





# THE COMPELLING SYNERGIES BETWEEN CREDIT RISK AND COMPLIANCE RISK

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A DECADE SINCE the financial crisis, much good work has been done to advance the state of risk management in banking institutions. Moreover, many firms have realized that consolidating or coordinating risk management functions in previously siloed areas results in significant synergies, efficiencies, and cost savings.

A prime example is the better alignment of credit risk management with compliance risk management—driven mainly by enhanced data management and the application of new digital and analytical tools.

## **Credit and Compliance Data**

Data of sufficient comprehensiveness and integrity is a foundational element of all risk management disciplines. In managing credit risk and compliance risk, it is vital to obtain and share accurate, complete, and up-to-date data about customers, clients, and counterparties.

Managers of both risks need to understand the precise nature of the individual or entity that the institution is dealing with and the extent to which it is exposed. This information is so critical to anti-money-laundering regulation that a distinct portion of the AML compliance world is devoted to “know your customer” requirements.

Identity, profile, structure, and relationship are the four dimensions of data required. Managers of credit risk and compliance risk need precise data in each of these categories, and their data needs frequent overlap. The data is typically recorded as customer master data and supplied to systems that use it for transaction and risk management, compliance, operations, and other functions.

#### *Identity*

A fundamental requirement of both credit and compliance risk management is to understand the precise identity of any party to a transaction. Key information for verifying the identity of individuals includes current and prior names and addresses, date of birth, and government identification number such as a tax ID or passport number. Documentary verification for businesses must show the existence of the entity, such as articles of incorporation or a partnership or trust agreement.

At times, institutions would be wise to add nondocumentary identification methods, such as contacting a customer by phone or using a third party such as a credit reporting agency, public database, or reference from another bank. An institution need not establish the accuracy of every identifying element so long as it has a reasonable belief in the person's true identity.

#### *Profile*

Once identity is established, the financial institution must understand the person's key attributes—typically by developing a risk profile, which can be used to assess both creditworthiness and the potential for suspicious or noncompliant activity. Relevant data for that profile includes annual income, net worth, domicile, type of occupation or business, historical and expected activity and revenues, sources of funds and wealth, and indications of past malfeasance. Also, managers of credit risk and

## A FUNDAMENTAL REQUIREMENT OF BOTH CREDIT AND COMPLIANCE RISK MANAGEMENT IS TO UNDERSTAND THE PRECISE IDENTITY OF ANY PARTY TO A TRANSACTION.

compliance risk need information on and views about high-risk industries (such as online gambling and cannabis-related businesses) that have a higher-than-normal propensity to default or engage in illegal behavior.

Moreover, both sets of risk managers must assess geographical factors. For example, countries may be flagged as high risk due to social or political issues, the local legal environment, or indications of corruption, which will impact credit and compliance assess-

ments. Furthermore, reputational risk attributes, such as the presence of a politically exposed person or other data of an adverse nature, are an important consideration when assessing a borrower's likelihood to avoid repayment of an obligation.

#### *Structure*

Another important and overlapping data dimension is the full legal structure that the customer or counterparty is part of and where it fits within that structure. Credit officers and compliance risk managers need to understand legal structure, which directly affects financing, liability, and tax considerations, because complete credit and compliance assessments cannot be made otherwise.

In the case of credit, for example, the bank may look to related entities within the corporate hierarchy for credit support. Or it may need to understand the potential for cash being transferred from one entity to another. In the case of compliance, the complexity and geographic scope of the legal structure may affect the potential for illicit activity to occur within it.

#### *Relationships*

The final data dimension is the ability to precisely identify the relationships and connections between parties within the organization. A common example is identification of the "ultimate beneficial owners," those natural persons with a significant ownership or controlling interest. AML due diligence is required for all nonexempted legal entities in order to 1) understand if there are bad actors who may influence the customer, and 2) assess whether the entity's creditworthiness may be influenced by a majority owner or some other person acting in a manner not in the interest of creditors.

#### **New Digital and Analytical Tools Tools**

The increasing amount of structured and unstructured data produced on

a daily basis, as well as the ability to process increasingly massive amounts of such data through artificial intelligence (AI), is dramatically transforming the due diligence and surveillance activities key to credit and compliance risk management.

An example is the use of natural language processing to extract data efficiently from the volumes of documents on customers, including the data they themselves may provide.

In addition to AI, robotic process automation (RPA) with applications for risk management are now broadly and cheaply available. These can be leveraged for pre-transaction due diligence on the prospective customer or counterparty, particularly when the collection of data is a repetitive, routine manual task governed by predefined rules. RPA bots can be used to collect, verify, and process customer data, at on-boarding and during regular intervals, from documents, public databases, government websites, and other sources. They bring advantages such as faster and more efficient cycle times, increased accuracy, 24/7 operations, and the freeing up of personnel for more productive, revenue-generating, and satisfying work.

Finally, techniques can be used to mine large amounts of data to detect suspicious activity and, increasingly, support predictive models that may flag future credit or compliance issues. In the case of AML, for example, these may be a part of advanced models that generate transaction alerts.

### Operating Model

This new environment requires risk management teams to rethink their operating models in order to improve their reliability and comprehensiveness, lower costs, and avoid unnecessary and confusing variations in the data and how it is interpreted. Changes in organizational alignment and rationalization of roles will allow for greater scale and accuracy, reduced

costs, and alignment with regulatory guidance on best practices for independent risk management.

Increasingly, independent risk management is moving to a challenge and oversight mandate. Tasks that used to be performed by credit and compliance teams, including basic due diligence and ongoing surveillance, are being migrated to the frontline units known as the “first line of defense.”

As a result, business divisions are establishing risk management units that include specialist operating functions—“mid-offices,” to borrow a sales and trading term—that are well suited to operating these tasks and using new tools.

### Conclusion

The data that institutions need for credit and compliance processes is often gathered by different functions, yet it frequently overlaps and is derived

from the same sources. Managers of credit risk and compliance risk can achieve greater productivity and efficiency through better coordination, the elimination of siloes, and the use of modern digital tools and analytics. <sup>®</sup>



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## A HARMONIOUS APPROACH TO DATA

**High quality, reliable** customer data is a foundational requirement for business and risk management. Banks require an integrated view of the customer to both manage credit risk and comply with regulations. Excellence in customer data management also supports the business objectives of creating customer intimacy, improving the customer experience, reducing cost, and driving efficiencies. However, with the explosion in information, particularly of an unstructured nature, available on customers, data is often fragmented, incorrect, and incomplete—with duplicated efforts in different functions of the bank.

With increasingly advanced digital technologies, banks can create enterprise capabilities to govern and manage customer data. This will allow for:

- An integrated customer database that can be easily accessed and exploited
- Clean, standard data achieved through the application of AI and machine learning, with a focus on critical master data elements
- The ability to track data lineage and business metadata
- Enhanced data security and access protocols

Using new age digital technologies, banks can achieve enhanced enterprise capabilities to govern, harmonize, and manage customer data across business functions.

