

STREAMLINING THE COMPLIANCE PROCESS – AN OVERVIEW OF REGTECH

FINANCIAL INDUSTRY ADVISORY SERVICES: BRIEFING NOTE



REGTECH: THE NEW PLAYER IN FINTECH

Regulatory technology (regtech) is a rapidly growing sub-segment of the fintech ecosystem that focuses on technologies that deliver regulatory requirements more efficiently and effectively than existing capabilities.

The need to comply with regulations impacts a wide range of industries, so the adoption of technology-driven business

models to facilitate and streamline this compliance by industry players will likely prove to be a universal benefit.

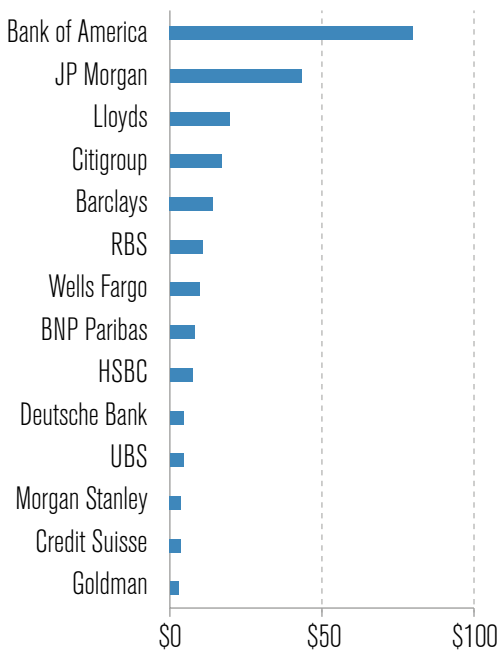
In this briefing note, we provide an overview of the state of the regtech market and developments that are emerging in the financial industry.

WHY THE GROWING INTEREST?

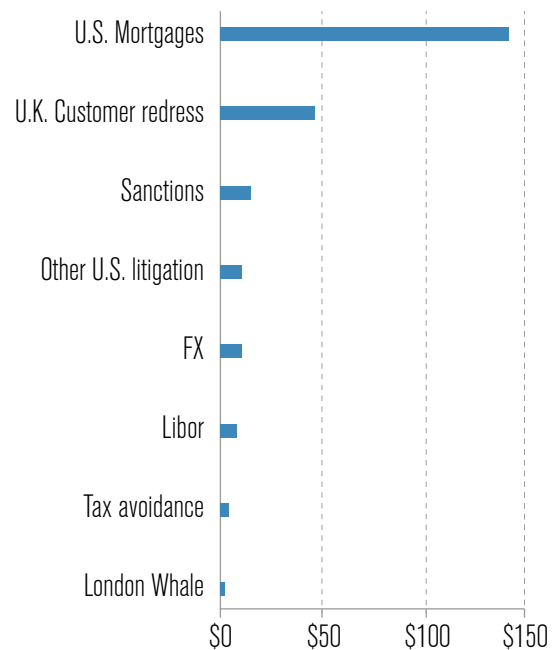
The cost and complexity of compliance has increased significantly across the financial industry. Since the end of the financial crisis in 2009, incumbent players have been preparing for new regulations (such as U.K. structural reforms, the Markets in Financial Instruments Directive

(MiFID II), the Market Abuse Regulation (MAR), etc.) as well as remediating ineffective business processes that have often resulted in enforcement actions and litigation events. Since the financial crisis in 2008, the top 20 banks have paid more than \$235 billion in fines¹.

TOTAL FINES BY INSTITUTION (U.S. \$ BILLION):



TOTAL FINES BY TYPE (U.S. \$ BILLION):



Source: Thomson Reuters - Banking Misconduct Bill

¹ <http://www.ibtimes.co.uk/20-global-banks-have-paid-235bn-fines-since-2008-financial-crisis-1502794>

Together with inefficient practices, these factors have all led to ballooning compliance budgets despite a challenging cost environment for banks overall.

