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How Reg-Tech Can Help Firms Build a Healthy Compliance Culture

Stephen Scott, CEO and Founder, Starling Trust Sciences

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As global security threats and incidents widen, and financial institutions face increasingly heightened scrutiny and requirements for AML/CFT compliance, banks and other financial institutions have been facing a number of potential "disruptions" to their traditional business models. These range from so-called "fin-tech" startups that provide financial services outside regulated channels, to heightened expectations for policing activities that are stretching traditional risk management and compliance departments.

Many global institutions have de-risked entire customer sets, or have jettisoned certain businesses where profitability has been questionable, where the risk of servicing such operations is less well known, or where institutions are unable — or unwilling — to take on additional costly compliance activities. Technology can play an important role in this arena, potentially offering institutions an alternative to exiting certain businesses altogether.

RANE recently interviewed Stephen Scott, CEO and Founder of Starling Trust Sciences, a Predictive Behavioral Analytics company that helps companies map out organizational trust dynamics to reduce risk and increase compliance. Select excerpts from the discussion below provide insights on: 1) how and what specific technologies can be leveraged to address risk and compliance; 2) why innovation in "reg-tech" has trailed "fin-tech" in providing cost-effective solutions for financial institutions facing a fast-changing regulatory compliance environment; and 3) how organizations — including and especially financial institutions — may benefit by re-conceptualizing risk and compliance from a top-down, tick-the-box approach, to a bottom-up effort focused on context and culture that more comprehensively monitors and manages risk.

⇒ *On the evolving regulatory environment for bank compliance, including Anti-Money Laundering, and Combatting the Financing of Terrorism (AML/CFT)*

To my mind, there are two camps, philosophically, in terms of how regulation needs to operate across the compliance spectrum. One view that several regulators have embraced — such as SEC Division of Enforcement Director Andrew Ceresney — is a top-down, outside-in sort of a view, which is pushing for chief compliance officers to act almost as an extension of the SEC inside organizations. Ceresney has issued what I consider to be very precise guidance on doing precisely the wrong thing in calling for companies to strive towards a "culture of compliance."

I would contrast this top-down and outside-in approach with the approach that the Federal Reserve Bank of New York is taking. [NY Fed President] Bill Dudley recently spoke on this topic, emphasizing the view that enhanced risk management and compliance begins with company culture, which can't be mandated from the top-down but, rather, which must be cultivated and adopted from the bottom of the organization on up. Perhaps with the tone being set from the top but a tone that is established within the organization rather than being driven from the outside.

"Context drives conduct," Dudley argues. The trick, then, is to establish the right context. This is an internal challenge. The SEC seems to miss this.

These are two diametrically opposed points of view about how human beings work, in practice, and this debate is driving changes in regulation throughout the banking sector. But there's a lack of coherence as there is not a consistent view on what regulation should do in what is already a very complex set of circumstances. And this leaves bank management struggling to determine how best to drive change around what the British regulators have come to call "conduct risk."

I don't think there's a way to split the baby on this one. You either believe that risk needs to be managed from outside the organization by some bureaucrat, whose priorities are subject to change with each new administration, or you believe that risk should be managed by companies themselves, from within. It's a "rules based" approach versus a "principles based" approach. And you either believe [the former] is a reasonable approach, or you don't.

I don't. My suspicion is that bank management would prefer tools that empower them to manage risks within their organization versus being a company that "ticks the box" in a cynical effort to placate regulators.

That "tick the box" mentality is alive and well, and I believe that the regulators, many of them, are getting fed up with that approach. They're calling for more substantive change that is clearly demonstrable through reliable metrics. I think the whole [regulatory] field is in flux at the moment, and I really do think that there are these two very different camps. Each will appeal to different buyers, and different startups or vendors will fall into one of these two camps.

⇒ *On why the pace of "fin-tech" innovation for the risk and compliance side of financial institutions (or "reg-tech") has been relatively slow*

As a recent piece published by the Institute of International Finance (IIF) made clear, we've seen a lot of action in the "fin-tech" space, but innovative technology solutions to address regulatory compliance needs have not appeared as swiftly, despite all the regulatory spending [required by banks].

I understand that some of the folks at the IIF explored this issue recently out in Silicon Valley. They asked some leading venture capitalists and others, "Why are we not seeing more reg-tech in the financial services sector? More startup activity in this space? More enthusiasm for it? Why has there been no feeding frenzy among startups despite a glut of spending which ought to signal opportunity?"

And the answer that they've heard is that the knowledge base and skill set required to build a tech business and the knowledge base and skill set required to operate in the regulatory environment effectively very seldom reside in the same person. There are just not very many people who can connect Sand Hill Road to K Street — and then to Wall Street. This has been a difficult combination to assemble.

⇒ *On the ways in which advances in technology can help institutions to address ever increasing regulatory demands*

I think there are two broad trends we see in the enterprise tech space today that are relevant to us and to others who hope to build products that address human capital and behavioral risk matters.

