

Dissertation abstract entitled:

Compliance risk of banks in the consumer credit market in Poland -
economic and legal perspective

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The financial market is developing dynamically and is subject to constant change, including globalisation. Consequently, financial institutions operate in an uncertain environment. This in turn creates various types of risk in the activities of these entities. This is becoming a common phenomenon and is a permanent feature of the functioning of financial institutions. The type, scale and materiality of risk will vary from institution to institution. This is primarily due to the nature, scope and scale of their activities. However, every financial institution has both financial and non-financial risks.

Obviously, the causes and factors for the occurrence of risk and the different types of risk in each institution may vary, which is a direct result of the specific activities. Risks in a financial institution may arise from internal actions of the institution, especially decisions taken or not taken, erroneous operations or internal processes. The occurrence of risk in a financial institution is also influenced by external factors that happen independently of the entity's activities.

Risks are also present in the activities of a bank. Due to the role a bank plays in the economy, the specific nature of its activities and the range of services it provides to customers, risk is a permanent and inherent element in a bank. Although risk in a bank is an undesirable phenomenon, it nevertheless conditions its activities and influences the achievement of the entity's intended results. Risks also make it possible to achieve specific objectives.

Risk in a bank is not uniform. This is because the bank provides a variety of services, has different internal processes and carries out a variety of financial market operations. As such, there are a number of bank risks in the bank's operations. These may themselves create additional subcategories of risk, of which operational risk is a prime example.

One type of risk present in a bank is *compliance risk*. This risk may occur in the activities of other business entities, including financial institutions, i.e.: insurance companies or investment fund companies. Importantly, the occurrences of this risk in each entity may be very similar due to the nature and nature of the risk. The same is true of its consequences.

Due to the fact that the largest number of legal solutions for compliance risk management have been established for banks and due to the consequences of this risk in banks,

it was made the subject of analysis in the dissertation. The compliance risk of banks in the consumer credit market in Poland has been subject to special research issues.

Compliance risk in a bank arises as a result of the entity's failure to comply with applicable laws (both EU and domestic), guidelines of financial market supervisors (international, EU and domestic), internal regulations, market standards and ethical standards that apply to its business. The occurrence of this risk exposes the bank to consequences of an economic and non-economic nature.

For the first time, the problem of compliance risk in a bank from a global perspective was presented by the Basel Committee on Banking Supervision in 2003 in a Consultative Document entitled: "*The compliance function in banks*"¹. Following the *Basel Committee on Banking Supervision*, some action to regulate this type of risk at EU level was taken by European Union regulators in 2004 in the so-called MIFID package². However, the financial crisis of 2007 - 2008 and especially the years afterwards revealed the need for a new approach to this problem by regulators and supervisors. This was mainly due to the numerous emerging irregularities in banks' market practices towards its customers. Hence, over the last 10 years there has been some evolution in the regulation of this risk and the compliance function, both at EU and national level. In particular, the years following the financial crisis have revealed that compliance risk is not only about ensuring compliance with legal and prudential requirements for the conduct of business, but also compliance with consumer protection laws in the financial market, especially banking³. Given the specificity of this risk, it is necessary to analyse it in

¹ Basel Committee on Banking Supervision, Consultative Document, *The compliance function in banks*. October 2003, <https://www.bis.org/publ/bcbs103.pdf> (accessed 17.07.2021).

² Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC and COMMISSION DIRECTIVE 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive

³ Rutkowska-Tomaszewska, E. Financial services consumer protection law in the light of the rational legislator assumption: some selected remarks. *Acta Universitatis Wratislaviensis. Przegląd Prawa i Administracji*, 120(2), 2020, <https://doi.org/10.19195/0137-1134.120.85>, Rutecka-Góra Joanna, Rutkowska-Tomaszewska Edyta Bank pension products and prohibited contractual clauses and compliance risk *Business Legislation Review*, 2021, 12, pp. 42-54 10.33226/0137-5490.2021.12.6

economic and legal terms. This approach to the problem is presented in the doctoral thesis. However, the latter approach should be addressed first.

