

## COMPLIANCE AND THE RECOVERY OF FINANCIAL SERVICES OF THE EUROPEAN UNION: NEW CHALLENGES FOR LATVIA'S BANKING SECTOR

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### Abstract

Determinants of international banking failures have been widely discussed and summarized. A combination of global and systemic complexity of products that fails down on correct managing of the banking risk systems; consumers who are eager for credits and regulators who are unable to spot the potential global inter-relationships – consequently have led to the failures. As a response to the financial crisis the European Commission has been working actively to complete a comprehensive financial reform to address poor risk management, lack of responsibility and to correct the underlying weaknesses in the supervisory and regulatory framework.

The regulatory development is substantially increasing the role of compliance. One of the main supervisory objectives in EU countries is to ensure compliance with relevant laws and regulations. Regulations as such are not to be blamed in a context of financial crisis, moreover we have to draw our attention to the control mechanism that is being reformed and overhauled. Compliance in general terms is the adherence to the existing rules and regulations laid down by those in authority. Currently there is a widespread understanding that compliance means respecting all the regulations and supervisory expectations relevant to financial institution. Compliance means not only adherence to the letter of the law but moreover it is also concerned with adherence to the spirit of the law. Compliance should be considered as something more significant than just a function of conformity with laws and regulations. Banks must have culture of integrity and ethical business conduct. This is one of the main reasons why the development of compliance is a joint effort between the financial industry and the regulators. Recognition of the broader role of compliance as a part of the governance framework for banks is yet very strong and confirmed by guidelines from Basel Committee.

The aim of the paper is to highlight possible impact of EU financial reform to the compliance and theoretical constitution of sanctions as one of the main drivers for development of compliance management in Latvia's banking sector.

The article shows several research results of the surveys performed by the EU. The perceived threat of regulatory sanctions is one of the key drivers for compliance strategy in banks. The EU new financial reform program has five key objectives and among them it should be stressed upon – the more effective sanctions against market wrongdoing. The levels of administrative pecuniary sanctions (fines) vary widely across the Member States and seem to be too ineffective activities in some countries. Latvia and other Baltic countries are ranked among them. Analysis of the Latvian laws regarding administrative sanctions has been performed by the author and consequently it can be stated that fines are very small comparing with Nordic and other developed countries.

The author in his research concludes that due to the current relatively low level of sanctions in Latvia and the Commission's activities to strengthen and adequately enforce the Member States, the banking sector of Latvia should pay a greater attention in discussing the issue of compliance and reviewing the current practices. Besides, the discussion is needed regarding education, professional examination and certification for the compliance specialists in Latvia.

**Keywords:** compliance, banks, regulation, sanctions, Latvia.

### Introduction

The paper deals with European Union (EU) proposal for financial sector reform and sanctions impact to the compliance in banks. The creation of the single market and the opening of borders have been two of the main driving forces behind growth in Europe. Common Market, Single Market or Internal Market: the changes to the name over the years illustrate the longstanding policy objective of the Union. Completing the single market in financial services that includes banking, insurance and securities is recognized [Monti, 2010] as one of the key areas for EU's future growth and jobs. The banking crisis 2007 to date has threaten single market completion and create debate about how to safeguard the financial services from further and future failures.

Determinants of international banking failures have been widely discussed and summarized by the researchers [O'Sullivan, 2010], [Garcia, 2009], [Clarkson, 2009]. A combination of global and systemic complexity of products, which banking risk systems doesn't correctly manage; consumers are eager for credit and regulators also are unable to spot the potential global inter-relationships – all that have led to the significant failures [Hindle 2009]. As a response to the financial crisis the European Commission (2009) has been working actively to complete a comprehensive financial reform to address poor risk management, lack of responsibility and to correct the underlying weaknesses in the supervisory and regulatory framework.