Companies in the "predictive analytics" camp work on the idea that you can distill signal from noise, and that you can see anomalies in data that suggest something worrisome – such as detecting potential fraudulent purchases on credit cards. A lot of the work we see in predictive analytics is based on understanding both "big data" and network analytics, and they're looking for red flags in the data in much the same way as "signals intelligence" folks do in the military or the intelligence community.

Then there are those in the "people analytics" space. These companies also have a good grasp on network science and marry that to behavioral science in some fashion or another. But they're perhaps less adept at working with large data sets. Most of the companies that we see in this space are really just gathering "data" through the use of surveys — and I question the validity and real usefulness of such inputs.

I believe that an adequate approach to regulatory risk really needs to focus on the behavior of people and be demonstrated through impartial data. You need to connect all three points: behavioral science, network analytics, and big data. We refer to companies that combine all three as "predictive behavioral analytics" companies, and we believe they will dominate the "reg-tech" space.

⇒ *On what regulators expect from institutions in terms of demonstrating that they are strengthening their risk and compliance efforts*

Some regulators are being, I believe, purposely vague. They're trying to perhaps prompt the banks to develop new means of addressing risk and compliance rather than telling them precisely what to do. Regulators say, "What we want to see is that there's no more bad behavior in banking." Or that bad behavior is at least [limited to] the few "rogue employees" rather than being "par for the course" and reflective of an underlying culture that is "toxic."

And they're using that very language, talking about a "toxic culture" in banking. There's now a great emphasis on culture and behavior. There's a sense of frustration among regulators. They don't want to see more of the same. The tools and processes that the banks have put in place thus far just haven't taken care of the problem, and yet you're seeing big budgets put in place that are only likely to [achieve] more of the same.

Regulators are looking to see something new, something that's compelling and that demonstrates how banks are working proactively to comply with regulations, and to ensure strong conduct risk management. I think that's why we'll see more predictive behavioral analytics in the future.

⇒ *On the cultural divide that organizations need to overcome in order to get the most out of regulatory compliance technology*

Do I believe that senior bank leadership sees the benefits of these tools? I don't know. I think so many of these tools are so new to the market that their value is yet to be fully demonstrated and understood. I think that the market is saying, "Well, show me something new, but show me that it's credible — and that my board and the regulators will find it credible." That should trigger innovation in reg-tech over time.

And I do expect to see this in the very near term. We are seeing some positive developments around the world through a reframing of compliance and risk among regulators and bank management alike. These problems are increasingly being cast as "conduct risk" and "conduct risk management" issues. This formulation focuses on behavior – and on culture as a driver of behavior. As we've been out in the marketplace, it's very evident that [senior bank management] take the regulatory focus on conduct and culture very seriously. These are real regulatory threats that are being considered carefully at the level of C-suites and boards.

Also, there is an increasing understanding that this can't be managed solely in the HR or risk and compliance departments. We need to get risk management folks and the HR folks together. They are often very different creatures with very different worldviews, and just getting those two different constituencies together in the same organization can be a challenge.

But it is essential in addressing behavior and conduct. So the companies that are successful, as a first step, are going to have to learn how to communicate across these constituencies internally and to bridge this cultural divide. Being able to regard the same data in the same light helps here, and this is another value that comes through working with behavioral analytics tools — they bring quantitative metrics to qualitative challenges.

⇒ *On how Starling aims to use technology to change corporate and compliance culture*

We're in the early days, both in terms of regulatory emphasis and in business response. And it's also early days here at Starling — we're a young company. But our value proposition has been very well received among banking executives with whom we've spoken — in the U.S., the UK, in Europe and in Asia. People seem to understand our approach.

We like to think of ourselves as the 'Rosetta Stone' for company culture. For most organizations, operational outcomes flow directly from the behavior of their people. The problem is that most organizations lack adequate insight into the underlying drivers of that behavior, and wind up managing by hindsight and anecdote.

There are a few necessary assumptions in our approach.

First, you have to believe that the behavior of your people drives the outcomes of your organization. We think that's pretty non-controversial and don't get much push-back there.

The second thing is this: Behavior is contagious. We find that the market sort of nods in agreement when we make that argument, and we've got lots of science that backs us up here.

The third thing is that the pathways of "behavioral contagion" are knowable — just as you can track the likely pathways of an infectious disease in the epidemiology of, say, Ebola. Again, people seem to get that pretty intuitively.

If they buy those three propositions we then ask, "Do you know the pathways of behavioral contagion at work in your organization?" That's when jaws drop open. Because, no, they don't. They're unsure who takes their behavioral cues from whom within the organization. The org chart may show who is ostensibly responsible for driving desired performance among staff. But who drives actual behavior on a persistent day-to-day basis?

This kind of information is powerful. Give those people who are good culture-carriers, those who are driving the right sort of behavior, identify who they are, whom they touch, and give them a bit of a wind at their backs to do more good — that's the approach we bring to market, and it seems to make a lot of sense.

