For purposes of this paper it is important to note that compliance officers are not responsible for corporate compliance. They advise and assist the management of the company who is responsible to ensure that the company complies with all applicable laws. Other corporate officers and consultants may also contribute towards corporate compliance decisions. For instance, if regulatory requirements are not clear, the management of a financial institution may seek the advice of in-house legal counsel and sometimes external legal counsel. In some cases counsel and the compliance officer may not be in agreement. This is often due to the fact that legal advisors may focus primarily on the hard law obligations of the institutions while compliance officers are also sensitive to the impact of relevant soft law requirements and the attitude of the supervisor. Heads of business units may also offer their views. They may be concerned about the potential impact of proposed compliance controls on their units and may hold contrary views regarding appropriate responses. In such cases, the management will consider the different opinions and determine the corporate approach.

This study primarily engaged the views of compliance officers but, in some cases, legal and business representatives who are involved in compliance also participated in interviews. These interviews provided helpful perspectives on the tensions that may arise and the different approaches that these role-players may advise under certain circumstances.

4 Regulatory requirements and financial inclusion in South Africa

4.1 Anti-money laundering (AML) / combating of terrorist financing (CFT)

For purposes of this report a very brief overview of a number of relevant issues relating to AML/CFT and financial inclusion in South Africa will suffice. The objective of this overview is to contextualise examples cited by the interviewees and the participants in the workshop.

South Africa criminalised money laundering in the 1990s. A more comprehensive AML framework was introduced by the Financial Intelligence Centre Act 38 of 2001 (FICA). In 2004 terror financing measures were introduced by the Protection of Constitutional Democracy Against Terrorist and Related Activities Act 33 of 2004. The measures were introduced in part to enable South Africa to meet its obligations in terms of various United Nations conventions and resolutions of the Security Council and also to meet international standards set by the Financial Action Task Force.

As part of the prescribed AML/CFT customer due diligence controls, financial institutions must identify their clients and verify some of their details. The details to be obtained and the means by which they have to be verified are prescribed by the Money Laundering and

12 Compliance Institute of South Africa (2007) Principle 12.

Terrorist Financing Control Regulations. These regulations were issued in 2002 and took effect on 30 June 2003.¹³

In respect of natural persons, the regulations require institutions to obtain the prospective customer's full names, date of birth, identity number and residential address.¹⁴ The regulations also require institutions to obtain the income tax number (if issued) of a customer, but, simultaneously with the release of this requirement, an exemption was issued that exempted institutions from obtaining the tax number.¹⁵ The regulations require institutions to verify customers' names, dates of birth and identity numbers by comparing them to the person's official South African identity document. If the person is, for a reason that is acceptable to the financial institution, unable to produce an identity document, the institution may accept another equivalent document which was issued to that person. Where necessary these particulars must also be compared with information obtained from any other independent source. The residential address must be compared to information that can reasonably be expected to achieve verification of the particulars and can be obtained by reasonably practical means.¹⁶

Institutions implemented different practices relating to these identification and verification requirements. For example, some required their clients' tax information. They regarded the tax exemption as temporary and wanted to avoid the costs and relationship disruption that will follow the lifting of the exemption. The majority of institutions relied on the exemption and did not require tax information. Some requested tax information but made it clear that disclosure was voluntary.

Institutions also followed different practices relating to address verification. There was uncertainty about the types of documents that would meet the twin tests of (a) reasonably achieving verification and (b) being obtainable by reasonably practical means. Some had a long list of potential documents that can be offered to verify an address while others were very prescriptive and only accepted the most secure documents. In 2005 the FIC issued a guidance note for banks, listing a number of documents that would be suitable for address verification purposes.

The National Treasury became increasingly concerned about the lack of access to financial services by the majority of South Africans. It was recognised that the FICA identification and verification requirements may limit access to financial services. South Africans who do not live in formal housing may for instance find it impossible to meet the address verification requirements and may therefore be unable to open a bank account. As a consequence the regulations contained a specific exemption, Exemption 17, that exempts holders of small, low risk accounts from the requirement to provide proof of their residential addresses. Unfortunately this exemption was not extensively used because its conditions were not market-appropriate. Exemption 17 was revised in 2004 to enable the launch of basic banking products, especially the Mzansi account. Nearly 7 million of these accounts have been opened and more than 70% of them by persons who have not held a bank account before.¹⁷ These accounts are, however, subject to various account and transaction restrictions that limit their application to mainly low income persons.

Various supervisory bodies such as the South African Reserve Bank, the Financial Services Board (FSB) and the JSE must supervise compliance with FICA by financial institutions under their supervision. The FIC monitors and gives guidance to these institutions and the supervisory bodies regarding their compliance with FICA and their FICA-related duties. In

13 De Koker (2005).

14 Reg 3(1) of the Money Laundering Control Regulations.

15 Exemption 6(2).

16 See regs 3 and 4 of the Money Laundering Control Regulations.

17 See Bankable Frontier Associates (2010).

the past the FIC did not have direct supervisory powers. This has changed when the Financial Intelligence Centre Amendment Act 24 of 2008 took effect on 1 December 2010. In terms of the new provisions the FIC is the AML/CFT supervisory body of any AML/CFT-regulated entity that is not currently being supervised by a body designated under FICA. It has also acquired the power to intervene and exercise supervisory powers in respect of the currently-supervised entities, under specific circumstances.

The Amendment Act provides for a new administrative penalty system and for higher penalties to be imposed on institutions. It also allows some of the penalties to be imposed on specific persons within those institutions when they are deemed responsible for the compliance failure. Compliance officers are acutely aware of the new penalty system because they regard themselves as likely to be deemed responsible for such compliance failures. Such persons may incur civil penalties of up to R10 million.

In April 2004 the FIC issued a guidance note (*General Guidance Concerning Identification of Clients*) to assist institutions in the interpretation of the identification and verification requirements. It advised institutions to follow a risk-based approach requiring a higher level of verification for higher risk clients. Higher risk clients are clients that would be more likely to engage in money laundering or terrorist financing. Guidance notes do not have the force of law. Although the guidance note was viewed as helpful, institutions were uncertain whether they were allowed to implement a comprehensive risk-based approach. The FATF standards recognise a risk-based approach in terms of which enhanced due diligence measures are implemented in respect of high risk customers and simplified measures in respect of low risk customers. Except for Exemption 17, the guidance note and FICA are silent on simplified measures in respect of low risk customers.

Many participants also made reference to the making of photocopies of identification documentation. Section 22 of FICA requires institutions to keep record of any document or copy of a document obtained by the institution to verify a person's identity. Some institutions interpreted this as a duty to make a photocopy of the documents. This practice received some regulatory support. Other institutions disagreed and allowed details of the documents to be captured without making a copy of it. In July 2009 the Ombudsman for Banking Services and the FIC issued a joint statement that acknowledged that FICA does not clearly state that an institution must make a copy of the document, but that the most prudent and practical manner to comply with this obligation would indeed be to make and keep a copy of such a document. Accordingly, organisations that do not keep copies of documents that are used for client verification purposes may be considered by the FIC to be adopting a "non-compliant" response. From a hard law perspective, however, the making of photocopies will be classified as over-compliant until the FICA requirements are amended to compel the making of such copies.

Over-reporting of suspicious transactions provides a further example of over-compliance in the AML/CFT context. FICA requires certain suspicious transactions to be reported. Institutions engage in "defensive reporting" when they also report transactions that may actually not be reportable. This generally happens when they have difficulty determining whether particular transactions are reportable or not. They then elect to rather over-report than run the risk of penalties for non-reporting. Over-reporting adds to the costs of compliance without proportionally advancing the objectives of suspicious transaction reporting.

The South African AML/CFT framework provides a number of valuable examples of ranges of compliance responses to regulation and regulatory interventions to guide those responses. All financial institutions have to comply with the AML/CFT laws and the key financial supervisors in South Africa must supervise their compliance. As a consequence all

participants in the study were able to relate to AML/CFT examples in the context of compliance and over-compliance.

