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RegTech:

A Technology-first Approach to Regulatory Compliance

An RPG Company

Introduction

The banking and financial services (BFS) industry, despite being heavily regulated, is always under constant and intense scrutiny. Historically, the industry has experienced several crises that have given rise to rigorous regulations. The sub-prime crisis of 2008 was a significant milestone that pushed governments and regulatory bodies to impose stringent regulations globally. This crisis paved the way for Dodd-Frank Act, Basel III, European Market Infrastructure Regulation (EMIR-EU), Current Expected Credit Loss (CECL), and Consumer Protection regulations. These directives play an important role in mitigating the impact of financial market failures. They also improve the stability of markets and protect investors. The market's ability to sustain and bounce back post the COVID-19 pandemic is largely attributed to the industry's regulations.

Though regulatory compliance is a safety net for the BFS industry, the need to remain compliant is a huge overhead that requires continuous investment.

Evolving regulations indirectly necessitates firms to upgrade their infrastructure with the latest technologies since many legacy systems aren't customizable to accommodate such changes. It forces firms to not only modernize their systems at a significantly higher cost but also demands highly skillful resources for implementation and support. Managing regulatory compliance has become a unique business opportunity in itself. Regulatory technology or RegTech has tapped into this market in the current technology-driven solutions era.

RegTech harnesses technologies such as artificial intelligence, machine learning, blockchain, automation, and analytics to improve regulatory governance, fraud detection, and reporting. RegTech firms help the industry strengthen compliance, reduce costs, and mitigate risks. They hold the potential that could significantly transform the industry.

In search of regulatory efficiency: Making the leap from FinTech to RegTech

The term 'RegTech' was coined by the UK's Financial Conduct Authority (FCA) in 2015. It was defined as – "A subset of fintech focusing on technologies that may facilitate the delivery of regulatory requirements efficiently and effectively". RegTech aims to develop advanced technology solutions to make firms compliant with regulatory requirements cost-effectively. RegTechs provide a specialized service to multiple firms at a time resulting in savings in terms of infrastructure, logistics, and resource overheads. The subject matter expertise provided by RegTechs help remove ambiguity and misinterpretation of regulations, thereby reducing cost in the form of penalties due to errors and delays.

Key drivers in adopting RegTech

Cost of Compliance & Penalties

Deloitte[1] reported that operating costs for compliance have increased by over 60 percent for retail and corporate banks. For instance, after the passage of Dodd-Frank Act banks' non-interest expenses have increased by an average of more than $50 billion per year[2]. Non-compliance weighs down heavily on the firms in the form of hefty penalties. A study shows that non-compliance costs 2.17 times[3] more than the cost of compliance.

Resource Overheads

Regulatory reporting and compliance activities are labor-intensive, time-consuming, and redundant due to the sheer volume and intricate nature of data. An estimated 10-15 percent of a financial institution's workforce[4] is dedicated to regulatory and compliance requirements.

Reporting Errors

Rapid digitalization creates an explosive amount of data that requires complex processing to generate insights. However, large volumes and increasing complexity of data substantially increases the margin of error for financial institutions.

Interaction Monitoring

The pandemic-infused lockdowns hampered face-to-face interactions between bankers/advisors and clients. As a result, they were forced to seek alternate channels of communication. This made the traditional methods of interaction monitoring unviable and the scrutiny of client communication for malicious practices unfeasible.

Evolving Regulations

The amount of regulations governing the financial markets have been growing exponentially. Firms have been facing an uphill task in implementing these new regulatory changes and remaining compliant. Bain & Co. estimates that compliance accounts for 15-20 percent of 'run the bank cost', and 40 percent of 'change the bank cost'.