A bank, by failing to comply with the applicable laws (both EU and national), guidelines of financial market supervisors (international, EU and national), internal regulations, market standards and also ethical standards, exposes itself to the occurrence of irregularities in its operations, including abuses in relations with its clients. The occurrence of compliance risk exposes the bank to the risk of legal sanctions. According to the scope and degree of violations of the applicable laws by the bank, authorised authorities, financial market consumer protection institutions and common courts take appropriate action to limit them and enforce the legally required action by the bank. Often the forms of action of the above-mentioned entities take the form of a legal sanction (administrative, civil, supervisory). As part of the sanction applied, the competent entity may impose a financial penalty, the maximum amount of which is determined by law. Importantly, it may be measured. Its final amount will depend on the degree of violations of the law. This is what explains the need to analyse compliance risk in a bank in legal terms.

In economic terms, on the other hand, compliance risk in a bank can be considered in two ways. Firstly, although it is a non-financial risk, its occurrence affects the financial position of the bank. In particular, the materialisation of this risk exposes the bank to financial losses and a decrease in income. Depending on the magnitude of this risk and its impact on the bank, these can take different forms and magnitudes. It may also necessitate a change in funds/equity for this risk. Therefore, the bank must not allow excessive losses from the occurrence of this risk.

Secondly, compliance risk, like other risks in a bank, must be managed by the relevant unit and in a specific manner. The specific nature of this risk requires that this risk be managed on a strictly defined basis and at appropriate levels within the bank. What needs to be emphasised is that the identified compliance risk is subject to an assessment, on the basis of which it is possible to determine its level of materiality in the bank. The results of the assessment obtained make it possible to determine what actions must be taken in the next stages of managing this risk. If this risk is managed in an inappropriate manner, it can amplify the occurrence of material losses and, as a result, threaten the bank's security, including its financial stability and liquidity.

The considerations outlined above justify the need to analyse a bank's compliance risk in economic and legal terms. This approach has also been adopted for bank compliance risk in the consumer credit market in Poland, where a very strong relationship between economic and legal aspects can be seen.

Due to the fact that legal (both EU and national) and internal regulations are subject to constant change the state of compliance is not constant. As a result, banks are exposed to compliance risk in their operations. This risk can therefore be regarded as permanent and unavoidable in the bank's activities. The analysis of compliance risk in commercial banks operating in Poland shows that these entities identify this risk in their activities and in most of the analysed cases separate it from other types of risk in the bank. Some of the banks also indicate that this is a significant risk in their activity.

Compliance risk is usually treated in a general way as a risk occurring in the bank's activities. This way of recognising this risk can be seen in legislation, supervisory guidelines and recommendations or literature. Banks also generally recognise this type of risk.

It is often the case that compliance risk is included in the category of operational or legal risk. In the first case, it should be noted that this is due to the fact that the causes generating both types of risk are very similar and some of them may cause both types of risk at the same time. In the second case, the same relationship exists. There is a close connection between the bank's compliance risk and legal risk primarily in terms of the causes generating both above mentioned - they arise from breaches or non-compliance with legal regulations. With the exception, however, that compliance risk occurs when the bank fails to comply with the laws applicable to banking activities and legal risk with all applicable laws, e.g. on data protection or taxation.

As the bank operates in different areas and provides differentiated services to customers, it can be considered that it is exposed to compliance risk also in relation to these areas and services. This means that compliance risk may be narrowed down to a specific area or banking product. This is indicated, for example, by J. Rutecka - Gora and E. Rutkowska - Tomaszewska, who narrowed down the problem of non-compliance risk to bank pension products in the context of the use of contractual patterns and abusive clauses. To date, they are the only ones in Poland who have analysed compliance risk in relation to a specific product

offered by a bank. In contrast, in foreign literature, the problem of non-compliance risk is analysed mainly in relation to mortgage loans.

