

# REGTECH ON THE RISE TRANSFORMING COMPLIANCE INTO COMPETITIVE ADVANTAGE

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Financial services regulation has expanded at an astounding rate since the financial crisis – and, consequently, so has the cost of regulatory compliance. What was once a negligible expense has become a material component of banks’ annual spending.

Hence the emergence of RegTech. Over the past five years, hundreds of start-ups have begun to apply digital technology – including APIs, artificial intelligence (AI) and robotic process automations (RPAs) – to the now numerous and burdensome tasks required to comply with regulations. RegTech promises not only to cut the cost of compliance processes but also to improve effectiveness to make them quicker and more reliable, reducing hassle for customers, and lessening the risk of costly compliance failures.

But the potential of RegTech extends beyond making compliance more efficient. The data and analytic techniques that satisfy regulators’ demands can also deliver commercially valuable insights about customers and markets. Used properly, RegTech can become a source of competitive advantage.

Banks and other Financial Institutions (FIs) are just beginning to adopt RegTech. Some progress has so far been made in using RPA and pattern recognition technologies to improve the detection of internal and external financial crime cases. Biometrics are also facilitating the Know Your Customers (KYC) processes. We expect rapid progress in other areas of RegTech, transforming regulatory compliance and wider risk management over the coming years.

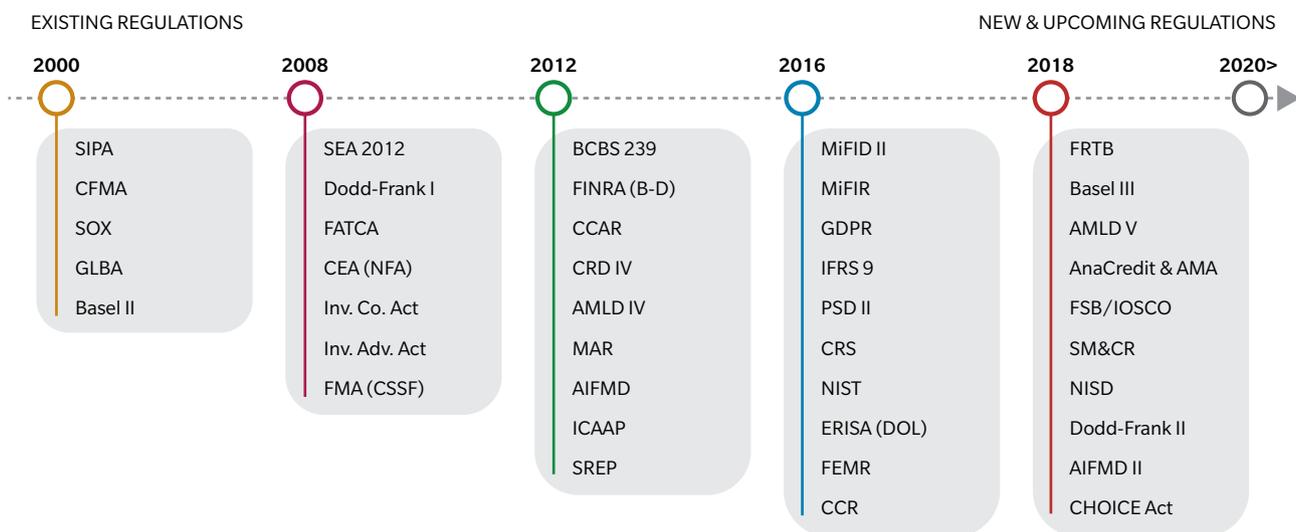
But this progress won’t “just happen”. Bringing about this transformation, and realising the benefits that RegTech offers, will require banks to change their people strategies, augmenting current competencies with the new skills in data and advanced analytics. They will need to become more “agile” in the way they work, and more collaborative, both internally and with third parties, including the regulators, technology suppliers, and even their competitors.

# THE REGULATORY BURDEN CONTINUES TO GROW

Increased financial sector regulation was always likely to follow from the financial crisis. But few could have estimated the extent of it. Ten years on, the wave of new regulation shows little sign of abating (see Exhibit 1). These new regulations concern not only capital and liquidity requirements – the issues arising directly from the crisis – but consumer protection, money laundering, data access, privacy, cyber-crime and much besides. Complying with these regulations and adapting to their strategic implications has become the major preoccupation for CROs, CCOs and the broader C-Suite.

The most direct and obvious effect of this growth of regulation has been on the complexity and as a result cost, of compliance. While headcount in customer-facing roles has been declining, the number of bank staff working in compliance and control roles, which are usually high-paid, has exploded. Oliver Wyman estimates that between 10% and 15% of financial services employees are dedicated to compliance and risk management, with much of their effort devoted to wading through regulation-related paperwork. Since 2008, investment banks’ spending on compliance and control has tripled. In a recent article<sup>1</sup>, the *Financial Times* estimated the compliance costs of the banking industry globally to be \$780 billion, in part because of inconsistencies in national regulations.