The regulatory developments are substantially increasing the role of compliance. This is confirmed by research. One of the main supervisory objectives in EU countries is to ensure compliance with relevant laws and regulations [Garcia, 2009]. Through market research and interviews with industry executives, the IBM Institute for Business Value identified a number of significant industry trends that will impact the retail banking industry. Regulatory burdens intensify – heightened requirements around privacy, security, partnership risk and operational risk will require banks to take a more proactive, enterprise wide approach to managing compliance issues [Hedley, White, 2006]. Regulations as such are not to be blamed in a context of financial crisis, moreover the control mechanism that is being reformed and overhauled [Chambers 2010]. Compliance in general terms is the adherence to the existing rules and regulations laid down by those in authority [Edwards 2006]. Currently there is a widespread understanding that compliance means respecting all the regulations and supervisory expectations relevant to financial institution. Compliance means not only adherence to the letter of the law, moreover it is also concerned with adherence to the spirit of the law. This is one of the main reasons why the development of compliance industry is a joint effort between the financial industry and the regulators. Recognition of the broader role of compliance as a part of the governance framework for banks is yet very strong and confirmed by guidelines from Basel Committee (2010).

There is a large number of various studies and surveys on compliance matters from international financial community: EU, European Commission (2009, 2010), Basel Committee (2008), PricewaterhouseCoopers (2002), KPMG (2005), Securities Industry Association (2005) and academic researchers: Verhage (2009), Birindelli (2008), Haynes (2005), Sathye (2008), Taylor (2005), Rossi (2010), where has been pointed out series of issues concerning compliance, among which the research on the gap between national and foreign banks, and the evolution of compliance in different countries. Interpretation issues with regards to certain definitions and judgment of business practices have been identified. This raises a question if more attention should be paid to the academic research of compliance management in Latvia's banking sector.

Several studies [Kudinska, 2004], [Romānova, 2008], [Solovjova, 2008] have been concluding regarding Latvia's commercial banks, but none of them included matters of compliance management. Solovjova (2008) analysed Latvian banking internal stability factors and concluded that they could be divided in three groups: organizational, technological and economical. Banking Governance condition was defined as one of the most important organizational factors. This is in line with recent recommendations from Basel Committee (2010). Strategy is a key element of bank's success in a current competitive environment. Senior management of banks is responsible for overall strategy. Solovjova (2008) defined and described strategy pyramid, which contains financial, marketing, personal management, information technology and safety. Therefore the discussion regarding compliance strategy in Latvia's banking sector is needed.

Considering the above-mentioned aspects the **research problem** being solved in this article should be constructed as follows: how to define strategic drivers for compliance development in order to promote scientific debate in

Latvia about compliance management practice and support practitioners.

**Research object** Legal framework for compliance in Latvia's banking sector.

**The aim** of the article is to evaluate possible impact of EU financial reform to the compliance and theoretical constitution of sanctions as one of the main drivers for development of compliance management.

**The research tasks** are the following:

- Systemize knowledge around compliance;
- Evaluate importance of sanctions in development of compliance and level of administrative sanctions in Latvia in comparison with other EU countries;
- Evaluate the readiness of Latvia commercial banks to fulfil the requirements for compliance management.

**The research methods** involve analysis of the EU policy documents and studies; Latvian laws related to sanctions in the financial sector; compliance literature review and theoretical analysis of the research in this field.

**The research novelty** is investigation of Latvia's legislative documents and practice related to the compliance function in commercial banks.

### Compliance Knowledge and Theoretical Background

Recent observations [Complinet, 2011] suggest that in the new regulatory environment knowledge of compliance is becoming increasingly important across all areas of business. Bank regulation models and supervisory approaches have changed significantly. The new role of the supervisory bodies requires significant consistency between the knowledge bases with the supervised entities [Carretta, 2010].

The compliance departments should not enclose knowledge and operate more as internal consultants. Holland (2010) noted that lack of basic knowledge of banking risks and value drivers by the board and senior managers were implicated in the banking crises. He concluded that in general by ensuring greater bank learning, knowledge creation, and knowledge use, governments and regulators could help reduce individual bank risk and the likelihood of future crises. The same time he admitted – given the history of bank learning, incentives to learn and implement knowledge effectively are only to arise at the top of banks with clear regulation and *tough sanctions*.

In Latvia like in Belgium [Verhage, 2009] the certification of the compliance profession is still under discussion. Birindelli (2008) noted highly skilled resources: competencies and experience as an essential to discharge compliance liabilities effectively.

Edwards (2006) established a compliance competence partnership model where the regulator and regulated need to work together in a proactive partnership in order to achieve compliance competent organization.

The above discussion leads to think about further research and discussion regarding education, professional examination and certification for the compliance specialists in Latvia. This problem will be observed and evaluated by the author in the next paper.