The analysis of irregularities occurring in the Polish banking sector allows us to conclude that compliance risk has materialised in various areas of commercial bank operations. It is particularly visible in the area of consumer credit. This is indicated by numerous irregularities in the market practices of banks, which were found by consumer protection authorities and institutions in the financial market, supervisory authorities and common courts in Poland in the years 2015 - 2021. The problem analysed in the paper concerns the risk of non-compliance in the area of consumer credit only in the sense of Article 3, paragraphs 1 and 2 of the Act of 12 May 2011 on consumer credit⁴. Outside the scope of consideration were other credits granted to consumers.

Due to the fact that the scale of irregularities and abuses of banks towards consumers in the consumer credit market in 2015 - 2021 was high, it can be concluded that there was a lack of compliance in commercial banks in Poland and thus compliance risk materialised in the area of consumer credit. Therefore, this allows us to separate this type of risk from the general compliance risk in the bank and make it the subject of specific analyses.

The main part of the dissertation is the identification and assessment of banks' compliance risk in the consumer credit market in Poland in relation to ten selected commercial banks operating in Poland that grant consumer loans.

The method of identifying banks' compliance risk in the consumer credit market developed in the thesis is a new solution. Such a method of identifying this particular risk has not yet been proposed in Poland or internationally, which fills the existing research gap.

The identification of banks' compliance risk in the consumer credit market was carried out on the basis of the collected data on banks' irregularities in the field of consumer credit in the period 2015 - 2021. For this purpose, the selection of banks was carried out first. In the first stage of selection, five qualitative criteria were used to select 25 banks. Due to the large number of banks meeting these criteria, a decision was made to select only ten banks. Using a further two qualitative criteria, a further selection was made. The number of banks meeting the first

criterion was 8. In contrast, 11 banks met the second criterion. Therefore, a quantitative criterion was applied. Using it, one bank was removed from further analysis.

For each of the selected banks, a review of the bank's internal compliance risk identification methods was conducted. None of these methods contained information on bank irregularities and abuses in consumer credit. The selection of banks was necessary to analyse the irregularities that occurred in the consumer credit activities of specific entities. The analysis of these irregularities made it possible to identify 3 main areas of compliance at the bank in the field of consumer credit:

- offering credit,
- concluding a credit agreement,
- the granting of credit.

Due to the fact that within each of these areas different actions and activities are undertaken, which must follow applicable laws (both EU and national), guidelines of financial market supervisors (international, EU and national), internal regulations, market standards and also ethical standards, the author of this work has distinguished other more specific compliance areas. Such a "downward" division allows for a more precise identification of compliance risk in the bank in the area of consumer credit and the effects of this risk already at the stage of its identification.

Such a way of framing the compliance areas of banks in the consumer credit market seems to be justified by the fact that the credit procedure consists of several stages and non-compliance can occur at any of them. The author also draws attention to the fact that the identification of compliance risk in the first area makes it possible to limit the occurrence of such risk in the other areas. Namely, non-compliance in the first area may cause non-compliance risk in subsequent areas, but not vice versa.

The selection of banks and the designation of compliance areas in the area of consumer loans made it possible to identify compliance risks of banks in the consumer credit market in Poland in 2015 - 2021. For this purpose, publicly available data from the websites of the Office of Competition and Consumer Protection, the Polish Financial Ombudsman and the Polish Financial Supervision Authority was used.

The paper presents the identified credit compliance risks of banks that occurred in the areas indicated above. Each of them has been characterised in terms of their source, nature and impact.

The identification of banks' compliance risks in the consumer credit market was necessary for the next stage of the work - the assessment of these risks. However, it should be pointed out that due to the problems encountered in obtaining the required quantitative data from banks, as well as other entities, i.e. the Office of Competition and Consumer Protection, the Financial Ombudsman and the Financial Supervision Commission, the author decided to extend the risk assessment to loan institutions.