Customer due diligence processes of course have broader functions than AML/CFT control. For example, client identification and verification is required to combat fraud and support consumer protection. Client data is often also gathered to support marketing of additional products and to support good customer service. In this discussion the focus falls on customer due diligence as an AML/CFT compliance requirement, but it is clear that these additional functions of customer due diligence may impact on the design of the processes that the institution elects to implement.

4.2 Other regulatory requirements

The study focuses on AML/CFT requirements, but during the discussions held in interviews and the workshop, participants also referred to compliance responses to other regulations that can impact on financial inclusion, notably those in relation to the Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS).¹⁸

FAIS was adopted to improve consumer protection by regulating market conduct in relation to a wide range of financial products. It aims to ensure that clients of financial services providers are able to make informed decisions and that their reasonable financial needs regarding financial products are appropriately and suitably satisfied. FAIS regulates institutions and persons selling financial products as well as the communication between the providers of those services and the clients, for instance regarding advice and intermediary services that are provided and disclosure that is required. It sets fit and proper requirements for those who provide financial advice or intermediary services and requires them as well as key persons associated with them (i.e. representatives and key individuals) to register with the FSB.

Many financial institutions grappled with the question whether the services that they and their related parties provide brought them within the ambit of FAIS and require them to register with the FSB. The disclosure of purely factual or administrative information to a prospective client would, for instance, not constitute “advice” for purposes of FAIS. Some institutions that registered as financial services providers and ensured compliance with the Act, subsequently determined that they were actually not required to register. Their response to FAIS can therefore be classified as “over-compliant”.

Compliance with FAIS is costly. It includes steps such as registration with the FSB; ongoing training programs for relevant staff members and agents; document management requirements to evidence compliance; and ongoing compliance monitoring. While the participants did not question the value of the Act, it is evident that certain institutions complied with FAIS even though they were not required by law to do so, thereby incurring expenses that they were not legally compelled to incur. This in turn may limit their capacity to increase financial inclusion. Overly conservative compliance practices would, for instance, unnecessarily raise the transaction costs and could make low value transactions less viable from a commercial perspective.

A range of compliance responses were also evident in relation to the interpretation of “financial advice” and “intermediary services”, especially in respect of certain microinsurance products. The FSB clarified its views on the legal position in a guidance note on intermediary services and representatives, to the effect that mere clerical or administrative acts do not amount to intermediary services. Employees who render such services therefore do not

18 See in this regard, South African National Treasury (2008).

need to be registered as representatives under FAIS. Some retail institutions interpreted this quite liberally by extending it to their standard insurance contracts, for instance goods insurance, that a client could enter into by “simply ticking a box”. They held that as long as their retail staff did not provide any advice or intermediary services as defined, the employees would not need to be registered as representatives under FAIS. This is an instance of liberal compliance. In order to remain within the boundaries of their liberal interpretation of FAIS, they strictly avoid any communication with clients that may constitute intermediary services or advice. Some of these institutions therefore sell some insurance products on a purely passive basis without any verbal disclosures about the product, even though FAIS excludes disclosure of certain factual information about the product from the definition of advice. In some cases, this liberal approach may cross the line and constitute non-compliance, as FAIS requires institutions to provide clients with sufficient information to ensure that they know they are purchasing a financial product when they tick the relevant box and that they understand the essential features of the product.¹⁹

PART B: The study

5 Design, methodology and findings of the study

The study focuses on the behaviour of compliance officers and various compliance stakeholders working within the South African banking industry and in particular probes the reasons why certain banks elected to implement specific compliance policies or procedures that are conservative. The study is exploratory in nature. Its main aim was to identify key drivers of conservative compliance behaviour to prepare the ground for further empirical studies.

Data was gathered by means of convergent interviewing using an unstructured format. Compliance drivers that were identified in earlier interviews, were discussed with later interviewees and either validated or distinguished. To ensure the integrity of the data, those interviewed as well as other compliance practitioners and stakeholders were invited to a initial workshop where the preliminary findings were discussed and the main findings presented in this paper were endorsed. In 2011 the draft report was discussed at a further workshop attended by 69 representatives of financial institutions and supervisory bodies.

Conservative compliance behaviour is sensitive to probe because this type of response is not necessarily welcomed by the business units of institutions. They often press for a more liberal approach as that would tend to increase the market or decrease compliance costs. It was foreseen that compliance officers would be reticent to participate in the study and to share their perspectives if the study focused on policies and procedures that they implemented in their own companies. During interviews and the workshop the participants were therefore asked to reflect on behaviour in the industry in general. Compliance officers often move between the key financial institutions. They also share information in joint committees and other fora. Accordingly, they were therefore able to discuss the practices and the reasons behind the practices of other financial institutions. Interviewees were furthermore assured that their names and the names of their institutions would only be published with their consent.

Given the sensitivity of the subject matter it was important to engage an interviewer who is knowledgeable and experienced in the field of compliance. The interviews were therefore

19 See in general Wessels (2008).

conducted by John Symington who was a compliance officer and is currently a compliance consultant. He was president of the Compliance Institute of South Africa and instrumental in setting certain national compliance standards. Senior compliance officers and regulators were therefore able to relate to him and that assisted in gathering data.

To identify the interviewees, the financial services market was analysed. A range of large, medium-sized and smaller institutions, especially those offering financial inclusion products, were identified. Within each band a number of institutions were approached with requests for interviews. Twenty interviews were conducted during August and September 2009. Eleven of these interviews were conducted in person. Nine had to be done by telephone, generally because the compliance officer concerned was not available for an in-person interview. The interviews ranged between one and two hours in length. Two of the interviews involved more than one representative from an institution.

To further ensure the integrity of the key findings, the interviewees and other experts were invited to participate in a workshop where they were asked to comment on the preliminary findings. Sixteen participants attended the workshop, including Doubell Chamberlain (Cenfri) and John Symington (facilitator). In general, their responses validated the findings and assisted the researchers in highlighting additional variables that may be relevant. The draft report was discussed with individual participants and the findings were presented at an interactive workshop in Sandton on 15 April 2011 that was attended by 69 representatives of and stakeholders in regulators and regulated institutions. Their feedback validated the key findings and also shed further light of some of the drivers of conservative compliance behaviour. The responses led to a number of amendments and refinements to this report.

6 Identified drivers of conservative compliance behaviour

The following general drivers of conservative and over-compliant corporate responses were identified. In many cases more than one of these drivers would be present. The impact of these drivers on a particular corporate response depends however on a number of factors that are discussed in par 7.3 below.

6.1 *An institutional compliance culture can encourage conservative compliance responses*

A compliance culture can be defined as:

“The culture of shared values, beliefs, assumptions and behaviours existing within an organisation that characterises the organisation, especially in relation to compliance obligations”.²⁰

Compliance officers often hold that it is difficult if not impossible to achieve corporate compliance in the absence of a general corporate culture that supports compliance with legal obligations. This culture is often called a “sound compliance culture”. The need for a sound compliance culture is for instance recognised by the *South African Generally Accepted Compliance Practice*.²¹ Corporate governance specialists also support a sound compliance culture as indicative of corporate citizenship.

A number of interviewees identified a sound compliance culture as a driver of conservative compliance behaviour. If the management embraces the need for, and fosters a sound

20 Compliance Institute of South Africa (2007) Definitions.

21 Compliance Institute of South Africa (2007) Principle 12: ‘An appropriate Compliance Culture, including desired ethical behaviour, should be promoted throughout the organisation.’

corporate compliance culture, they often signal that they wish to comply with the spirit and not merely the letter of the law. Within such a context, compliance officers and business units would be reluctant to advise that a liberal compliance approach should be followed where this challenges the spirit of the law.

6.2 A conservative approach to risk in the industry encourages conservative compliance responses

Where the industry approaches risk conservatively, that is often reflected in the compliance culture and responses of individual institutions.

Banking representatives indicated that the nature of their business and the need to protect their institutional reputation often lead to a more conservative compliance approach. As one bank compliance officer stated: “It is right and desirable that banks should be conservative”. A similar approach seems to have informed the decision of some entities to register as financial service providers under FAIS without actually being required to do so by the letter of the law.