Theoretical core knowledge for compliance is recommended by National Occupational standards of UK [FSP, 2011] to structure around three areas: financial market and the financial services industry, the regulatory environment and compliance role.

## Financial Market and Financial Services

In literature on compliance [Callioni, 2008] market is defined as a place, physical or virtual or both, where sellers interact with buyers. Market is a place where value exchanged, allowing for non-financial transactions of value. A market is a complex system. By complex means a system with many interconnected parts, with the whole amounting to more than the mere sum of the parts. Market is also complicated. By complicated is meant that we are dealing with something that is difficult to understand. Generally, markets are both complex and complicated, and therefore the understanding their complexity may help to reduce the level of complication.

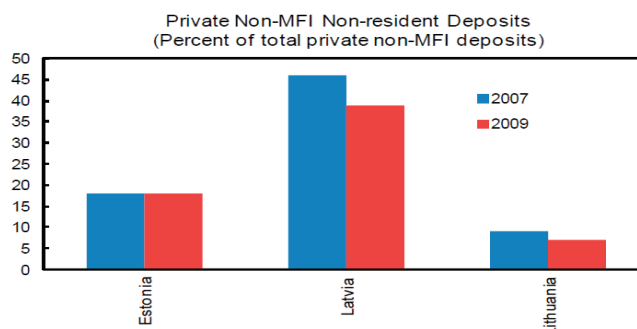
The creation of competitive and efficient European financial market started in 1998 when European Council set the Financial Services Action Plan (FSAP) and since that plan was being a top priority of EU policy [Milles, 2008], [Callioni, 2008]. This has been confirmed by EU report released in May 2010 [Monti, 2010] that is urging Parliament and Council to give a central consideration to the single market for financial services.

Any complex system requires operating rules [Callioni, 2008]. The single market is a construct based on law [Monti, 2010]. Thus, it is crucial that Member States take seriously their obligation to timely transpose and correctly apply the rules agreed to [Monti, 2010].

### Latvia's Financial Market

Latvia is among those countries that have developed financial sector as a bank based model [Clarkson, 2009]. There are 21 banks and 10 branches of foreign banks (ALCB). All banks are accepting deposits, grants commercial and industrial loans and provides other banking services for the public. They are called commercial or full-service banks. The bank assets form the greatest share of the total assets in the financial and capital market of Latvia [Ministry of Economics, 2010]. At the end of the 1<sup>st</sup> quarter of 2010, the total amount of the bank assets reached LVL 21.5 or EUR 30.5 billion and account for over 98% of all financial assets. Three banks are owned by large Nordic and German banking groups (SEB, Swedbank, DnB Nord), representing 45% of the total banking system assets. Two banks owned by top-tier banks from the Russian Federation (MDM bank, the Bank of Moscow) and two by large Ukrainian private banks (Privatbank, Pivdenny), and altogether they account for 3% of the total banking system assets. There is one bank owned by Austrian banking group (UniCredit Bank) accounting for 3.5% of the total banking system assets. One bank is a 100% state-owned (LHZB), accounting for 4.5% of the total banking system assets. The number of clients who have opened accounts at Banks in Latvia were 2.9 million as of December 2009 (FKTK). On June 1<sup>st</sup> 2010, the market capitalization was LVL 600.4 million and the total amount of gross premiums signed in the insurance market reached LVL 223.3 million of 2009. The research confirms that capital markets in all CEE countries including Latvia are more underdeveloped than banking sectors [Dinger, Hagen, 2009]. Various international institutions [US Department of State, 2010, International Monetary Fund, 2007] are noting the importance of banking sector by recognizing Latvia as a growing regional financial centre with sizeable non-resident deposit base. The Figure 1

provides comparison with neighbouring countries. Latvia is a regional financial centre of some significance and acts as an important trade and financial gateway between CIS countries (mainly Russia) and Western countries. The high volume of throughput of transactions in accounts in Latvian banks shows, in part, the financing of trade, but also contains a substantial component related to capital flows and transactions designed to minimize the impact of tax and currency control requirements in the originating countries, mainly in the CIS.



Source: Haver; IFS; BIS, Locational Banking Statistics; and EBRD

When the size of the banking sector is measured relatively to financial wealth, the gap between the developed EU banking systems and those of the CEE countries is not as severe as argued in studies based on the traditional approach of measuring the size of the banking system with respect to GDP [Dinger, Hagen, 2009]. It is important to confirm that not only the size, but also other areas (including compliance) of Latvian commercial banking are in line with developing trends.