To assess the compliance risk of banks in the consumer credit market, the Author developed 2 methods of measurement this risk. The first is the so-called risk map, which was developed on the basis of variables selected for banks. While the second is a weighted average method of the characteristics of the variables selected for lending institutions. Importantly, these are methods that have not previously been used in the literature to assess this risk. Both methods are the main contribution of the paper. The proposed methods attempt to fill an existing research gap. They are compliance risk assessment methods specific to banks and lending institutions in the field of consumer credit. These methods can be used separately or in combination and the risk assessment results obtained can be comparable. The entity assessing compliance risk in the field of consumer credit can therefore decide which method is more appropriately applicable to that entity.

Before assessing the compliance risk of banks in the consumer credit market, it was necessary to select variables. They were selected on the basis of information on irregularities in the consumer credit activities of banks and lending institutions.

The first method proposed is a risk map, the so-called risk matrix. It was developed on the basis of the variables that were selected for the banks. These variables allowed the risk map to be constructed on a five-point scale. First, the author determined the probability of a risk event occurring and assigned an appropriate value ranging from 1 to 5. Next, the consequences of a risk event occurring - losses due to compliance risk in the area of consumer credit - were determined. Four groups of consequences were identified - financial, impact on achievement of

objectives, impact on reputation and removal of the consequences of this risk. Each of these was assigned a value ranging from 1 - 5. Subsequently, an assessment of the bank's compliance risk in the area of consumer credit was carried out by multiplying the values of the probability levels by the values of the loss levels (effect of the event). The result obtained by multiplying the values of the probability level and the values of the loss levels informs about the compliance risk in consumer credit. The results obtained are in the range of 1 - 25. In the paper, the significance levels of this risk were determined:

- Low 1 - 5,
- Moderate 6 - 10,
- Medium 11 - 15,
- High 16 - 20,
- Very high 21 - 25.

Each of these levels has been interpreted by the Author of the paper. The actions that should be taken to manage these risks have also been proposed.

The second proposed risk assessment method is the risk score as a weighted average of the individual variables. This method was developed on the basis of the variables that were selected for lending institutions. The choice of these at this stage of the work was justified by the fact that lending institutions, next to banks, constitute an important part of the consumer credit market in Poland, and there are similar irregularities in their activities to those of banks in terms of consumer credit. The method proceeds in 3 stages:

1. Establishing uniformity of variables,
2. Carrying out standardisation,
3. Determination of the weighted average.

First, variables of equal interpretation were selected - the higher the value of the variable, the higher the risk. For each of them, a relative value was calculated by relating the specific variables - their values to the size of the entity. For each year of the 2015 - 2021 period and each of the analysed lending institutions, the value of the variables was calculated. The variables were then normalised for the entire group of entities. As the values of all institutions for a given variable were the same, it was decided to eliminate it in the calculation.

Normalisation was carried out using the formula:

$$z_{ij} = \frac{x_{ij} - \min(x_{1j}, x_{2j}, \dots, x_{nj})}{\max(x_{1j}, x_{2j}, \dots, x_{nj}) - \min(x_{1j}, x_{2j}, \dots, x_{nj})}$$

Where:

i - index of subjects (there are *n* subjects),

j - index of variables,

z - value after normalisation,

x - value before normalisation,

min - minimum value of a given variable (*j*-th) for all entities,

max - maximum value of a given variable (*j*-th) for all entities

After normalisation, the resulting scores fell within the interval [0;1]. If a given variable x_{ij} had a minimal value, then the value of the given variable after normalisation took on the value 0. Conversely, if a given variable x_{ij} took on a maximum value, then the maximum value of the given variable after normalisation took on the value 1. In the final step of this method, a weighted average was determined. The values obtained after normalisation were assigned appropriate weights with a value of 0.2 or 0.3. The weighted average value of all variables was then calculated for each subject and year. The results obtained from this assessment made it possible to determine the magnitude of compliance risk in consumer credit per lending institution and per year.

The obtained results of this assessment allowed us to determine the magnitude of compliance risk in the field of consumer credit per lending institution and per year. However, it should be pointed out that the evaluation results obtained are not reliable. They have very low values and indicate that there was no compliance risk in the lending institutions. This is due to the fact that almost all variables, with the exception of one variable, took on values of 0 or 1. In particular, these were the variables relating to the number of decisions issued by the President of the Office of Competition and Consumer Protection. However, although the value of these variables took on a value of 0 or 1, it should be pointed out that such decisions are issued in the case of unlawful market practices by a lending institution towards consumers.