Exhibit 1: Increasing regulatory burden



1 *Financial Times*: "Differences in Financial Regulation Cost Businesses \$780bn annually", 12/04/2018

2 *CB Insights*: "The State of RegTech", 20/09/2017

Compliance failures have also become expensive. In the last 10 years, the sector has paid \$321 billion in fines and penalties<sup>2</sup>. And this doesn't count the negative effect of fines on a firm's reputation and on shareholders' confidence.

It is not only financial institutions that are burdened by the more onerous regulatory environment but also their customers. For example, the apparently simple business of opening a bank account has become a much more demanding, complex and often time-consuming process, for consumers as well as banks, as a result of anti-money laundering and KYC regulations. More generally, the compliance costs of banks must ultimately find their way into the prices customers are charged or impact shareholder returns.

In extreme cases, the "regulatory risk" now entailed by some lines of business or customer classes have made banks withdraw from them, with no feasible returns being sufficient to compensate for the elevated risk of penalties. A vivid example is the withdrawal of many banks in advanced economies from correspondent bank relationships in developing economies in Africa, Latin America and the Caribbean – a trend which threatens the ability of small businesses in these countries to engage in international trade.

<sup>2</sup> CB Insights "The State of RegTech", 20/09/2017

# REGTECH TO THE RESCUE

Over the same period that the regulatory burden has grown so rapidly, great advances have been made in robotic process automation (RPA) and information technology. Data storage has become much cheaper and artificial intelligence (AI) techniques for learning from data, heralded for decades, are finally delivering results.

It is a happy coincidence. Applying this “digital” technology to regulatory compliance promises to significantly reduce costs, while simultaneously making compliance processes faster and more reliable. Many of the tasks now performed by slow, error-prone and expensive human beings can instead be done by machines.

For example, the KYC process is already being expedited at some banks by using new ways of checking customers’ identities, including retinal and other physical sources of information. Real-time analytics are being used to improve the speed and accuracy of checks for financial crime and money laundering. And semantic analysis of the communications of staff with high compliance risk, such as those responsible for the Libor scandal, is helping to reduce banks’ compliance risk.

Such advances are set to continue over the coming years. We expect RegTech to help transform financial sector regulatory compliance in four ways.

## Exhibit 2: Four ways RegTech will transform compliance

	AREAS OF REGTECH	HOW IT HELPS REDEFINE THE FUTURE OF COMPLIANCE
1	Technology that allows more efficient methods of sharing information	<b>Alternative regulatory reporting</b> methods including data provision, collection and predictive analytics. Shared utilities via cloud or other online, on-demand platforms. Including capabilities that allow the banks and FIs to communicate among each other, and also with the Regulator(s) thereby eliminating the need for lengthy reviews and investigations.
2	Technology that drives effectiveness by closing the gap between intention and interpretation.	<b>Data ontology standards</b> to enable risk-theme based (e.g. credit risk, misconduct, cyber, fraud) regulatory interpretations, assessment and reporting at a real-time. Reduce / eliminate the need for post-trade surveillance and transactions monitoring including adoption of machine-readable and machine-executable regulations.
3	Technology that simplifies data, allows better decision making and enables cognitive automation.	Alternative, <b>secondary regulatory data architecture</b> with open-source APIs to enable simplified, real-time reporting and decisions. Cognitive automation enables reading and performing risk and compliance tasks. Influence further change to simplify the existing 3LoD operating models.
4	Technology that allows regulation and compliance processes to be looked at differently, proactively.	<b>Holistic digital compliance</b> including data integration, verification and visualisation. Demand for integrated, utility based risk management and reporting covering a wide array of regulations, across both financial and non-financial risks.

However, the most profound change could come from the digitisation of regulation itself. In principle, financial regulations could be written into supervisory systems that banks simply plug into. Compliance would be built into bank processes and adaptation to regulatory change would be automatic. (However, this can only work where regulation is based on strict, objective rules. Where it is principles-based or subjective – specifying, for example, that customers be treated “fairly” – human involvement will always be needed.)