### Regulation

Regulation is undoubtedly the founding spark and ultimate justification of all compliance activity in the financial services industry. It is almost certainly true that there would be no Compliance if there had first been a regulatory system in which to put them. To get to grips with compliance one should have a sound understanding of the regulatory environment that gave rise to it [Mills, 2008]. The term regulation is derived from Latin. The word *regula* in Latin means a rule. Regulation is viewed as operating rules and is about “stopping people doing bad things” or maintaining order for society and for economy. People understand regulation as the effort by state, through operating rules to shape the market. Regulation is intended to ensure conformity with agreed norms. It is a way of controlling behaviour, either of individuals or of organizations. As human society becomes more complex, the complexity of regulation also increases.

Predictability is the primary component of order. Predictability is enhanced by reliability and means that similar sets of circumstances ought to produce similar consequences. Elements of order are as follows: 1) a set of rules is required; 2) process to govern the development of the rules, to ensure they remain relevant to the society they support. In real world that means having a government; 3) compliance, which means abiding by the rules that govern a society, profession or other domain; 4) enforcement, which means taking steps to ensure compliance or to deal with transgressors. Logically,

enforcement is subset of compliance, a mechanism to make sure that the rules are not broken. However enforcement seems to have taken a life of its own [Callioni, 2008].

To understand how the regulation works in the financial sector we can use principles of game theory. Game theory is the systemic study of behaviour in situations involving interdependencies. It also is known as “multi-person decision theory” or “the analysis of conflict”. The roots of game theory are to be found in the work by John von Neumann and Oskar Morgenster [Solovjova, 2008], who defined two types of games: in rule based games, players interact according to specific “rules of engagement”, which are generally explicit; in the second type, players interact without explicit rules, although they may still abide by implicit “rules” or understandings.

Whatever the nature and character of state, the state will tend to want maximum compliance (effectiveness), while people and especially business will want minimum interference and minimum transaction costs (efficiency). The outcome will be a trade-off between efficiency and effectiveness, which will move through a pendulum cycle, driven primarily by level of trust in the bargain between the ruler and the ruled one. The stronger the trust, the lower the risk of non-compliance, resulting in a lower requirement for verifying compliance, with a consequent reduction in transaction costs. The lower the trust, the higher the requirement for verification, with a consequent hike in transaction costs. The optimum point in the cycle is when there is enough regulation to maintain order and predictability, without imposing an unacceptable amount of red tape [Callioni, 2008].

### EU Regulation

Against the above-mentioned background it’s important to review EU regulation for financial sector. FSAP was endorsed at Lisbon European Council of 2000, and had laid the legislative foundations for the EU financial services industry: banking, insurance, securities and asset management. It detailed 42 measures of four types: directives, regulations, communications and recommendations. In 2001 and 2002 FSAP was added with Lamfalussy Process covering securities market, banking and insurance. The Lamfalussy Process involves a four-layer approach to the implementation of EU financial services legislation. Level 1 – The European Commission and the European Council agree on basic framework of the legislation being considered. Level 2 – The European Commission specifies the technical details of the framework agreed at Level 1. Level 3 – each member state implements the measures taken at Level 1 and 2. Guidelines and best practice standards are issued in order to bring about uniform implementation. Level 4 – this will involve the European Commission checking Member States’ compliance with the FSAP measures, with the threat of enforcement action for any that are “under-performing” [Mills, 2008].

### Compliance

What compliance means – has been much debated by financial institutions and regulators. Compliance in general terms is the adherence by the regulated to rules and regulations laid down by those in authority. Compliance is the certification or confirmation that the doer of an action meets the requirements of accepted practices, legislation,