On the basis of observations of the consumer credit market in Poland in 2015 - 2021, it should be concluded that such a risk was If the author had full data on the identified compliance risk of consumer credit in lending institutions, the obtained risk score as a weighted average of individual variables would have been other significantly higher.

The work is theoretical and empirical with methodological elements. It uses qualitative and quantitative methods, including methods of economic analysis of law. In the theoretical part of the work, a review of domestic and foreign literature on banking risk and compliance risk was carried out, as well as a review of national and EU regulations on compliance risk and its management. The irregularities identified in the market practices of selected commercial banks in Poland in the area of consumer credit in 2015 - 2021 were analysed. Statistical methods were used in the study to present the size of the consumer credit market in Poland from 2015 - 2021. Quantitative tools were used to identify compliance risk in the area of consumer credit in banks and lending institutions.

The study used data from external sources. The necessary information was obtained from the websites of the Office of Competition and Consumer Protection, Financial Ombudsman, Financial Supervision Commission, National Bank of Poland, and Credit Information Bureau. Data on the financial performance of lending institutions was obtained from the EMIS database. The LEX database was used to analyse the legislation.

Structure of the work:

The subject matter of the dissertation is presented in five chapters. Of these, the first three are theoretical with empirical elements. Chapters 1 - 3 serve to lay the foundations for the research described in Chapters 4 - 5. Chapter 4 is empirical and Chapter 5 contains methodological proposals.

In the first chapter of the paper, the author characterises the problem of risk in bank operations.

However, she begins her considerations in this area by defining the concept of risk itself, presenting its various approaches in the literature. The differences between risk and uncertainty are presented. Attention was drawn to the fact that risk can be understood in negative and neutral terms. It was emphasised that risk in the activities of any entity, as well as in human life, is inevitable and occurs at every stage of the decision-making process. The author then moved on to the analysis of risk in business activities. The causes and factor of the occurrence of each type of risk were indicated.

In the second part of the chapter, banking risk was presented. At the very beginning, the Author made it clear that there are many differing definitions of the concept of banking risk in practice and literature. Therefore, a literature review was carried out in order to unify this concept.

In the next step, the reasons for the occurrence of risk in bank activities were presented.

This was followed by a classification of banking risk. The different ways of classifying this risk by the Basel Committee on Banking Supervision, regulators and academics were presented. A general characterisation of the different types of bank risk was made.

The next step was to present how banking risk is managed. Due to the fact that there are many types of bank risk and each of them is managed in a separate way, the author addressed the problem of bank risk management in a general way. She indicated: what are the objectives of managing this risk, what is a risk management system, who is responsible for managing the risk and how the banking risk management process works.

Chapter two presents the bank's compliance risk and outlines how this risk is managed.

Part one of this chapter presents the concept of compliance risk in regulation. In this respect, selected regulations that relate to this risk and the compliance function in a bank are presented. Attention is drawn to the evolution of this concept over the past years. The concept of compliance risk as formulated by the Basel Committee on Banking Supervision, which gave rise to the definitions of the concept of compliance risk proposed by European and national supervisors and regulators, is presented first.

This was followed by a presentation of the concept of compliance risk in a bank and the compliance function as introduced by EU regulations and guidelines of the European Banking Authority. Subsequently the concept of compliance risk in a bank in terms of Polish regulations was presented.

In the third part a review of the legal and economic literature was carried out, in which definitions of compliance risk were formulated and the problem of compliance assurance in banks was discussed.

In the fourth part of this chapter an analysis was made of whether and how commercial banks operating in Poland at the end of 2021 distinguished compliance risk from other risks in the bank. In addition, a review of the definitions of the concept of compliance risk constructed by the banks themselves was carried out.