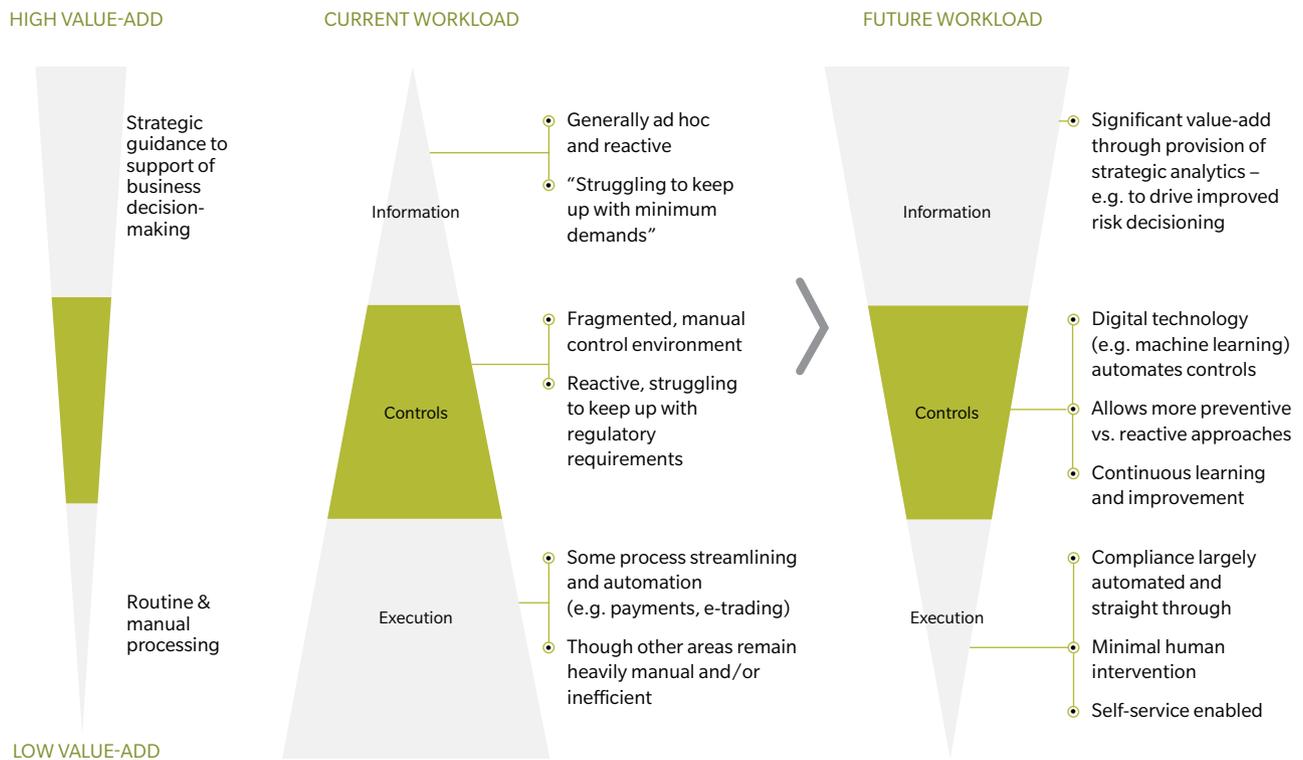
RegTech can do more than radically improve the efficiency of compliance. The data and analysis required to satisfy regulators’ demands is also valuable for making business decisions. For example, they can be used to identify not only customers who are potential money launderers or fraudsters but who are likely to default on loans, run large deposit balances or otherwise behave in ways conducive or detrimental to the bank’s profits. This technology can also help a bank understand where “macro risks” are emerging – for example, from political or economic developments in countries where it has exposures – thereby informing not only tactical but strategic decision making.

# MOVING TO REGTECH

Five years ago, the broader FinTech sector was capturing the imagination of investors and boardrooms. But RegTech was viewed as a niche enabler of client-facing solutions, and not its own investment category. Fast forward to 2018, and RegTech is coming of age. As with other areas of FinTech, progress has been led by start-ups. Between 2013 and 2017, \$5 billion was invested in RegTech startups through 585 deals. Thirty-three deals invested another \$533 million in the first quarter of 2018<sup>3</sup>.

This investment means that the RegTech is almost sure to continue advancing. But banks cannot rely on the technical progress of start-ups alone. Adopting RegTech and getting the most from it will require banks to make progress of their own.

Exhibit 3: How RegTech will change the compliance workload



3 Fintech Global, April 2018

They will need to improve their data environments, which still impede the use of advanced analytics. This will usually entail moving data to the cloud. The information security protocols of most cloud service providers comply with the leading regulatory frameworks. And they allow for the rapid scalability and reconfiguration required for effective use of RegTech.

Adopting RegTech will change the kind of work done at banks (see Exhibit 2) and, with it, the kind of staff they need. The many standardised and relatively low-level roles now employed in compliance and control will need to be replaced by fewer data scientists and systems engineers, the latter being acquired either by recruitment or retraining.

And banks will need to collaborate more effectively, not only with the specialist firms that supply the technology but with the wider industry. Acting alone, banks can use RegTech to reduce their compliance costs. But the greatest gains will be delivered by digitisation of regulations themselves and their integration into the fabric of financial services. Moving towards this goal will require an unprecedented collaboration between banks and their regulators, not only on their data interfaces but on the nature of banking regulation itself.

# IMPLICATIONS FOR FINANCIAL SERVICES?

Adopting RegTech will require most to change their business practices and cultures and, to acquire additional skills in data science. This is a long-term effort but financial services firms can take steps now to start moving in the right direction:

- **Secure executive buy-in:** Establish digital and innovation executive-mandated top priority for the organisation
- **Mobilise a digital measurement team:** Create a team that will prioritise, monitor, assess, and measure the innovation pipeline based on value generation
- **Adopt an incremental approach:** Use an iterative method to tackle complex challenges such as data quality and accessibility issues
- **Learn from previous initiatives:** Implement a mechanism to understand and share lessons learned from previous digitisation programs.
- **Launch a cultural change campaign:** Embed a culture of innovation and digital augmentation.
- **Create a digital and innovation working group:** Identify a diverse and cross-functional group of stakeholders that will meet regularly to drive efforts forward

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