

# Regulatory Outsourcing in Retail Banking: Banks Reap Cost Savings but Retain Responsibility

**Retail banks are continuing to outsource certain regulatory compliance tasks, but many are still keeping their compliance activities close to home.**

By Lisa Valentine



Perhaps it's wishful thinking, but the vendors and consultants FSO Magazine spoke with about trends in retail banking regulatory outsourcing agree that banks will continue to look to service providers for the most mundane of compliance activities such as OFAC list lookup, anti-money laundering compliance and documentation required for Sarbanes-Oxley compliance.

The reasons given for outsourcing regulatory activities are, not surprisingly, the same reasons given for outsourcing any function, including lower costs and not having to hire expertise or extra staff in-house.

What follows are perspectives on the advantages of compliance outsourcing in retail banks, challenges to be overcome and predictions for the future of the compliance outsourcing industry.

## **SMALL BANK FOCUS**

Scott Edwards is Interim President and Advisory Director for Edwards & Associates, a financial advisory services firm based in the southwestern U.S. that focuses on internal audit, loan review, appraisal review, compliance, policies and A&D for financial institutions. Edwards & Associates niche is smaller, community-based financial institutions with between \$30 to \$60 million in assets.



*Scott Edwards, Interim President and Advisory Director, Edwards & Associates*

Edwards explains that his client base has a much different perspective on outsourcing than larger financial institutions. Whereas a larger bank can attract, retain and afford to hire staff to handle their regulatory compliance activities, a smaller institution is limited both in the monetary resources it has to spend on staffing as well as its

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**“Getting and retaining talent is the biggest challenge facing community banks today.”**  
**Scott Edwards, Edwards & Associates**

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ability to attract experienced talent to what tends to be rural, less populated areas. The banks in Edwards' market tend to outsource all of their compliance functions. Fewer still will outsource only the oversight of the compliance processes they already have in place at the bank. These banks overwhelmingly also outsource their core processing functions.

Edwards explains that his firm helps these small institutions with a multitude of tasks, including devising internal policies to support compliance, monitoring those policies, and providing updates when regulations change. Most of their work centers around anti-money laundering and bank secrecy act compliance, Regulation DD, and training in completing suspicious activity report and currency transaction reports.

Although they may outsource many or all of their compliance activities, banks still must designate a compliance officer per regulations. However, this designee is not necessarily required to have any compliance training, essentially serving as the internal liaison and coordinator with Edwards & Associates for tasks such as office visits, implementation of new systems, or during examinations. Oftentimes a bank employee who demonstrates initiative and a positive

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attitude becomes the de facto compliance officer.

“We spend onsite time with every bank,” explains Edwards. “We work side by side with bank staff to build their compliance function.”

Asked why small community banks hire a firm for regulatory outsourcing, Edwards explains that banks need to do what they are in the business of doing – namely making loans, accepting deposits and performing arbitrage. “Smaller banks want to move the things out of the bank that they don’t have expertise in. It’s typically less expensive to outsource the function rather than doing in-house,” he adds.

Edwards predicts that the demand for regulatory outsourcing by smaller banks will continue and will even accelerate as the outsourcing industry as a whole continues



*Dr. Linda Eagle, President, Edcomm Banker’s Academy*

to expand. Bottom line is that regulatory outsourcing makes bottom-line sense. “When banks look at the requirements to hire regulatory compliance, the expertise it would cost them at least 1.5 times what we would charge them. In addition, an internal person tends to get distracted from their compliance responsibilities. Soon, your compliance officer isn’t doing any compliance, says Edwards.

**COMPLIANCE TAKES BACKSEAT TO OTHER OUTSOURCING**

For retail financial institutions, regulatory compliance isn’t typically the first area of the bank to experiment with outsourcing. Other functions, including human resources, information technology, and back office operations such as check processing, are often first picked for outsourcing, says Dr. Linda Eagle, president of Edcomm Banker’s Academy. Eagle has worked with hundreds of retail banks throughout the U.S. and across the globe.