The fifth part of this chapter was devoted to the problem of compliance risk in a bank that occurs as a result of non-compliance with ethical principles. Reference has been made in general terms to codes of ethics and codes of good practice to be followed by banks. Attention has been drawn to the consequences of non-compliance with ethical principles by a bank in a situation where the bank declares its compliance (e.g. an internal code of good practice, a code of good practice developed by an association institution, e.g. the ZBP).

In the sixth part, the author presented the problem of the risk of non-compliance in a bank with regard to the application of good practices - corporate governance principles in a bank. She indicated that compliance must be ensured first and foremost at the level of the bank's authorities.

In turn, the seventh part of this chapter analysed the relationship of compliance risk with other risks in the bank's activities. First, the relationship of compliance risk with financial risks: credit, liquidity and operational risks is presented. Next, the relationship of compliance risk with non-financial risks: regulatory, legal and reputational was examined.

The eighth section of this chapter presents the non-economic and economic consequences of compliance risk in a bank and the relationship between them. The non-economic consequences of compliance risk are characterised first. A catalogue of them is presented and their interpretation is made. Next, the economic consequences that de facto occur due to the occurrence of non-economic consequences are indicated.

In the last part of this chapter, the process of compliance risk management in the bank is presented. It is first indicated that compliance risk management takes place within the bank's internal control system. Next, the bank's compliance function was characterised and its role and essence were indicated. Lastly, the management of compliance risk at the bank was presented.

Chapter three characterises the consumer credit market in Poland between 2015 and 2021.

The first part of this chapter presents the entity structure of this market and indicates the size of the market by year, but considering only consumer credit providers.

The second part of this chapter deals with the bank as a specific creditor of consumer credit. In this part, the author pointed out that the bank, as a consumer credit lender, is obliged to comply and ensure compliance with the provisions of the Consumer Credit Act but also to the relevant extent of the Banking Law.

In turn, the third part characterises consumer credit with particular reference to the rules of its offering and granting by the bank.

The last part of this chapter was devoted to the loan as a product that can be provided by a bank, but also by lending institutions. Attention has been given to the relationship between a loan and consumer credit.

The fourth chapter is an empirical chapter in which the compliance risk of banks in the consumer credit market in Poland is identified.

In the first part, the author, using qualitative and quantitative criteria, selected commercial banks in Poland to identify this risk. The author described the method of bank selection and justified her choice. Within the framework of the first part, internal methods of compliance risk identification in selected banks were also presented.

The second part of this chapter presents the concept of compliance risk in consumer credit. An interpretation of this concept has also been made.

In the third part of this chapter, a general identification of compliance risks in the consumer credit market was carried out on the basis of the collected data. Areas of compliance at the bank in the area of consumer credit have also been identified.

In the fourth part of this chapter, a general identification of banks' compliance risks in the consumer credit market for the period 2015 - 2021 was carried out. The identified banks'

credit compliance risks that occurred in separate areas were presented. Each of them has been characterised in terms of their source, nature and impact.

Chapter five presents proposed methods for assessing the compliance risk of banks and lending institutions in the consumer credit market.

In the first part, the author presented 2 methods on the basis of which consumer credit lenders can carry out a compliance risk assessment for consumer credit. The first method is a risk map (matrix), which was developed using variables extracted for banks. The author constructed the map on a 5-point scale. She proposed risk materiality levels that range from 1-25. Each of these levels was interpreted and the actions that should be taken in the event of the risk are indicated.

The author then proposed a second method, risk scoring as a weighted average of the individual variables. This was developed on the basis of the variables that were selected for lending institutions. For this purpose, a normalisation was first carried out. The resulting values were assigned appropriate weights. Further, a weighted average was calculated for specific variables and the result obtained informed about the risk in a given lending institution and in a particular year.

In the second part, the author presented the selected variables to carry out the assessment of compliance risk in the consumer credit market are presented. The problems of obtaining data to develop a method for assessing this risk were also presented. A distinction was made between variables relating to banks and lending institutions. In the third part of the chapter, the compliance risk assessment of consumer loans was carried out using second method.