6.3 Business management processes may support conservative compliance responses

Business management processes may support conservative compliance responses (1) to ensure a uniformly high level of compliance and (2) to facilitate compliance monitoring.

The management of the institution may be committed to a uniformly high level of compliance, for instance, because they believe that such a response supports good corporate governance and a sound compliance culture (see above) and/or to simplify the management of client risk and corporate compliance obligations.

One interviewee indicated that “blue chip companies do not change their standards for different types of business that they conduct.” In other words, the same compliance processes would apply to products and services that are delivered to customers at the lower end of the market as would apply to the higher and more complex segments of the market. Client take-on procedures, for example, in these institutions tended to be uniform, requiring all clients to provide extensive information and documentation to meet the institutional customer due diligence requirements. That enables the clients to migrate smoothly from simple to more complex financial products. It also facilitates the identification and management of client risk. It does mean, however, that the institution elects not to implement the simplified customer due diligence measures in respect of simpler products and low risk clients but rather requires compliance with the highest compliance standards that it must meet as an institution.

This factor seems to be less relevant in smaller institutions with a lesser need for a uniform compliance approach and in larger institutions that structured their lower end business into separate legal entities, thereby allowing separate governance of that business and its compliance obligations.

Some interviewees also linked the specific instances of conservative responses to business management imperatives. A number of banks, for instance, adopted a standard practice of photocopying client's identification document when FICA customer due diligence was undertaken. This was done years before the regulator indicated that copying such documents is good practice. Banks did so because their compliance divisions have to monitor that staff members were complying with the customer due diligence obligations as well other business imperatives that require verification of client identity, e.g. for fraud prevention purposes. It was decided that monitoring could be best supported by requiring such copies to be made and retained in the clients' files. These files could then be inspected to monitor staff compliance levels. The banks did not prescribe internal rules regarding the

quality of such photocopies because their mere presence in the file rather than the information reflected in the document was of importance.

6.4 When compliance officers lack expertise, compliance practices tend to be conservative

The knowledge and expertise of the compliance officers of an institution has a bearing on its compliance response. If the compliance officers do not have a legal background or adequate access to legal expertise and are insufficiently qualified, skilled and experienced, they may over- or under-interpret the legal obligations of the institution and this will be reflected in their advice to the management of the institution. Where this occurred in the South African financial services industry, it seems as if the response tended to favour a very conservative or over-compliant approach rather than liberal compliance with the relevant law. The support provided by the South African compliance profession appears to assist less experienced compliance officers to understand the basic corporate compliance obligations. This enables them to avoid non-compliant responses but it is not necessarily sufficient to enable them to understand when the line between compliance and over-compliance will be crossed.²²

A number of interviewees indicated that there is a shortage of qualified, skilled and experienced compliance officers. In some instances, participants indicated that compliance officers had relevant qualifications, but did not necessarily have the required skills and experience.

Lack of expertise seems to be an important driver of over-compliance, especially where the regulatory requirement is unclear and there is insufficient guidance, whether from the industry or the regulator, regarding the correct compliance response.

6.5 When foreign compliance requirements apply, local institutions may adopt compliance practices that exceed local requirements

Institutions that are subsidiaries of foreign financial institutions or have important correspondent links with such institutions often design elements of their compliance procedures to meet foreign standards, when those standards are higher than the local standards. This is particularly the case in respect of AML/CFT law.

The international money laundering and terrorist financing control standards (the 49 Recommendations of the Financial Action Task Force) require financial institutions to ensure that their branches and subsidiaries located abroad adhere to these standards to the extent that the local regulatory requirements permit.²³ In addition, the complexity of managing diverse compliance obligations that differ from country to country also drives compliance functions of international financial institutions to standardise compliance controls on a uniformly high level. International banks or financial services providers with an international foot print therefore adopt a compliance approach where all group operations, wherever located, must apply the “higher of home and host country regulatory requirements”. The group head office will typically define the approach to be taken in respect of due diligence. In practice, client take-on procedures tend to be standardised and deviations are only allowed where the local regulatory requirements, especially privacy laws, prohibit certain procedures. The procedures are normally designed to meet the strictest criteria of the key countries where the group operates. Where the group compliance function determines a uniform compliance procedure, local subsidiaries are not in a strong position to simplify the procedures to respond to a local context posing lower ML/TF risks.

Further, where organizations have international business partners, these business partners will typically require that the AML/CFT standards that meet their own compliance

22 Larger organisations often have in-house legal advisers that could assist in clarifying the law.

23 Recommendation 21 of the FATF Forty Recommendations.

requirements must be applied by the local institution.²⁴ Local institutions that find themselves in these business relationships may therefore not be able to utilise the space created by local laws for a simplified approach to low risk products, unless the laws of the country where the parent company or main international business partners are situated, allow similar simplification. In general, this is not the case. As a result, these institutions may tend to adopt overly conservative compliance responses, viewed from the perspective of the local laws and conditions, taking into account the AML/CTF risk relating to the client base in question.

6.6 Foreign compliance examples may guide local institutions to adopt conservative compliance practices

Local institutions often look to international examples when they design compliance responses to new local laws that reflect global financial standards or practices.

Financial laws are converging internationally. Drafters of new financial laws often look to the laws of other countries when producing the draft of new local laws. Local regulated institutions therefore also turn to their international counterparts for advice and guidance when they have to implement compliance procedures in relation to such new laws. For instance, when South Africa adopted its first generation of money laundering control laws in 2001, many South African institutions turned to their United Kingdom counterparts for guidance.

The controls and procedures in some institutions still reflect this guidance and inhibit a more flexible response to the South African regulations.

6.7 Concern about expenditure to upgrade or change compliance processes tend to encourage compliance responses that anticipate future requirements

While the interviews indicated that their managements were committed to reasonable spending on compliance procedures, they were also careful to design systems to limit upgrading costs. Such costs could be occurred when laws changed or where the supervisor disagreed with the company's compliance practice and required changes to be made.

A number of interviewees indicated that this consideration was important when they designed their AML/CFT compliance procedures. The South African government is committed to meeting the FATF's AML/CFT standards. Its current laws are not fully compliant with those standards. Some institutions therefore implemented procedures that comply with the current South African law but will also be compliant with the changes that are anticipated. These procedures therefore go further than the current South African law requires.

Some interviewees indicated that their institutions had to change aspects of their compliance practices to meet the expectations of their supervisors. They believed that their practices were compliant with the law but the supervisor disagreed. The changes, especially those relating to customer identification and verification practices, were expensive. It also questioned the judgment of the compliance officers who implemented the original practices. In view of these experiences compliance officers tend to err on the side of caution and advise their management to follow a conservative approach that anticipate future requirements of the law or their supervisor.

24 This was illustrated by the steps that South African banks took before 2003 to maintain correspondent banking relationships with American and European banks. The foreign banks required the South African banks to implement AML/CFT customer due diligence measures if they wanted to maintain correspondent banking relationships with the foreign banks. Given the importance of these relationships, large South African banks implemented some key customer due diligence measures before required to do so by South African law.

Similar factors are at play in relation to FAIS training obligations. Not all institutions are availing themselves of an exemption from training obligations in relation to simple products, such as micro-insurance products, because they expect training requirements to increase in future and wish to avoid or at least minimise the costs of re-training in relation to those products.

6.8 Corporate processes to manage compliance with discretionary requirements tend to support a conservative compliance response

Some requirements allow discretion to be exercised, for example, to determine the most appropriate AML/CFT address verification requirements for a particular client.

Compliance officers indicated that they are loath to design procedures that would entrust such a discretion to employees. An individual employee may exercise that discretion incorrectly, exposing the institution to regulatory sanctions. It may also give rise to a range of compliance practices, which will in turn complicate the management of compliance processes and customer records. As a consequence, the institutions tend to exercise the discretion and provide employees with rules regarding the handling of clients. These rules need to be clear and simple to avoid confusion and extensive training. They therefore tend to be more limited and rigid than envisaged by the regulatory requirement.

6.9 Concern about penalties and sanctions tend to encourage conservative compliance responses

It came as little surprise that compliance officers indicated that they are sensitive to potential fines, penalties and sanctions that they or their companies may incur.