But regulatory compliance outsourcing for retail banks is



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picking up steam, says Eagle. One reason for the increase is simple mathematics: retail banks have more regulatory compliance tasks they need to manage. Without increasing staff, outsourcing is the only way to meet increased compliance dictates.

Another, perhaps more important, reason is that bank examiners tend to look favorably on retail banks that have taken the initiative to outsource compliance. A third-party outsourcing partner can provide an unbiased, expert take on whether the bank is meeting its compliance objectives.

“Hiring a third-party shows examiners that you are taking responsibility for compliance,” says Eagle. “These banks are managing risk and showing independence. This extra level of independence makes a strong case for banks. Their results may be more believable to examiners.”

Regulatory areas getting the most outsourcing action include customer due diligence (especially for corporate customers), OFAC lookup, records retention and maintenance, and some aspects of Sarbanes-Oxley compliance.

Although retail banks are finding it attractive to outsource regulatory compliance, they must be aware that although they can easily outsource tasks, they cannot outsource responsibility or oversight.

“At the end of the day, if your outsourcer messes up, the bank is not off the hook,” warns Eagle. She explains that while it’s possible to pass responsibility to the outsourcer for functions such as human resources, regulatory outsourcing is very different. “With regulations, you cannot give away your responsibility to comply. If you try to, you will lay an egg with the examiners. You can’t give up your accountability and liability in compliance issues.”

Banks need to assign an internal staff member with the responsibility of overseeing compliance outsourcing. But even so, regulatory outsourcing can make a lot of sense, says Eagle.

“Compliance is not a noose around your neck but to protect the customers, the employees, and the bank,” reminds Eagle.

## POWER PLAY

For Sankar Krishnan, Managing Director



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**“Validating customer lists is easier to do with a trusted third-party.” Sankar Krishnan, Adventivity**

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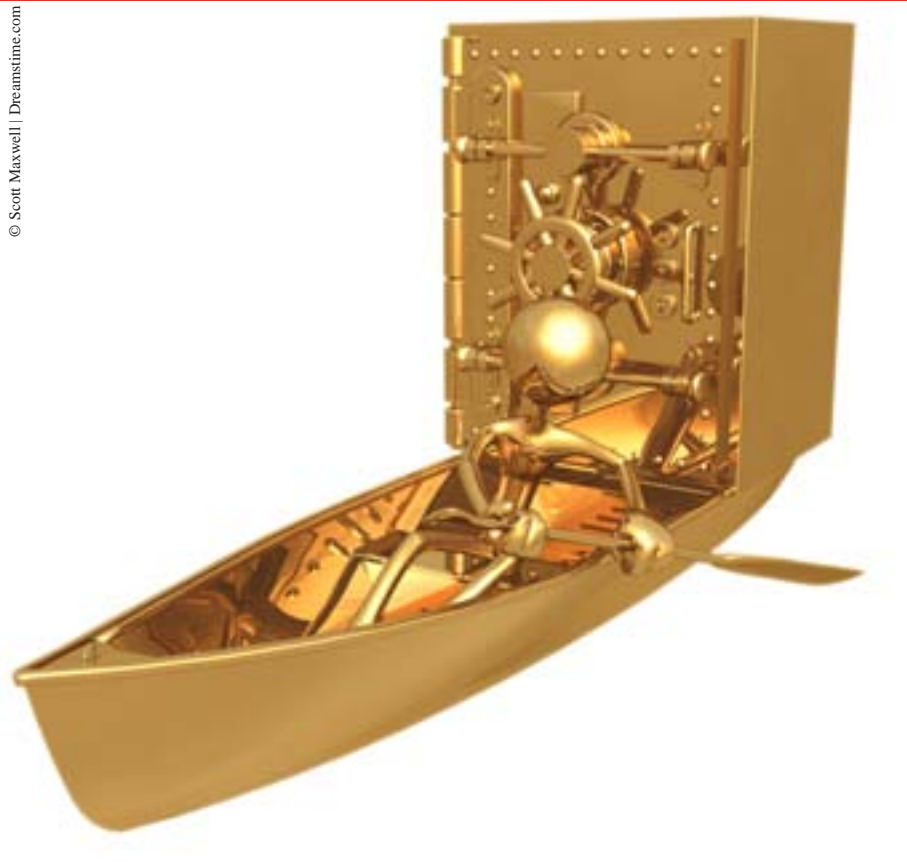
*Sankar Krishnan, Managing Director, Adventivity*