And this approach also works when you're looking to identify those who have gone off the fairway. This allows management to better decide what club they need to use to drive their people out of the rough and back on course.

⇒ *On the importance of having quantitative metrics around compliance and behavior analytics to meet regulatory requirements*

I think [regulators are] trying to be proscriptive. There's a difference between taking a rules-based vs. a principle-based approach. But when you change culture and behavior, I don't think a rules-based approach is effective. Beyond broad parameters, you have to leave it to organizations themselves [to best figure out] how to manage those [culture and behavior] risks. The more you try to dictate that from the top-down, the more people are going to find loopholes.

And it is important to demonstrate — or quantify — risk and performance. How do you demonstrate that? How do you provide good, quantitative metrics to what is a qualitative challenge? That, I think, is the great problem — providing the credible and timely quantitative metrics that help them to understand and manage their qualitative challenges proactively.

And this is the beauty of a data-based approach versus surveys. You'll see it in the data and be able to demonstrate to any stakeholder that has interest — whether they're directors, regulators, employees, investors — you can provide data rather than anecdotes to support your argument.

⇒ *On the most troubling aspects of AML and CFT risk for a financial institution*

In my mind, I think if you're a bank worried about AML risk, you have two concerns: Concern one is that you've *unknowingly* taken in [illicit] money or facilitated the movement of [illicit] money … and you get spanked for it. The second problem is that one of your people made a *conscious* decision to [facilitate an illicit] transaction and knew what they were doing. There might be a case of a bad actor from outside [infiltrating the organization], and there's always going to be some of that, but the other is that you, as an organization, have someone working for you who is not acting in keeping with the stated values, norms, and objectives of the company.

That latter scenario where an employee is either knowingly facilitating an illicit transaction or simply turning a blind eye to appropriate due diligence — this is where banks under an AML lens get very nervous about terrorist financing. And this is where I think that there is an opportunity for predictive behavioral analytics to help management to get out in front of such behavioral and cultural risks.

⇒ *On the challenge of understanding (and limiting) behavioral or conduct risk—knowing that such risk can never be eliminated entirely*

I'm not a lawyer, but rather approach this with more of an MBA frame of mind. Where there's no risk, there's no opportunity for profit. Wherever there is potential for commercial endeavor, there will always be risk-taking. Among global regulators of the banking sector, and within banking, there is a poorly understood risk that is behavioral and cultural in nature. And we are asking banks to say they know and understand those risks, when they don't. There's this great "questing about" at the moment as bank leaders are working to get their arms around what conduct risk is. I think the solutions market is experimenting with what that is as well and it seems pretty clear that the way we've approached such risks in the past will not be the way we address them going forward.

⇒ *On three overarching priorities that will determine success or failure of regulatory compliance efforts in the financial arena*

Context drives conduct, as Dudley puts it. If you want to drive improved conduct, get a handle on context. I don't know that the regulators have a clear answer as to how this is to be achieved, but there are three big things to think about here, I think.

One is regulatory action that represents the bottom-up, inside-out approach that is articulated quite well by Bill Dudley versus the top-down approach from [New York Governor Andrew] Cuomo and Ceresney. Which do we believe will be more effective for regulated entities? I would put that question before the regulators directly.

Second question: What do the banks themselves want? I don't believe that banks are predominantly full of nefarious people … I think that is a caricature, and that many of them struggle with a lack of visibility within their own organizations. My thesis is that senior bank managers are left swinging a stick at a piñata blindfolded [in their efforts to address risk *while* trying to meet regulatory requirements]. They turn to things like employee opinion surveys, lot of subjective stuff masquerading as "data" but that isn't reliable data. We need to provide management with tools that permit them greater internal visibility. We need to remove the blindfold.

Lastly, how do you get different, but essential personnel within an organization to understand risk and compliance in the same language? What we're seeing at many banks is that HR and risk managers are increasingly viewed as two constituencies that need to work collaboratively on new internal committees that are being stood up. We haven't seen this done in quite the same way before. I'd try to get a better handle on that dynamic. How do we know when we have it right? What would be the data or the outcome that might make the regulators feel that banks have done their job adequately in this regard? What does success look like?

In my view, reg-tech companies have a lot to offer in this regard. It's an exciting time to be working in this space.

RELATED READING

- William C. Dudley, President and Chief Executive Officer, NY Federal Reserve Bank, Opening Remarks at Reforming Culture and Behavior in the Financial Services Industry – Workshop on Progress and Challenges, November 5, 2015
- RegTech: Exploring Solutions for Regulatory Challenges, Institute of International Finance, October 29, 2015
- Keynote Address by Andrew Ceresney, 2015 National Society of Compliance Professionals, National Conference, November 4, 2015
- A Chilling Message: Prosecuting Chief Compliance Officers, Volkov Law Group, June 24, 2014