GLOBAL BANKS HAVE SIGNIFICANTLY INCREASED SPENDING ON COMPLIANCE

- JPMorgan employed 4,000 additional compliance staff in 2013 and spent an extra \$1 billion on controls.
- Deutsche Bank's 2014 results included €1.3 billion in extra regulatory-related spending. Some €500 million was described as 'temporary or one off,' another €400 million was related to regulatory projects which have not yet been completed, and the final €400 million was for 'incremental headcount to comply with additional regulatory requirements.'
- Citibank's CFO said that about half of the bank's \$3.4 billion in efficiency savings in 2014 was being 'consumed by additional investments that Citibank was making in regulatory and compliance activities.'
- UBS spent SFr900 million (\$946 million) on regulatory demands in 2014. SFr400 million of this is permanent costs.
- HSBC said it would take on 3,000 more compliance staff in 2013, bringing the total number working in compliance to more than 5,000. That number has since increased to more than 7,000, according to the bank's latest annual reports.
- RBS posted a loss of £2bn in the first half of 2016, which included a £1.3bn provision for litigation and conduct issues.

Source: FT article 'Banks face pushback over surging compliance and regulatory costs' and RBS H1 2016 report

New startup ventures driving innovations in regtech have been the first movers to develop solutions that seek to address the cost and complexity issues related to complying with regulations. Financial industry incumbents and the financial regulators, for example the U.K. Financial Conduct Authority (FCA), have also begun to take notice of the

possibilities that regtech solutions can deliver. All of these groups are seeking to understand how regtech can become a catalyst and tool to reengineer internal configurations and operating models in order to recover cost and increase effectiveness of compliance.

CURRENT STATE OF THE INDUSTRY

Over the past 12 months, we have observed a rapid increase in the number of startups with business models that focus on providing compliance and technology enabled regulatory solutions to the financial industry. This new category within the fintech landscape came into prominence following the 3D FinTech Challenge run by Dassault Systèmes and Deutsche Börse in April 2015, which focused on accelerating regtech focused business models. It is important to note that the emerging regtech space is not just the domain of new entrant startups, but there already are a few established firms that

provide software, data- anagement and surveillance tools to the regulatory and compliance functions of financial institutions. Some of these firms have solid business models and have been supporting compliance functions for several years.

We are observing three groups of players driving activity in the growing regtech ecosystem and have called these groups the regtech Startups, the Financial Institutions and the Regulators.

THE REGTECH STARTUPS



The Startups represent a growing group of entrepreneurs who are utilising currently available technologies to address specific regulatory compliance 'pain-points' experienced by financial industry participants. What is attracting entrepreneurs to this regtech space and driving the evolution of their business models is the recognition that the financial industry has been spending and will continue to spend very large sums of money on their regulatory readiness.

Despite the multiplicity of startup firms in the regtech space, there appears to be a comparatively lower level of investment in these firms to date, with some estimates stating that only £100 million of total funding has been provided to this market², in comparison to a quarterly investment in fintech of \$5.3 billion in Q1 2016³. Understandably, given the lower level of investment in

startups, many are focussing on specialist products for a single regulatory area, such as regulatory reporting, know your customer (KYC) and market monitoring.

A key issue for some startups, alongside under-investment in their products, is a gap in their banking and regulatory knowledge. The more successful startups ensure that they gather relevant expertise in the complex requirements of financial services firms and the regulatory environment they face early in their product development. This helps to ensure that their technology solution is fit for purpose and flexible enough to meet the myriad of regulatory requirements and expectations. The ability of the regtech solutions to fit alongside often complex and outdated existing banking systems is also a key factor in their success.

² Speaker at regtech summit, September 2016

³ <https://newsroom.accenture.com/news/global-fintech-investment-growth-continues-in-2016-driven-by-europe-and-asia-accenture-study-finds.htm>

THE FINANCIAL INSTITUTIONS



The fintech revolution has forced incumbent financial players to expand their perspective on how the use of digital technologies can improve, or potentially disrupt, current business models. This increasing fluency with new digital technologies and their potential application by bank management teams is enabling a similar movement in the emerging regtech space. It is still early in the 'courtship' between incumbent financial institutions and startups and some have begun the journey of exploration and dialogue which will eventually lead to proof-of-concept experiments and pilot implementations. Recurring feedback that we have heard from these 'early movers' is that regtech startups have been primarily addressing single problems areas. They would like to see regtech solutions that encompass a wider set of related problem areas or even address an entire risk area.

"It is still early days for regtech overall. Interactions between incumbents [banks] and startups have moved past the idea stage and some have started meaningful courtships with relevant startups with their solutions. But it's just the 'third inning' and the industry and regtech propositions will further consolidate and gain sophistication."