at Adventivity, a provider of Knowledge Process Outsourcing (KPO) to the financial services industry, regulatory outsourcing by retail banks has less to do with decreasing compliance costs but more about increasing their share of the market. He explains that banks are well aware that their continued growth will come from new markets and new customers—ones that they are not familiar with and will require due diligence.

“Banks outsource compliance because each retail bank is trying to increase its share of business and they understand that business is not going to grow from the customers they know but the customers they don’t know or bank with,” he explains.

To decrease the amount of time it takes to perform due diligence, banks are looking to outsource compliance tasks to offshore locations to take advantage of time zone differences. While a request for customer due diligence may take four or five days if performed by in-house staff during bank business hours, banks can use their offshore partner to work during the bank’s overnight hours, effectively increasing the processing window. Rather than a full week to clear a customer, banks using an offshore provider can clear the customer in 36 hours.

Krishnan, like Eagle and Edwards, notes that retail banks are most likely to outsource activities pertaining to regulations such as anti-money laundering,



**“The offshore providers know they have less wiggle room because they will be branded as offshore providers.” Akiba Stern, Morgan, Lewis & Bockius**

Know Your Customer, and OFAC list lookups. “Validating customer lists is easier to do with a trusted third-party,” contends Krishnan, noting that although the processing is outsourced, the command and control remains with the bank. “Banks realize that they are still responsible for their regulatory framework.”

### **LIABILITY REMAINS**

Akiba Stern, an outsourcing attorney at New York city-based Morgan, Lewis & Bockius, says he does not see all that many retail bank clients outsourcing their compliance function. Instead, from his perspective, retail banks are continuing to beef up their internal compliance functions, partly because of the realization that although they may be able to outsource specific tasks, the regulatory buck stops with them.

“Retail banks cannot outsource their obligations in respect to compliance,” says Stern.

However, Stern notes that he does see a few retail banks continue to use service providers to outsource certain sub-functions such as checking OFAC lists that roll up to an overall compliance effort. “At the end of the day all our clients understand

they cannot outsource compliance and are ultimately responsible. Their regulators will not permit them to outsource their obligations,” he adds.

In addition, the service providers themselves are wary of assuming liability



*Akiba Stern, Morgan, Lewis & Bockius*

if a bank client does not live up to its compliance obligation. “Service providers want to do a series of tasks for a financial institution. They want banks to tell them what to do. The bank has to have an internal compliance department that will review the outsourcers’ activities and stay on top of changes in the laws,” he says.

For example, a retail bank may be interested in outsourcing its customers’ privacy rights. However, the outsourcer will have access to the customer data. The bank needs to build in obligations on the part of the service provider for issues such as regulatory audit rights and include the code of conduct in the event of a customer data breach. “The code of conduct for the service provider must be spelled out and include what steps they have to take and who has the liability and pays for it.”

For some banks, the benefits of regulatory compliance outsourcing outweigh any potential problems. The most pressing benefit, not surprisingly, is cost savings. “Service providers sell standardized operating procedures, giving them economy of scale they can pass along to the banks,” says Stern.

While there are good regulatory outsourcers available, banks still need to be careful. Well-known U.S. based providers such as IBM, Accenture, and Hewlett-Packard have to perform; otherwise, will get a black mark from the regulators. But don’t discount offshore providers, says Stern. These offshore firms know that because they are offshore, they are already under the microscope.

“The offshore providers know they have less wiggle room because they will be branded as offshore providers. They don’t have as much comfort because Lou Dobbs will skewer them,” says Stern. □