A number of the interviewees specifically referred to the Financial Intelligence Centre Amendment Act 24 of 2008. This Act provides for increased penalties for AML/CFT non-compliance, including administrative penalties and penalties that can be imposed on individuals who are responsible for the non-compliance. Compliance officers regard themselves as particularly vulnerable to such personal fines should their companies be held non-compliant. They therefore tend to err on the side of caution when interpreting provisions that are not clear.²⁵

6.10 The desire to maintain a good relationship with regulators and supervisors tend to encourage conservative compliance responses

In some cases compliance officers would advise a conservative approach to preserve a good relationship with regulators and supervisors.

Interviewees emphasised the importance of a good relationship between compliance officers, regulators and supervisors. A good relationship may assist the institution to access informal supervisory guidance. Experience has also shown supervisors are likely to be more lenient when institutions that have a good relationship with it are found to be non-compliant. In cases of legal uncertainty, especially where the regulator or supervisor indicated that they prefer a conservative compliance response, compliance officers will tend to advise their institutions to implement a conservative approach to maintain a good relationship with that supervisor.

Interviewees also cited examples where the senior management of large financial institutions and the supervisor reached agreement on implementing specific control measures even though the institutions were not legally compelled to adopt those measures. Senior management therefore appear sensitive to retaining the goodwill of a powerful supervisor.

25 For example, a workshop participant stated that “compliance officers are conservative because they can’t afford to get things wrong”.

6.11 A belief that the supervisor is intolerant of compliance errors tends to result in conservative compliance practices

If compliance officers believe that regulators are intolerant of errors they tend to react more conservatively.

An interviewee for instance asked: “Is there any margin of error that is acceptable?” The Financial Services Authority (FSA) in the United Kingdom took the position that a zero tolerance approach will not be conducive to a risk-based compliance approach in the context of AML/CFT. Risk assessment will not always be perfect and the FSA therefore allows a margin of error provided that institutions acted reasonably and can justify their actions. South African institutions are, however, not sure what the approach of South African regulators is. Interviewees raised this as a particular concern in view of the higher penalties and fines envisaged under the Financial Intelligence Centre Amendment Act of 2008. Until the position is clarified, compliance officers appear to assume that regulators are intolerant of all errors and advise their institutions accordingly.

6.12 When the law is uncertain, compliance officers tend to advise that conservative compliance practices should be adopted

Legal uncertainty refers to a lack of clarity regarding the requirements of a particular regulatory provision.²⁶

When the regulation is unclear, compliance officers are concerned that measures that they implement may not meet the requirements of the law. They then tend to design procedures and systems that would meet the different interpretations that the regulator and the courts may give to that particular obligation. As a consequence, the compliance response may actually go beyond a reasonable interpretation of the law. This tendency to overdesign is exacerbated when the provision is accompanied by heavy penalties and regulatory enforcement action.

Compliance officers give particular attention to the interpretation that the supervisory bodies give to the law. The interviewees welcomed formal public guidance on the interpretation of particular provisions, especially when the supervisor applied formal rules of statutory interpretation when interpreting a particular provision. If the guidance is not based on the rules of interpretation, institutions are torn between the guidance, the regulatory text and the interpretation by their legal counsel (whether internal or external). The uncertainty will tend to result in a conservative approach even where such guidance may advise a more liberal approach.

Legal uncertainty and fines, penalties and enforcement action seem to reinforce one another as drivers: if the law is unclear but the regulator threatens heavy enforcement action, compliance officers would tend to advise a conservative and cautious approach. Even though the institutions may feel that they have good legal grounds for a defence against enforcement action, they may decide to adopt a conservative approach to avoid conflict with the supervisor. South African institutions are highly reluctant to take legal action against supervisory bodies and will rather adopt conservative responses than litigate against a supervisor.

26 Lack of legal clarity may be due to factors such as the wording of the regulatory provision and confusing or contradictory interpretations by the supervisory body or other relevant parties. In the FAIS context the FSB has for example disagreed publicly with some of the interpretations handed down in rulings by the FAIS Ombud. See in general Wessels (2008).

6.13 *Appropriate management of other risks and opportunities may dictate a more conservative approach*

A compliance officer may advise the institution to implement a conservative or even overly conservative approach where an alternative approach may expose the institution to risks that may not be directly related to the regulatory requirement in question.

For example, compliance officers indicated that they were unwilling to advise their institutions to simplify client identification and verification requirements, because it may increase exposure to criminal abuse. South African institutions are sustaining significant losses as a result of fraud. Identity theft and identify fraud are of particular concern. Civil liability is also of concern, for example where third parties sustain losses as a result of fraudulent accounts that were opened negligently by a bank. Even where an institution is allowed to implement simplified customer due diligence measures, it may not therefore elect not to do so where it may dilute its anti-fraud controls.

The institutional response may also be conservative where such a response serves its broader business interests. Customer due diligence processes are not only designed to serve AML/CFT or anti-fraud purposes. The institution may wish to use the processes to gather sufficient customer data to enable it to better serve the needs of individual customers or to target its marketing efforts. In some cases institutions may gather information that will assist its credit-scoring of the customer. This is done even if the product is not a credit product where the institution wishes to market credit products to its customer base in future. Reasons such as these may inform an institution's decision to adopt customer due diligence measures that exceed the regulatory requirements.

6.14 *Business information systems may dictate a more conservative approach*

Institutions with a large client base and a high volume of transactions rely on expensive business information systems to record, store and retrieve data that is required for client due diligence purposes. These systems tend to be structured in a fairly rigid way to ensure consistency. They are also designed to meet various regulatory requirements as well as business needs. Changes to these systems are often expensive and can take years to be implemented in full. A business that may wish to implement a flexible compliance approach, that recognises different levels of due diligence for different levels of AML/CTF risk, may be prevented from doing so by the current architecture of its business information system. The costs of changing a business system may therefore dictate a more rigid and conservative response.

7 General perspectives on the findings

7.1 Caveats

This limited study identified a number of key drivers of compliance behaviour. The list is, however, not necessarily exhaustive. Further research is required to determine a more comprehensive list. It is also important to note that the data collected during the study may be influenced by the relatively small number of participants and by the fact that most of the compliance officers that were interviewed are members of the Compliance Institute of South Africa. Members of the Institute must meet high standards of knowledge and integrity. They also tend to be knowledgeable about the key regulatory requirements and enjoy access to the compliance support materials of the Institute. This may influence their views and the way in which they communicate their views.

It is submitted that two drivers of compliance behaviour, in particular, require further research and a broader participation to draw more representative conclusions:

- (1) The impact on compliance behaviour when compliance officers lack expertise. The interviewees indicated that compliance practices will tend to be conservative when compliance officers lack expertise. The picture might be different if the research base is broadened; and
- (2) The impact on compliance behaviour when the regulatory requirements are uncertain. Members of the Compliance Institute of South Africa tend to advise that conservative compliance practices should be adopted under these circumstances. Non-members may not hold the same view.

It seems reasonable to expect that a more comprehensive study that includes interviews of compliance officers outside of the professional compliance environment may lead to an amendment or refinement of these findings.

7.2 Hard law and soft law

A number of the drivers appear directly or indirectly linked to the impact of soft law.

Relevant soft law for purposes of this study includes the King III Code on Corporate Governance and its two predecessors (King I and King II), guidance notes issued by the FIC, the FATF Recommendations, the Basel Core Principles for Effective Banking Supervision and the Wolfsberg Global Anti-Money Laundering Guidelines for Private Banks, as well as FAIS guidance issued by the FSB.