prescribed rules and regulations, specified standards, or the terms of a contract [Principles – Basel, 2010]. In literature Biegelman (2008) compliance is defined as a state of being in accordance with established legislation, guidelines, standards or specifications. Compliance includes concepts of obedience, observance, deference, governable, amenable, passive, non-resistance and submission. Linked to this are aspects of duty that include doing what ought to be done, moral obligation, accountability, propriety, fitness, to be on one’s good behaviour, answerable, to act morally and ethically. The difficulty in defining compliance with any real precision is noted by Parker [Edwards, J., 2006]. She advocated that the term “compliance” is too passive to indicate that it is engaged with its legal, social, environmental and ethical responsibilities. Indeed, some leading compliance consultants prefer the term “integrity programme”, because “compliance” connotes a simplistic obedience to rules rather than engagement with ethical and social responsibilities. In 2001, Belgian regulator defined “Compliance” as “the actual implementation of the integrity policy of the financial institution” [Verhage, 2009]. Implementing Anti Money Laundering procedures is only one of the many duties of a compliance officer, as the regulator also mentions a number of other specific tasks related to integrity policy: formulate guidelines for employees, development of procedures and codes of ethics, training and enhancing the awareness of employees, establishing and reporting incidents, investigation of rule-violations, monitoring transactions, client-screening, gives advice on new products, follows up on legislation, developing a deontological policy within the organization.

Under this approach banks can divide business conduct in four related integrity risk areas: client, staff, and financial services and organizational. Money laundering is most recognized in the first related area, market abuse and personal trading in the second, transparency of product offering in the third, and agreed sector/industry standards in the fourth [ING, 2009].

Pricewaterhouse Coopers (2002) undertook study and found a widespread understanding that compliance meant respecting all the regulations and supervisory expectations relevant to a financial institution and used this as a working definition of compliance.

Basel Committee on banking supervision is leading international institution setting up high-level compliance principles on bank’s management of compliance risk. In 2005 Basel Committee provided definition of the **compliance risk**, which is defined 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 organization standards, and codes of conduct applicable to its banking activities (together, “*compliance laws, rules and standard*”).

Regulators for financial services have framed Compliance within number of terms and concepts. The key regulatory concepts that comprise Compliance are defined by Mills (2008) as: Compliance risk; Reputational risk; Regulatory sanctions; Compliance laws, rules and standards; Compliance function; Compliance universe; Compliance department; Compliance Officer; Compliance culture; Cost of compliance. Regulatory authorities in the United States (US FDIC, US FED) are

requesting two very important concepts: Compliance management system and compliance programs.

A number of services and instruments have been developed in support of these obligations (for example, the automated monitoring devices for banks, or software, providing lists of “suspicious” individuals) – which results in the supply part of a market in compliance support – referred to in our research as the “compliance industry” [Verhage, 2009].

Basel Committee (2005) states that compliance laws, rules and standards generally cover matters such as observing proper standards of market conduct, managing conflicts of interest, money laundering, treating customers fairly, and ensuring the suitability of customer advice. 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. In a globalised financial services industry, the regulations driving compliance include among those regulations that are imposed at the international level and are imposed at the EU level.

In a context of EU, study in 2009 used some particularly important FSAP measures (the Selected Directives) that are making compliance landscape: the Prospectus Directive; the Financial Conglomerates Directive; the Capital Requirements Directives (the CRDs); the Transparency Directive; the Markets in Financial Instruments Directive (MiFID); the Third Anti-Money Laundering Directive (3AMLD).

In 2008 Basel Committee organized a survey “Implementation of the Compliance Principles”. Eight Committee member countries and 16 countries that are not members of the Committee participated in the survey. Respondents from 21 jurisdictions underlined two major issues they had to face when implementing compliance framework. One of these issues, which relates to small and medium-size institutions in particular, was how banks should organize their compliance function. This includes, for instance, the determination of what are the appropriate resources for compliance function in relation to the size, complexity and nature of the business; the relationship between internal audit and compliance; the independence of the compliance function. Another issue was the scope of compliance function.

Basel Committee urged also other countries to assess the implementation of compliance principles. Latvia implemented Basel Committee principles and definition of the compliance risk in May 2007, [FKTK 2007]. Birindelli (2008) confirmed hypothesis laying a special emphasis on the development of compliance risk management in foreign banks as in domestic banks. Sathye (2008) found empirical evidence suggesting that owing to scale economies in regulatory compliance, the burden has fallen more heavily on smaller financial institutions”.

In October 2010 Basel Committee issued Principles for enhancing corporate governance. The bank should maintain sound control functions, including an effective

compliance function that, among other things, routinely monitor compliance with laws, corporate governance rules, regulations, codes and policies to which the bank is subject and ensure that deviations are reported to an appropriate level of management and, in case of material deviations, to the board. Committee noted that in some cases, banks’ compliance functions have been designed to address only anti-money laundering issues, which turns to be inconsistent with Basel Committee guidance. The compliance function should have a broader scope and address the areas indicated in this document and in the Basel Committee guidance.