The cost of compliance and the case for RegTech

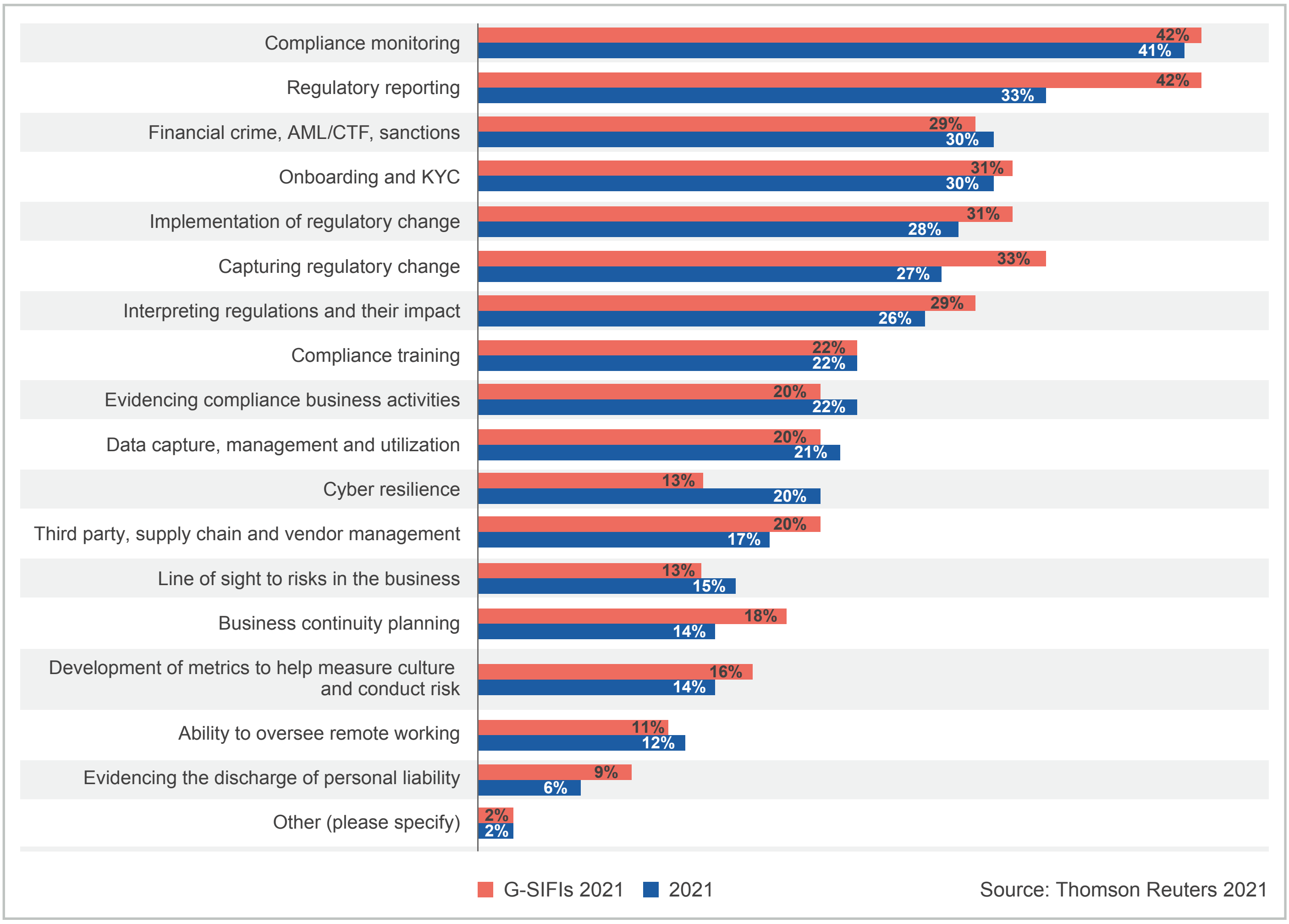
- Total cost of financial crime compliance in global markets totaled $180.9 billion
- Non-compliance costs 2.17 times more than compliance
- Operating costs have increased by over 60 percent for retail and corporate banks
- Non-interest expenses for banks have increased by an average of more than $50 billion per year
- Regulatory compliance accounts for 15-20% of RTB cost and 40% of CTB cost
- Nearly 15 percent of the workforce is aligned to ensuring regulatory and compliance alignment

Benefits of RegTech for financial institutions

Financial services is vulnerable to money laundering, financial fraud, cybercrimes, etc., making the risks sizable for investors and the industry. Wealth managers, advisors and bankers have also been subject to audits, trade surveillance, gift and entertainment request disclosures, political contributions, and others. There have been several historic instances in the past that have shaped the regulations and vigilance for financial institutions from time to time. These regulatory frameworks can never be static and will undergo constant transformation with evolving market dynamics and emergence of new technologies.