Chief Compliance Officer of global bank

THE REGULATOR



Regulators globally are at different stages of evolution in reacting to the emergence of regtech. Some – for instance, the FCA in the U.K. and the Monetary Authority of Singapore (MAS) – are being proactive in providing guidance and assistance to the development of new technologies. For example, the FCA published a 'call for input' specifically on regtech in November 2015. This is in addition to the FCA's ongoing 'Project Innovate' and the Regulatory Sandbox to ensure that providers of new technologies have access to the regulator and are being guided as to the regulatory hurdles that need to be overcome to have a viable product. Unlike many other regulators, the FCA has a mandate to promote financial market competition, and this has been used by the FCA as its catalyst for taking a proactive role in encouraging the development of the regtech sector. Other regulators – most notably in the United States – have been slower to react to the proliferation of regtech products. This potentially causes an issue for regtech firms and for

the regulated sector, as a lack of certainty from U.S. regulators will make international banks more risk-averse to new technologies.

"Regtech has the potential to free up large sums of operational and capital expenditure which are currently spent on compliance. This potentially increases firms' capacity to innovate. That is why we will look to encourage innovation and adoption in technology through our regtech work, working collaboratively to unlock the complexities and costs of regulation in new and creative ways."

Christopher Woolard, Director of Strategy and Competition, FCA

WHICH AREAS ARE GETTING THE MOST INTEREST BY REGTECH AND WHY?

We are finding that the initial wave of regtech business models are utilising currently available technologies such as cloud computing, big data analytics and open API (application protocol interface) to develop solutions that address greater process automation, more sophisticated data mining and greater analytical rigour for regulatory compliance areas. Some regtech startups are also experimenting with newer technologies such as blockchain and predictive analytics/artificial intelligence (AI), but these underlying technologies still have several more developmental evolutions before they achieve a level of maturity that would enable broad commercial application.

In the area of financial crime, the emerging regtech solutions have predominantly sought to reduce the cost of completing **KYC**, streamline **sanctions screening** or provide a more focussed approach to **transaction monitoring**. This is no surprise, with a 2015 report stating that most major international banks each spend between £700 million and £1 billion annually on financial crime compliance.⁴ We believe that targeting cost reduction will continue to be a key driver of innovation in regtech.

⁴ <https://www.bba.org.uk/wp-content/uploads/2015/12/Future-Financial-Crime-Risks-DIGITAL-final.pdf>

The other focus areas for regtech innovation include:

- **Regulatory reporting:** Regulatory reporting requirements are increasing, and the need to provide timely and accurate information is more important than ever. Many financial institutions struggle with this as they store data in multiple systems, and their data management capabilities are poor. We are seeing regtech tools that are able to pull data from multiple systems and perform accurate data cleansing with minimal compliance resource oversight.
- **Employee conduct risk:** Similar to operational risk and surveillance systems, we have observed emerging regtech tools that help identify and monitor staff conduct based on information garnered from a multitude of sources (e.g., emails, internal audit, risk registers, breach logs, customer complaint logs, etc.). This includes enhancing the ability of audit or management to perform various 'look back' investigations and produce meaningful Management Information (MI) for managing staff.

A&M AND THE REGTECH CONNECTION

We believe that technological development in the regulatory sphere will deliver solutions and business models that enable incumbent financial industry players to optimise how they can more efficiently meet regulatory obligations. These new regtech tools and capabilities, together with a more innovative way of thinking, are catalysing a revolution in traditional compliance mind sets to embrace reengineering and redesigning of internal models in order to better meet regulatory obligations.

Alvarez & Marsal (A&M) is leveraging its core strengths in regulatory advisory, process restructuring and knowledge of the regtech landscape to assist clients in thinking through and executing their initiatives in this area.

We are developing diagnostic tools to help clients gain an overview of their current state of regulatory compliance effectiveness and efficiency. A key advantage of the tool is that it includes assessments of the available regtech solutions, that can enable and accelerate improvements to key compliance processes. A&M is also working with regtech startups to refine their use cases and solution approach by leveraging our broad regulatory expertise.

If you would like to find out more about how we can help you navigate through the regtech landscape, please contact us to set up a private briefing.

 Get in touch.

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