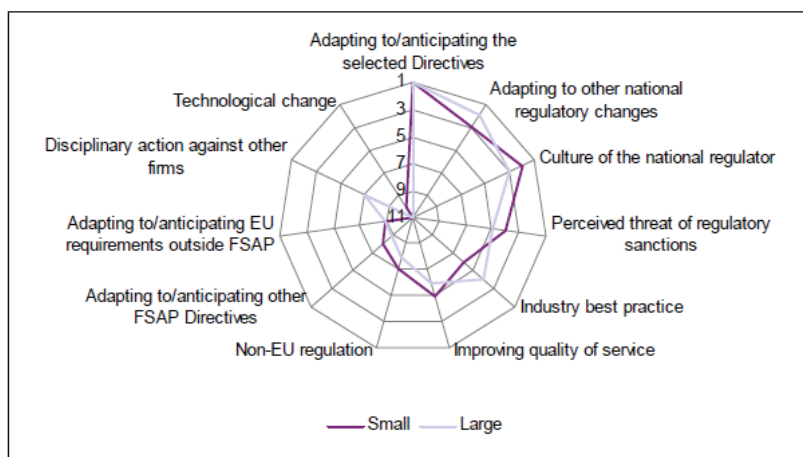
### Compliance Strategy

Compliance is not itself distinct from business strategy and therefore could be linked to Porter’s rubric of generic strategies [National Occupational Standards, 2010]. Cost leadership strategy is a strategy based on assumption that the cost leader in a market or segment of a market can gain a competitive advantage by producing at the lowest cost – every element of the value chain is scrutinized to see if costs can be cut, including compliance. In a cost-cutting environment banks have to see through a wall if the ultimate costs of non-compliance will far exceed any short-term budgetary savings. Rosi (2010) urge modern company to consider compliance leadership strategy as the core element in company’s overall strategy. Further studies of EU documents suggesting that compliance cost cutting strategy could be more risky for Latvian banking sector as for other Member States and therefore the attention should be paid to differentiation strategy.

The EU Commission conducted “Survey on the Cost of Compliance with Selected FSAP Measures” [European Commission, 2009]. The objective of the study was to obtain financial estimates of the costs of compliance with selected FSAP legislative measures for a sample of EU financial services companies (including banks) and a more precise assessment of where the costs of EU regulation lie. The study was based on direct interviews of a sample of companies to obtain their estimates of the costs of compliance with the provisions of selected directives. The study was completed in January 2009.

According the study the fundamental interest of the compliance function is in ensuring that the business complies with existing external laws and regulations, and internally-defined policies and ethical standards. Beyond this, the compliance function is seen, by an increasing number of firms, as having a crucial role to play in the mitigation of reputational risk. Thus, it follows that some spending on compliance would occur even in the absence of regulation. Further, such compliance activity need not be restricted to the compliance function itself.

The drivers of individual bank’s compliance strategies and resource allocation in order to enable a ranking of relative importance was discussed and information obtained. The study set out below a ranking based upon the composite results of the participants interviewed (where a rank of one represents the most important category). It follows that in these charts closeness to the outer ring represents the greater relative importance of that driver or resource.



Source: Interviews and EE analysis. For this purpose, a "large" bank has in excess of €500 m in operating expenses.

The perceived threat of regulatory sanctions is one of the key drivers for compliance strategy. This would require analysing developments in area of regulatory sanctions in EU and Latvia.

### EU Program for Financial Market Reform and Sanctions

In order to regain full confidence in the soundness of the financial system as one of the pillars for growth, the Commission proposed in 2009 and 2010 [EU - Driving European Recovery, 2009] an ambitious new reform programme with five key objectives in the following areas of: supervisory framework; regulation; market confidence; risk management and **effective sanctions**. The objective of commission is to make sanctions more of a deterrent. The imposition of penalties on firms is an important part of the instruments available to regulators and, following the financial crisis, regulatory authorities have shown a greater willingness to employ those [Armour et al., 2010]. Law literature [Wikstrom, 2006] argues that compliance with regulation should therefore be achieved through deterrence and deterrence experiences. A primary function of regulation of financial markets is to uncover and discipline misconduct. In the absence of effective monitoring and enforcement of rules of conduct, financial markets are particularly prone to abuse.