Although soft law requirements are not binding by force of public law, a particular set may acquire some binding impact through agreement or even unilateral submission to a set of soft law requirements, for instance a voluntary submission to compliance with a national corporate governance code. In some cases, the regulators, supervisors or other stakeholders, such as industry peers, influence such decisions. The FIC, for example, issued a non-binding guidance note for banks (Guidance Note 3).²⁷ In the guidance note it advises banks that in interpreting and applying the legislation relating to customer due diligence, international best practice should serve as a reference to clarify what is expected of the banking industry. It proceeds to state that it is fundamental to market integrity and financial stability that international standards set out in the FATF Recommendations, the Basel principles and the Wolfsberg guidelines be adopted by the banking industry as an extra prudential measure when South African legislation does not adequately address a specific issue. It also advises that supervisory bodies should be enforcing the implementation of best practices in the industries that they supervise. Although the FATF Recommendations, the Basel principles and the Wolfsberg guidelines do not have the force of law, this type of guidance note signals to the banks that they are expected to consider them and even be guided by them under certain circumstances and that some regulatory consequences may follow if they fail to do so.

The impact of the different sets of soft law may differ. Corporate governance codes for instance emphasise the importance of good corporate citizenship and compliance, the value of a corporate reputation and the role of appropriate risk management. These codes impact on the corporate culture and the way in which companies interpret their legal obligations. The King III report for instance holds that “exceptions permitted in law that present an opportunity for abuse which is contrary to the spirit, intent and purpose of the law, as well as proposed changes expected in legislation and regulation, should be handled in an ethical

27 Financial Intelligence Centre (2005) par 24.

and responsible manner”.²⁸ Statements such as these caution a company against a too literal and narrow interpretation of their hard law obligations.

Drivers such as those relating to an institutional compliance culture, a conservative approach to risk in the industry, the impact of foreign compliance examples, the management of discretionary requirements, compliance responses to uncertain requirements, and appropriate management of other risks (see par 6 above) can all in some part be linked to the desire to be – or at least to be perceived as - a good corporate citizen that complies with good governance standards.

The relevance of corporate governance principles was also evident from the comments by some compliance officers who viewed a conservative response as the correct and appropriate response by an institution that subscribes to high standards of good corporate governance, business ethics and social responsibility. DeHart-Davis and Bozeman addressed a similar question in the context of environmental law as follows:²⁹

“The very notion of overcompliance may well strike some as bizarre. One might ask, Just how is it possible to overcomply with environmental regulations? Since reducing pollution is in the public interest, a company that chooses to exceed environmental requirements is perhaps best viewed as a good corporate citizen rather than as an overcomplying and, at least by implication, inefficient firm. While this point certainly has some merit, the issue is generally more complicated. In some instances (including the policy we examine here), exceeding environmental regulatory requirements does not necessarily have a direct effect on pollution abatement. Furthermore, if companies overcomply there is always the possibility that the excess resources could have been put to better use, either by the company itself or for some alternative pollution abatement activity (e.g., purchasing pollution control equipment).”

In the context of financial regulation, over-compliance may not only amount to a less efficient application of business resources but may actually undermine some regulatory objectives, such as financial inclusion.³⁰ A generally conservative approach to compliance obligations may therefore reflect a responsible attitude to legal obligations, but each individual response and its impact must be considered to determine whether the particular response meets the standards of good corporate citizenship.

Soft law requirements that guide or set standards for national legislation are also relevant to compliance decisions. It is submitted that the impact of the FATF Recommendations can be linked, at least in part, to a driver such as anticipated future requirements (see par 6.7 above). The Recommendations embody standards that South African law will need to reflect in future. Good corporate governance standards require companies to manage their legal risks and to prevent wasting resources on complying with current requirements only where the compliance procedures can be designed to meet foreseeable obligations in a cost-effective manner too. The impact of such soft law requirements can be amplified by the hard law requirements themselves. The FATF Recommendations are, in some respects, very ambitious but are described as “minimum standards” that countries must meet.³¹ This signals to countries and financial institutions that compliance with the Recommendations is

28 Institute of Directors in Southern Africa (2009) 89.

29 DeHart-Davis & Bozeman (2001).

30 See also Haines & Gurney (2003).

31 FATF (2003) Introduction: “The FATF recognises that countries have diverse legal and financial systems and so all cannot take identical measures to achieve the common objective, especially over matters of detail. The Recommendations therefore set minimum standards for action for countries to implement the detail according to their particular circumstances and constitutional frameworks.” “Minimum” appears several times in the text of various Recommendations too.

good but that they are encouraged to exceed the mere minimum set out in the Recommendations.

While soft law and hard law requirements give rise to compliance obligations, there are important differences between the two types of requirements and their impact in practice on companies. Hard law is often clearer and it is easier to determine the relevant obligations. Soft law on the other hand is often aspirational and cast in broader language. It is therefore more open to interpretation. Soft law comes in many different forms and it may be very difficult to agree on which of the many sets of soft law requirements apply to the company. Some companies may focus primarily on domestic soft law instruments. Those that operate internationally may be more sensitive to international soft law or to a regional set of requirements for instance European or North American requirements. Companies also hold different views on soft law obligations. Ethical managements pay greater attention to these requirements than less scrupulous managements and even ethical managements may regard compliance with their soft law obligations as less pressing when the company finds itself under financial pressure. The participants also indicated different opinions in compliance teams where officers with a legal background were often more focused on hard law obligations than counterparts with a non-law background, especially where there was evidence of tension between the hard law and the soft law requirements or where the soft law requirements were particularly onerous and not backed by hard law requirements.

In some cases the difference between soft and hard law is somewhat blurred and different degrees of “softness” or “hardness” of soft law are evident. The incorporation of corporate governance principles and the King codes into the JSE Listing Rules and the Banks Act framework or even into commercial contracts makes it more difficult to classify the principles as mere soft law. The fact that the contextual or purposive approach to interpretation of statutes include consideration of the purpose and context of a hard law requirement, also impacts on this distinction, especially where the purposes are spelled out in soft law such as non-binding guidance. In certain cases the courts may refer to soft law codes to determine whether a company acted reasonably or not in the discharge of its hard law obligation. In such cases the non-binding soft law requirement becomes very closely intertwined with the hard law requirement.

Although the functioning of soft law requirements is complex, it is vital to consider these requirements in any discussion of over-compliance. These requirements create additional and sometimes broader compliance expectations that must be factored into a balanced analysis. A strict legal approach may identify a particular response as over-compliant when it exceeds the requirements of a binding regulatory requirement. However, that response may have been induced by soft law requirements that a company ignores at its peril. From a regulatory perspective it is important to identify the impact of both sets of requirements on the company’s compliance response. It is submitted that this can best be achieved by a more objective and balanced perspective that recognises both hard law obligations and soft law requirements and classifies the compliance response to each individually.

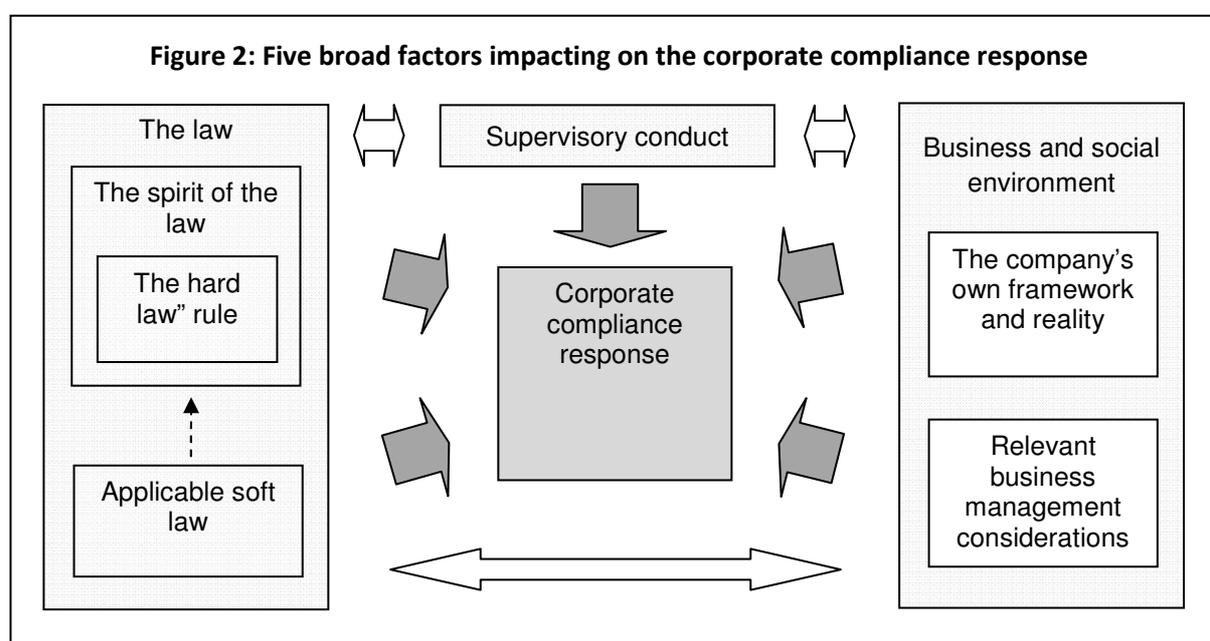
Such an approach would enable a response to be classified as compliant with the hard law duty but non-compliant with a soft law requirement (for instance compliance with a national AML/CFT obligations where the national law does not meet the FATF standards) or over-compliant with a hard law duty but compliant with the relevant soft law requirement (for example adopting customer due diligence measures that exceed national requirements but meet the Basel customer due diligence guidance).