Many financial firms lack the expertise, infrastructure, and resources to adhere to these transforming regulatory frameworks. Firms can now outsource critical regulatory compliance activities such as KYC/AML checks, trade monitoring, data protection, customer interaction monitoring, regulatory reporting, market abuse surveillance, identity management, and cybersecurity to RegTechs. They can benefit from substantial cost savings and also elude penalties due to accurate reporting and timely compliance.

According to a 2021 survey by Thomson Reuters, compliance monitoring, regulatory reporting, and financial crimes were the three key areas where firms were expecting disruption by RegTechs.



Fintech-regtech-and-the-role-of-compliance-in-2022.pdf (thomsonreuters.com)

Choosing the right RegTech provider

Evaluating RegTechs can be a daunting task. It is imperative for financial institutions to perform their due diligence before choosing the right RegTech partner. There is a huge cost and effort involved in integrating with RegTech providers and the cost of choosing the wrong partner can prove detrimental. Financial firms must evaluate the RegTech service providers across various dimensions:

Capabilities	Features such as KYC/AML checks, trade monitoring, data protection, regulatory reporting, market abuse surveillance, identity management, etc.
Seamless Integration	Integration with the current client onboarding, core banking, payment, order management, accounting and reporting systems
Scalability	Capacity to handle increasing number of clients/transaction
Adaptability	Ability to incorporate new regulations and modifications to existing regulations
Data Privacy	Credibility, coverage, and integrity in handling the firm's data
Implementation Support	End-to-end support for integrating the RegTech into the firm's ecosystem
Interoperability	Interoperability with existing business process, system and application
Cloud Capabilities	Ability to elicit and store data from the firm's front, middle and back office operations and the capacity to perform complex computations
Time to Market	Quick turnaround time for implementation of current (and future) rollouts
Security Standards	Security and control mechanisms in line with the financial institution's standard operating procedure
Future Enhancements	Probability that future enhancements of the RegTech will continue supporting the firm's strategic business and technical direction
Business Continuity	Robust infrastructure to ensure business continuity and a resilient disaster recovery plan in the event of an adversity

The RegTech growth story is just starting to unfold

The global investments in RegTech has tripled over the last five years, and this trend is likely to continue. The global RegTech market is expected to grow to $19.5 billion by 2026, at a CAGR of almost 21 percent from 2021[5] . There are reportedly over 600 RegTech firms across the globe currently, offering services in five key areas – profiling and due diligence, reporting and dashboards, risk analytics, dynamic compliance, and market monitoring.[6]

In the last couple of years, investments in RegTechs have significantly grown. Listed below are a few interesting acquisitions:

- Nordic Capital, a leading private equity investor, acquired Bearing Point RegTech to provide professional services in the regulatory value chain.
- Wealthtech company, Orion Advisor Solutions, acquired BasisCode Compliance to strengthen its compliance technology offering.
- Moody's Corporation acquired two RegTech companies — compliance automation platform, PassFort, and an onboarding technology developer, 360kompany.

The investments in RegTech and its projected growth indicate that RegTechs are here to stay. The relevance of RegTech in the financial landscape is undeniable, given the high costs of non-compliance and existing operational inefficiencies. RegTech solutions will help firms in being compliant and accelerate the speed of reporting, minimize financial fraud, increase accuracy, and reduce costs.

The road ahead for RegTech

Existing regulations will constantly evolve, and new regulations will be introduced to safeguard investors and the industry. Technology will play a key role in achieving compliance and fueling investment in data science, information systems, and digitization. Partnering with RegTechs will relieve financial firms from investing heavily to address changing regulations and in keeping pace with the latest technologies.

RegTech solutions can be seamlessly integrated with the existing IT infrastructure of firms. Consumer verification apps driven by AI can be leveraged by financial institutions to aid the KYC process. ML based algorithms help in keeping a tab on customer interaction to prevent fraudulent practices. RegTechs also harness blockchain technology to store immutable records of transactions and track the money trail, thereby facilitating AML checks.

RegTechs will proactively pave the way for firms to be regulatory compliant. Financial firms will no longer have to bear the burden of deploying time, money, and resources to understand regulations, and develop and implement compliance solutions. By choosing the right RegTech partner, financial firms can gain freedom from the extensive activities of handling regulatory compliance internally.

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