Commission stated that at present, **sanctioning regimes** are often weak and quite heterogeneous. Legal framework covering sanctions provided for in national legislation for the violations of EU financial services rules – including: type (administrative and criminal, pecuniary and non-pecuniary) and level of sanctions, addressees of sanctions, factors to be taken into account in the application of sanctions – and actual enforcement of sanctions. In the light of this review, Commission will make proposals on how Member State sanctions should be strengthened and adequately enforced.

Based on research studies on the level of fines – direct penalties [Armour et al., 2010] and its relation to the level of enforcement, the EU Commission made an impact assessment [EU – Impact Assessment, 2010] that defines the problem and explains the need for and the objectives of EU level action in the field of sanctioning regimes. It also provides an analysis of the rationale, the alternative and the impact of the Commission proposals on how sanctioning regimes

may be approximated at EU level, which are presented in the Communication on sanctions. The summary of assessment has been presented as a problem tree and several problems drivers were mentioned: type and level of administrative sanctions, application and enforcement of sanctions. Lack of dissuasiveness, effectiveness and proportionality of sanctions has been pointed among specific problems.

The specific problems can result general problems in a **lack of compliance with EU financial services rules**, such as prudential rules, conduct of business obligations, transparency obligations, etc. For instance, when the maximum amount of the pecuniary sanctions is very low, even for the most serious infringements, there is a high risk that sanctions will not have a sufficiently dissuasive effect, as the perceived reward from such behaviour will far outweigh the real risk.

As an example: in the banking sector, when an infringement of banking law and money laundering occurs in some Member States, the competent authorities will apply fines of less than 150 thousand EUR, which are very unlikely to have a dissuasive effect on the large banking groups operating in these Member States.

In accordance with literature [Armour et al., 2010], for a legal penalty to deter the wrong from which the defendant can gain a benefit  $w$ , the inequality

$$w < pD \quad (1)$$

must be satisfied [Becker, 1968], where  $D$  is the size of financial penalty and  $p$  ( $0 < p < 1$ ) is the probability of enforcement. The theory of optimal deterrence implies that policy-makers should calibrate the right hand side of inequality (1) according to the social cost of the wrong in question, through either the amount spent on detection and enforcement ( $p$ ) or the size of the penalty ( $D$ ).

Those divergences and weaknesses of sanctioning regimes can also have a negative impact on the trust between national supervisors and hence on cross border financial supervision.

The levels of administrative pecuniary sanctions (fines) vary widely across the Member States and seem too ineffective in some Member States, including for the same type of infringement. For instance, as regards the level of administrative pecuniary sanctions, the maximum levels provided for in national legislation diverge very widely: – Banking sector: the maximum amount of fines provided for in case of violation is unlimited or variable in 5 Member States,

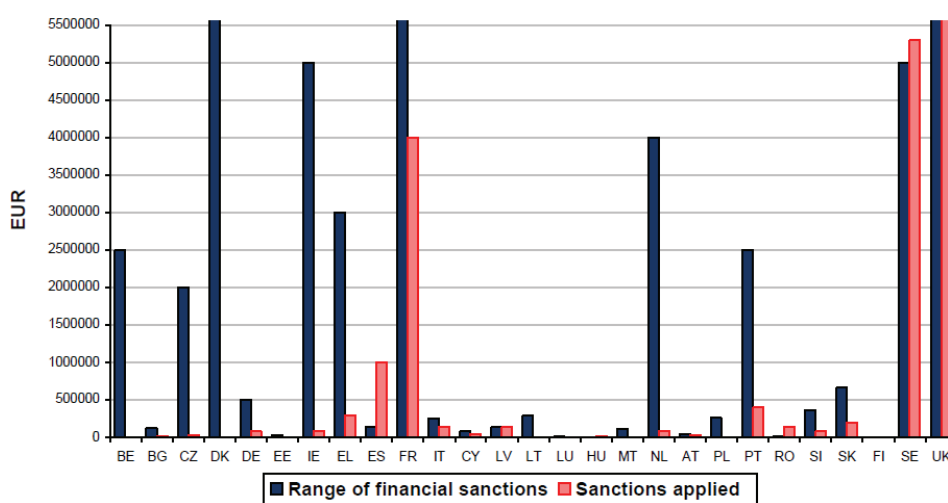
more than 1 million EUR in 9 Member States, less than 150 thousand EUR in 7 Member States.