The objective of such an approach would not be to elevate the legal standing of soft law requirements. It merely acknowledges their impact in practice and affords policymakers and compliance officers a tool to differentiate between their responses to hard law obligations and soft law requirements.

7.3 Key factors impacting on over-compliance

Over-compliant behaviour is clearly complex and although a range of drivers can be identified, more research is required to understand them fully and to construct a model that could anticipate their impact on a particular company. The corporate response to a regulatory requirement and to the identified drivers is often the result of a number of factors, many of which are directly or indirectly inter-related. The following five broad factors emerge from the preliminary findings (see Figure 2):

- a) The hard law requirement;
- b) Applicable soft law;
- c) Supervisory interventions;
- d) Relevant business management considerations; and
- e) The company's own framework and reality.



- (a) A specific compliance response, as defined for purposes of this study, is primarily a response to a particular **hard law** obligation. The obligations set by a hard law provision are determined through interpretation. The interpretation is influenced by the clarity of the text and clarity regarding the purpose of, and objective, with the requirement. The intention with and behind a requirement (i.e. its purpose and objective) is often called the “spirit of the law” in contrast with, and generally broader than, the mere “letter” or the wording of the law. The spirit of the law and the interpretation of the hard law can be impacted by soft law requirements, such as corporate governance standards. Closely linked to the hard law obligation are the potential legal consequences (penalties) in case of a breach or contravention.
- (b) The compliance response is also influenced by, or responsive to, applicable **soft law** requirements, for example:
 - Corporate governance codes guide companies to act ethically, to manage their compliance obligations and to guard against the risk of non-compliance. These principles guide and shape corporate compliance culture and impact on a

company's interpretation of its hard law compliance obligations. Corporate governance principles and relevant business management considerations also influence one another.

- Some soft law principles (and the “spirit” of the principles) are viewed as precursors of future development of hard law. In those cases they may guide a company to design its compliance response in a manner that anticipates and meets more onerous future hard law obligations. This is especially the case where governments submit to compliance with the particular soft law requirements, as is the case in respect of the FATF Recommendations.
- In some cases, a soft law requirement may elicit a compliance response in its own right, although that response is not enforceable by the state. This is often the case where the company submits voluntarily to compliance or where its peer group or industry accepts the soft law as relevant and monitors compliance.

(c) **Supervisory conduct** also impacts on the compliance response. Conduct includes actions or interventions as well as omissions. Interventions may be formal, such as guidance notes, inspections, inspection reports and enforcement action, whether in relation to that institutions or any of its peers, or informal, such as comments by a senior supervisor at an industry meeting. The interventions may or may not be backed by hard law, for instance where the supervisor announces its support for a set of soft law requirements and indicates that it will seek actively to amend relevant laws to ensure that compliance with those requirements become compulsory. In that case the mere announcement tends to elevate the status and impact of the set of soft law requirements, even though the necessary legislation has not been adopted. In some cases supervisory omissions are also relevant, for instance where the hard law is unclear but the supervisor declines to clarify its interpretation and its compliance requirements. Where the requirement is backed by onerous penalties, regulated institutions may adopt a conservative compliance response to avoid possible liability.³²

The supervisor's conduct will interact with the other relevant factors. It impacts on the interpretation and development of the law as well as on the business and social environment, while the supervisor, as a creature of law, is of course influenced by the law.

- (d) The compliance response is furthermore influenced by relevant **business management principles** (normal rules of commercial sustainability), such as the need to manage the business in a cost-effective manner and to manage its risks appropriately to ensure the sustainability of the business. Sustainability in this context includes being viewed as compliant with industry standards, avoiding crippling penalties and meeting the approval of the supervisor. This factor in turn influences, and is influenced by, soft law requirements such as corporate governance codes.
- (e) The **company's own framework and reality** also impacts on the compliance response. This includes its management's views on compliance, the company's compliance culture in general and its concern regarding the implications of non-compliance with the particular hard law requirement, for instance regarding the severity of the penalties that may be incurred and the probability that enforcement action may follow. This factor also includes the legal and compliance expertise at the company's disposal, its subjective interpretation of the hard law requirement (especially when the text thereof is flawed or too limited), its financial position, its ability to meet compliance-related expenses and its

32 In this manner the supervisor allows a shadow to form around the rule, thereby increasing its footprint. See 7.4.

views of, and relationship with, the regulator and supervisor. If the company is a subsidiary of an international group, it may be required to adhere to a uniform group policy. Its internal business organisation may be complex and it may be required to implement uniformly exacting compliance procedures to facilitate group-wide compliance management. It may be compelled to respond to counterparty requirements, for instance where international business counterparts require domestic companies to apply procedures that meet foreign standards. It also includes the company's perspectives on the broader purposes of the processes that it adopts to comply with specific requirements. Customer due diligence measures may, for example, be required to protect the business against fraud or may be viewed as supporting the company's marketing and customer service strategy. Some of these factors in turn are influenced by other hard law obligations (for example general corporate law and business law principles), by supervisory conduct as well as soft law requirements (especially corporate governance principles). Others, for instance marketing, are linked to the company's business opportunities and strategies and can also be closely intertwined with the relevant business management principles.

In this scheme, the particular hard law requirement often plays a leading role because it sets the enforceable requirements. The other factors can strengthen or drive a conservative response to that requirement. (They can also undermine its impact and lead to non-compliance, but that is not the main focus of this paper). Regulatory clarity, for example, tends to prevent over-compliant responses. This is, however, not necessarily the case, for instance where the local AML/CFT requirement, though clear, does not comply with the FATF standards. In this case some companies may anticipate an appropriate amendment to the South African law and elect to implement a procedure that complies with both the current South African legal obligation and the FATF standard. That type of responses will tend to be over-compliant when viewed solely from a South African hard law perspective, while being balanced from a broader FATF (soft law) perspective. It is, however, also important to recognise that a compliance response may be embedded in a broader corporate response that is driven by business considerations such as risk management or specific business opportunities. This would be the case, for example, where a company's customer due diligence measures were designed to meet a number of business objectives, only one which may be compliance with specific regulatory requirements.

The precise factors at play and the interplay between the different drivers will need to be analysed further before any firm model can emerge.

7.4 Over-compliance and financial inclusion

During discussions various perspectives regarding over-compliance and measures to promote financial inclusion were raised.

Some participants commented on the use of 'flexible' open-ended regulation that allows firms to exercise their discretion. This type of requirement is fairly common in a risk-based context where companies are required to assess the risks posed by various client types and products and to employ reasonable measures to control those risks. The participants indicated such regulation may result in conservative responses, especially by larger financial institutions, if it is not accompanied by sufficient regulatory guidance to enable them to assess the risks and determine the appropriate controls³³ or where it is accompanied by strict and harsh enforcement measures.³⁴ When certainty is absent and/or consequences of

33 See 6.12.

34 See 6.9.

non-compliance are grave, compliance responses will tend to be rigid and conservative. This may undermine the policy objectives that underlie the flexible approach.