Chart 6, compiled from input from Member States, gives an overview of the amount of administrative financial sanctions imposed in the banking sector (compared with the range of sanctions that is the minimum and maximum levels provided for in the legislation). From this chart it can be seen that the majority of Member States, imposed little or no sanctions during that period. It also shows that in most cases where a wide range of sanctions are allowed in the statute book, including very high sanctions that range of sanctions is not effectively imposed. Only in three Member States was a significant amount of sanctions, totalling over one million

EUR, actually imposed in the banking sector during that period.

In particular, if enforcement intensity is measured by financial penalties imposed, the US looks to be an outlier in world enforcement activity [Coffee, 2007], [Armour et al., 2009]. The gap in aggregate fines, even adjusted for differences in market capitalization, is so large (an order of four or five times anywhere else) as to pose the question whether misconduct outside the US in fact goes unpunished. However, it may be that regulators elsewhere—whose budgets are no less, in per capita terms, than the US—rely more heavily on reputational than financial penalties [Jackson, 2008], [Armour, 2009]. The difference may be more one of enforcement style than intensity.

**Chart 6 – Range of (financial) administrative sanctions against legal persons, and sanctions applied from 2005 to 2007 (in Euros)**



Source: CEBS report, p.50-52 and contribution from national authorities

### Sanctions in Latvia

The author has performed the analysis of legal documents, which determine the highest administrative sanctions that could be applied to credit institutions in Latvia. Such sanctions are prescribed in two legal acts – Code of Administrative Violation (Code of Administrative Violation, 1984) and the Law of Credit Institutions (Law of Credit Institutions, 1995). In all there are determined ten violation kinds and the fines are from 250 till 100 thousand LVL or the corresponding EUR. The highest sanction can be applied for the actions if the violation of the law “On Money Laundering Prevention” has happened. Consequently, the investments of the EU are being confirmed and Latvia is ranging among the countries where the bank’s fines are the lowest. Direct penalties according [Armour et al., 2010] are only one, and a surprisingly small, component of the overall sanctions available to regulators. There is another that has received less attention to date but is revealed in this paper to be potentially far more potent than direct penalties. A firm’s reputation demonstrates the expectations that its partners have of the benefits of trading with it. In general this is difficult to measure but the release of new information provides an opportunity to do so. [Armour et al., 2010] study the effect

on firms’ reputations of the announcement by a regulator of corporate misconduct and examine whether following a firm’s ‘naming’ as a wrongdoer by a regulator, it suffers ‘shaming’ in terms of lost reputation. [Armour et al., 2010] have found that reputational sanctions are very real: their stock price impact is on average ten times larger than the financial penalties imposed by the regulator. The study [Deloitte, 2011] confirms that Latvia is among those four EU Member States, which are not publishing penalties.

### Conclusions

The role of the compliance in EU financial market is growing and according research will continue to grow. This could be explained by the fact that main supervisory objectives in EU countries after financial crisis are to ensure compliance with relevant laws and regulations. The new regulatory environment will require original ideas, new methods and approaches to the knowledge concerning the compliance management. In general by ensuring greater bank learning, knowledge creation, and knowledge use, government and regulators could help to reduce individual bank risks and within the limits of possibility to avoid future crises. At the same time – given the history of bank learning, incentives to

learn and implement knowledge effectively are only to arise at the top of banks with clear regulation and *tough sanctions*.

Latvia's banking sector and regulator should have a discussion regarding development of education, professional examination and certification for the compliance specialists in Latvia. The perceived threat of regulatory sanctions is one of the key drivers for compliance strategy in banks. EU Commission proposed to make sanctions more of a deterrent and will make proposals on how Member State sanctions should be strengthened and adequately enforced. Research studies and review of Latvian laws that regulate banking industry confirm very low level of sanctions in Latvia. In addition to that Latvia is among those four EU Member States, which are not publishing penalties. The above-mentioned findings should urge Latvia's banking sector to pay greater attention to the issues of compliance management.

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The article has been reviewed.

Received in April, 2011; accepted in June, 2011.