When applied in respect of the model above, a regulator that employs flexible regulation accompanied by regulatory guidance and a reasonable enforcement policy will increase the clarity of hard law requirement while decreasing the potential of the company's own framework or relevant business considerations to steer the company towards an overly conservative compliance response.

Participants further argued that the regulator should support a more facilitative approach to financial inclusion by guiding the industry to adopt market development and inclusion as an industry objective. In the context of the model above, a regulator that adopts a policy in this regard strengthens the positive impact of pro-inclusion soft law on the interpretation of the relevant hard law requirements, on the business and social environment in general and, in particular, on the views regarding a company's corporate citizenship. This impact increases the potential for a balanced, pro-inclusion compliance response.

Many participants cautioned against an adoption of flexible and risk-based principles unless it is clear that the regulator and the industry are sufficiently mature and sufficiently resourced to ensure appropriate supervisory and compliance responses. Where regulatory, supervisory and compliance skills are limited, and the regulation and its enforcement is not appropriately adjusted to ensure the desired consequences, the compliance responses will most probably not be balanced.

7.5 Over-compliance with environmental laws

It is interesting to compare the findings of this study with drivers of over-compliance that were identified in the context of environmental law and standards.

Since the 1980s a body of research developed in respect of compliance responses to environmental regulations and standards. The research attempts, mostly by means of economic models, to explain why companies would willingly comply with non-binding standards to lessen their negative environmental impact or would willingly exceed binding targets, for instance in relation to emissions. A number of the studies identify a range of reasons for over-compliance with particular regulations.³⁵ DeHart-Davis and Bozeman,³⁶ for instance, identified factors external to a company such as intra-industry agreements and voluntary programs devised by regulators that may encourage companies to exceed the binding targets. They also list a number of factors that may provide an internal trigger for over-compliance. A company may, for instance, decide to over-comply:

- to enhance its reputation, especially where green consumers are likely to react positively to environmentally-responsible conduct³⁷ or where unhappy communities may trigger stricter regulation;³⁸

35 For overview of literature on the key theories, see Wu & Wirkkala (2009); Shimshack & Ward (2008); Gunningham, Kagan & Thornton (2004); Gangadharan (2006); Arora & Gangopadhyay (1995).

36 DeHart-Davis & Bozeman (2001).

37 For a study on credence goods and marketing, see Engel (1998).

38 Gunningham, Kagan & Thornton (2004) investigated the relationship between the social pressures (the "social license" under which corporations function), the economic realities they face (their "economic license") and the phenomenon of over-compliance in the pulp and paper industry. The industry is very sensitive about its reputation as a social backlash can trigger more costly regulation and even consumer boycotts. They found that individual companies in the industry would overcomply with requirements to limit emissions and visual impact to maintain good relationships with the communities in which they operated, even if the extent to which they are able to overcomply may be constrained by economic considerations.

- to avert regulatory pressure, closer supervision and stricter regulation in future or, counter-intuitively, to trigger stricter regulation. (In the latter case a company overcomplies to show the regulator that tighter controls should be imposed. This could be a motivating factor where the imposition of the new regulations will not affect the company negatively but will raise the costs of the company's rivals.)³⁹; or
- to increase its production efficiency. (Lower emissions may also be a consequence of employing more efficient production processes).

Wu and Wirkkala identified further factors at play when they studied compliance with environmental laws in Oregon. They found that diverse factors were relevant, including market forces, regulatory pressure and the personal values and beliefs of senior managers regarding environmental stewardship.⁴⁰ Regulatory pressure and especially enforcement action was also identified by Shimshack and Ward as a driver of over-compliance. Although over-compliance will not attract enforcement action, they found that many plants with emissions typically below the legally permitted level reduced their emissions even further after regulators issued fines on other non-compliant plants.⁴¹

Although there are some clear industry differences between drivers of over-compliance in manufacturing firms that are subject to environmental regulations and financial services companies in respect of AML/CFT laws, there are a few similarities, for instance,

- Concern about their corporate reputation, both within the community in which they function and in respect of their regulator;
- The impact of the values of and beliefs of their senior management regarding corporate responsibility and citizenship;
- Market forces, which in the case of manufacturing companies would mostly be driven by green consumers whereas conservative business counterparts would be driving compliance behaviour in financial services; and
- Regulatory pressure and enforcement action that would not only tend to steer non-compliant firms towards compliant behaviour but can also guide compliant firms to become even more conservative.

7.6 Regulators and over-compliance

Regulators are often favourably disposed to over-compliant behaviour. It tends to signal to them that a corporation has a sound compliance culture and is serious about meeting its compliance obligations.

Haines and Gurney argue that regulators actually use legal uncertainty in certain cases to push regulated institutions towards over-compliance.⁴² According to their argument uncertain rules accompanied by harsh penalties provide corporations with a strong incentive to go beyond compliance with the rule itself to ensure that it is free from liability.⁴³ An unclear but important legal requirement can be interpreted in a number of ways and a company that fears enforcement, may wish to ensure that it complies with all of the reasonable interpretations of that law. That increases the footprint of the rule or, as they describe it, leads to the rule having a "shadow" that is larger than the rule itself. According to Haines and

39 Denicoló (2008).

40 Wu & Wirkkala (2009).

41 Shimshack & Ward (2008).

42 Haines & Gurney (2003).

43 Gunningham & Johnstone (1999) 34-35 notes that an important benefit of more flexible, less prescriptive models of regulation is that they encourage the organization to do more than merely meet its strict legal requirements.

Gurney “shadowing” pushing regulatees to over-comply, is not necessarily an accidental side effect. Regulatory models are often designed to encourage companies to over-comply, for instance by recognising general over-compliance by the regulatee as an indication of good faith and a mitigating factor if a breach of a particular requirement occurred (see also par 6.10 above).

However, regulatory uncertainty is, at least theoretically, a double-edged sword in the hand of the regulator. Calfee and Craswell explored the relationship between uncertain legal standards and compliance.⁴⁴ From an economic perspective there should be sufficient incentive for exact compliance with a legal requirement if the requirement is clear, the penalty for a breach is sufficiently large and the probability of its enforcement is sufficiently high. Legal uncertainty on the other hand introduces two opposing effects. According to Calfee and Craswell it creates a positive chance that someone who breaches the requirement will not be punished, thereby spurring non-compliance. However, if the penalties are large, uncertain actors may wish to reduce the probability of punishment by “playing it safe” and modifying their behaviour by more than the law requires.⁴⁵

Not all regulated institutions will therefore react to unclear regulation by overcomplying. Some may actually identify an opportunity avoid compliance and to challenge the legal validity of any enforcement action that may be attempted.⁴⁶ Given these uncertainties and the basic legal requirement that the law should be clear and understood by those who are required to comply with it, it is submitted that regularity uncertainty should be avoided where possible.

In the context of this study the regulators are, however, concerned about the impact of over-compliance. During the course of the interviews and workshop various suggestions were formulated regarding steps that a regulator can take to prevent over-compliance, where this behaviour is regarded as counterproductive. These ideas are summarised below.

8 Preventing overly compliant responses

Where compliance responses to various regulatory requirements may be overly conservative and negatively impact on development and inclusion objectives, it is important to consider ways to prevent such a result.

In view of the findings of this study a number of guidelines were identified. These are provided especially for consideration by regulators who are currently designing and implementing AML/CFT identification and verification frameworks in various developing countries, but the underlying principles are also of broader application:

Consult with regulated institutions when drafting new laws to ascertain potential compliance responses: The introduction of new regulatory requirements may have

44 Craswell & Calfee (1986). See also Stevenson (2004). Uncertainty is also a relevant factor in relation to some environmental laws. See DeHart-Davis & Bozeman (2001).

45 Ferguson & Peters (2000) explored the impact of uncertainty of a rule on the cost benefit analysis of would-be avoiders of the rule. Vague rules are defined, making it more difficult to define clear loopholes. It also means that a greater emphasis is placed on the spirit of the law relative to the letter of the law. However, this outcome should be viewed in context. They summarise the key point as follows in their abstract: “A vague rule reduces entrepreneurs' ability to erode the rule through loopholes by making it more difficult to predict what actions will be permitted ex post. However, because a vague rule creates uncertainty about which activities are prohibited and which ones are not, it causes a chilling effect on economic activity and introduces inefficiency into the legal system.”

46 The reaction of some institutions to FAIS in relation to standard tick-box-type insurance agreements in the micro-insurance space can be regarded as an example of this phenomenon. See the discussion in 4.2 above.

unintended consequences. A regulator that understands the most significant factors that may impact on corporate compliance decisions is in a strong position to manage and guide compliance responses. Valuable though the consultation will be, it also has its limits and challenges. Companies may provide a broad range of responses because different factors may be at play in different companies. Furthermore, the responses may be limited because companies tend to rely on past experiences and current knowledge that may or may not be totally apposite to the proposed new law. It was found for example that banks initially struggled to provide meaningful feedback relating to the potential impact of proposed customer due diligence requirements on financial inclusion. Banks understood their markets and existing products and clients well, but inclusion is about new products, clients and market categories not served in the past.

Effective consultation requires active participation by the regulated institutions in discussions during the drafting stage of the law. During interviews of representatives of the regulators a number of examples were mentioned where the business community remained disengaged until the legislation took effect.

Consultation that is undertaken in a manner that recognises the strengths and the weaknesses of the consultation process will assist in addressing development imperatives.

Address policy and policy conflicts expressly: A regulator that wishes to advance financial inclusion should adopt a clear policy in that regard. The policy document should emphasise the social and economic developmental objectives of financial inclusion and should address the interplay and possible conflict between the inclusion policy and other policies, for instance law and order and consumer protection. Policy conflict should be resolved at government level to ensure that they do not create uncertainty at an institutional compliance level. Policy statements will assist in clarifying the spirit of the law, which will also assist in interpretation of compliance obligations, especially from a corporate governance perspective.

Clarify legal obligations: Regulatory objectives can best be met by clear regulatory requirements. The main regulatory instrument, whether it is an act or a regulation, should be clear. Where appropriate, the framework should allow for flexibility to recognise that different environments may require different approaches.

Allow adequate time for the implementation of regulatory requirements: Where regulatory requirements are brought into effect before organisations are ready to comply with them, organisations may respond with compliance behaviour that does not support the objectives of the regulatory requirements. Regulators expressed frustration with regulated entities that leave compliance “to the last minute” while business representatives often blamed a slow response on a lack of clarity. This issue can be managed through appropriate industry communication and timely regulatory and supervisory intervention.

Identify and manage interaction between hard and soft law requirements: A regulatory intervention may not be completely successful when contradictory or broader soft law principles apply. A more relaxed statutory regime may for example be undermined by more stringent soft law standards. It is important to identify applicable soft law requirements, including those issued by the regulator, and to consider ways to counteract their impact, if required. That may be done, for instance, by clear regulatory obligations that override soft law principles. Soft law can however also be utilised to strengthen the desired behaviour. Where corporate governance standards are relevant, the regulator could outline the importance of the social impact of the new rules and link compliance with those rules with the principles of responsible corporate citizenship. Where the regulator may issue soft law requirements, for instance by issuing non-binding guidance, it is important to prevent tension between the guidance and the actual hard law requirement. Guidance that supports and

interprets the hard law requirement increases legal clarity and certainty. Guidance that attempts to develop the law by going further than the hard law requirement, on the other hand, tends to create confusion, especially in companies where compliance officers have a legal background and tend to focus on black letter law.

Regulate for the long term: Institutions are concerned about the impact of future changes to client identification and verification requirements on existing customers. If they believe that the requirements will change in the near future they may attempt to anticipate those changes in their current procedures. This is more likely to happen when the requirements are expensive to meet, or are disruptive to business activities, should they be implemented in an incremental manner. It is advisable, where practical, to design such regulatory requirements to avoid the need for amendments in the foreseeable future. Further, when amendments are required, there are benefits in communicating their nature and the timeframe for their implementation as soon as practically possible. This enables institutions to manage the introduction of the new compliance requirements in an efficient and cost-effective manner, as well as support the achievement of regulatory objectives.

Address key pressures that may prevent the implementation of simplified customer identification and verification measures: This study identified a number of drivers that may complicate the adoption of simplified customer due diligence measures where allowed by the law. Three appear particularly relevant, although a number of others may also have bearing:

- 1 Internal management pressure to ensure that all products are subjected to similar, uniform client identification to facilitate management of customers and their files;
- 2 Pressures arising from correspondent relationships and foreign shareholding to comply with foreign legal requirements; and
- 3 Concern that simplified measures may expose the corporation to fraud or civil liability.

Regulators are not necessarily in a position to counter these pressures but may still attempt to shape and guide the compliance response. They could, for instance, compel institutions to implement simplified customer due diligence measures in respect of very low risk customers and transactions, and provide them with regulatory protection should any of the attendant risks eventuate. By means of an appropriate guidance note the regulator can clarify its understanding of reasonable and justifiable AML/CFT controls. It may assist banks to respond to pressures arising from correspondent relationships and foreign shareholding, emphasising international consensus regarding financial inclusion as a corporate social responsibility. In many cases it could point out that financial inclusion products hold no risk for foreign correspondent banks and that foreign shareholders will support good governance by allowing financial inclusion measures. Appropriate amendments to the law may also be considered where reasonable compliance processes by banks may leave them vulnerable to civil liability. Regulators may also undertake studies of the fraud risk related to financial inclusion products and ensure that the industry is sufficiently informed about the correct level of risk posed by the relevant products. If the fraud risk is perceived as high, companies will remain conservative and, it is submitted, the regulator will be reluctant to guide companies to expose themselves to increased risk of identity fraud. Under these circumstances companies will be mindful of the corporate governance obligations to manage their business risks and banks will in addition be sensitive to compliance with the Basel principles.

Provide certainty about regulator's approach to compliance and enforcement: Compliance officers and other stakeholders find it difficult to exercise their discretion if they believe that any error could be visited by regulatory enforcement action. It is therefore important that the regulator clarifies its approach and its views in this regard. A zero tolerance approach will encourage relatively conservative compliance responses. Clarity is also crucial to facilitate the development of appropriate business information systems that

could support the desired compliance response. Changes that may be required to existing systems are often expensive and companies would tend to respond conservatively if they are uncertain about regulatory expectations.

Cooperate with the industry to increase compliance expertise: Compliance officers with the necessary expertise and understanding of the regulatory framework are better able to exercise their judgement appropriately than compliance officers lacking expertise. It is therefore important to cooperate with the industry to increase compliance resources and expertise.

Build mutual trust: Risk-based client identification and verification procedures are best shaped in the context of mutual trust. Mutual trust supports communication and will enable parties to jointly identify drivers of over-compliant behaviour and the effective ways to neutralise them. Institutions and compliance officers must therefore act in ways that strengthen the trust that the regulator places in them while the regulator should act in a manner that builds the trust of stakeholders. To this end regulations should be sensible and clear and regulatory action should be predictable, transparent and fair.

9 Conclusion

South African experience regarding the impact of AML/CFT client identification and verification measures and other aspects of regulation on financial inclusion provides perspectives on the range of factors that may result in overly conservative compliance responses. This preliminary study indicates that these factors, which are to a large extent interlinked, include the hard law requirement itself, applicable soft law, business management principles and the framework and reality of the company concerned. The impact of soft law requirements, such as international regulatory and industry standards and corporate governance codes, is especially significant. These broad requirements are often principle-based and aspirational and tend to exhort companies to go beyond the requirements of the law.

The study identified a range of drivers of over-compliant corporate responses. On the strength of the data gathered and the views that were formed, the paper also proposes a number of preliminary guidelines for regulators that wish to prevent pro-financial inclusion measures from being undermined by overly conservative compliance practices.

Given the limited nature of this study, these findings are preliminary. They call for more comprehensive research on the phenomenon and drivers of over-compliant responses in respect of high impact regulatory requirements in the financial services industry. The factors that can influence this behaviour, the interplay amongst these factors and appropriate ways to mitigate or strengthen these factors, require further investigation.

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