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Regtech 2020 and Beyond – What Does the Future Hold?

by Gareth L. Evans and John B. Mason

Technology is undoubtedly changing the way many industries operate, with old functions being eliminated or automated for more efficiency, and new delivery channels emerging that allow companies to interact with each other and their customers in ways not imagined even a decade ago.

This is truer than ever before in financial services; perhaps no other industry has been affected as much by the technology innovation of the last five to ten years. And being arguably the most heavily regulated industry, it’s no surprise that firms are leaning on technology as a prime vehicle to help deal with the myriad of regulatory compliance functions necessary to run the business and stay in regulators’ good graces in an efficient and cost-effective manner.

That’s why regulatory technology (or “regtech” as it has become known) was one of the hottest topics for compliance and risk officers over the past year, and will remain a focus for compliance professionals in 2017. The need to identify whether planned business strategies will be flawed or possible to execute while remaining compliant will be of extreme importance in the coming year. Regtech will continue to evolve as financial firms grapple to stay compliant with new and existing regulations. With this trend gaining momentum, it’s of the utmost importance to understand how regtech will change your business now and in the future.
The Rise of Regtech

The cost of compliance continues to rise for financial firms. Some estimates pin the cost of governance, risk and compliance at 15-20 percent of the total cost of running the business at financial firms. That’s nearly one-fifth of an entire firm’s budget just to stay in business and avoid fines from regulators.

That’s where regtech comes in, providing firms with technology to reduce costs associated with compliance and the ability to run compliance operations more efficiently. Streamlining onerous processes by utilizing regtech allows organizations to maximize time spent on value-added projects rather than time-consuming assignments.

Additionally, regtech permits the removal of one easily mitigated risk – the human element. Technology can reduce exposure to the risks human interactions produce, permitting organizations to automate compliance without relying on individuals. Instead, human expertise is free to be better utilized in interpreting data rather than collecting it.

With better data mapping techniques, regtech compiles non-standardized data to create a single view of the risks inherent within organizations as well as produce the information regulators seek. Indeed, regtech solutions offer the promise of making compliance less complex and freeing up more capital to be spent on other more productive uses.

But not only can regtech help firms mine massive amounts of data in order to deliver the right information to regulators quickly, it can also help reduce the amount of data they need to hold overall. All the information required for regulatory compliance often overlaps; a piece of information on a trade or customer may potentially be used to satisfy multiple regulations. Condensing this information and creating ease of accessibility will help bring great efficiency gains, and will be greatly needed given the ballooning amount of regulations globally.

“The ambitious regulatory reform agenda implemented after the financial crisis has closed loopholes in the financial regulatory framework, but has also significantly increased compliance costs of financial institutions,” writes the Institute of International Finance in a report on the subject. “In an uncertain macroeconomic and financial environment, applying regtech could make an important contribution to increasing the profitability and efficiency of financial institutions, while improving their effective compliance with financial regulations.”

Data privacy regulations increase the need for regtech.

We have already seen an increase in data privacy laws and new regulations around security as cyber attacks against financial firms become more frequent and larger in nature. The European Union has updated its Data Protection Directive – originally written in 1995 – to take into account technology developed since then and is set to be implemented in 2017.

Under this updated regulatory statute, “any company or individual that processes personal data will be held responsible for its protection, including third parties such as cloud providers.” This means that any party that touches or has access to consumer data, wherever they are based, is responsible in the case of a data breach. This is especially important for financial firms, which – perhaps outside of government entities – hold the most personal data of any industry.

Not only must the firms themselves protect this data, but the many third parties and vendors they work with must do so as well. Violating this regulation comes at a hefty price. Companies face fines of up to four percent of their global turnover from the EU if found guilty of flagrantly breaking the rules.

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Institute of International Finance
The EU’s new, more stringent rules are hardly unique or an isolated occurrence. In response to the increase in digital interactions and the importance of keeping data safe, we are witnessing a massive increase in the amount of data protection regulation and laws around the globe.

A number of countries in Asia have started to adopt similar laws on the protection of personal data. Such laws will affect how companies collect and use data from individuals in Asia and how that data can be transferred out of the jurisdiction from which it is collected. According to international law firm Bryan Cave, only Australia and New Zealand have been deemed by the European Commission to have adequate safeguards in place for the transfer of data from European member states. As such, the Asia-Pacific Economic Cooperation (APEC) in recent years has adopted a privacy framework to encourage the development of data protection policies and laws.

In the United States, new measures such as 2014’s Personal Data Protection and Breach Accountability Act are aimed at mitigating the vulnerability of personally identifiable information to theft through a security breach. Measures such as these enable timely post-breach alerts and remedies for consumers, hold companies accountable for preventable breaches and make it easier for companies to share technical information after a breach occurs. These measures also strengthen criminal and civil penalties for the unauthorized collection or use of personally identifiable information.

Complying with these regulations will become even more challenging as financial firms sharing data becomes more common.

The concept of knowing your data can help particularly regarding the myriad of new customer data laws. Many of these new regulations require similar information, just in different jurisdictions around the globe. Understanding the commonality of data across disparate geographies and how they apply can place firms miles ahead of their competitors.

And although it will be challenging to comply with these and other new regulations forming globally, organizations should note that many of these items may have been addressed by older regulations, thereby reducing the need for a full overhaul of their current compliance programs or massive investment to comply with the newest regulatory requirements.

In addition, many firms have already taken steps on their own to drive and develop the compliant behavior necessary to create organizational reform within their business. Thus, if regulatory compliance is well managed and linked to broader risk management activities, then only incremental changes will be necessary in order to mitigate risk.
Regtech can also be essential in helping financial firms comply with several new regulations. These include:

Markets in Financial Instruments Directive II (MiFID II)

MiFID was originally applied in the UK in 2007 and is currently being revised to improve the functioning of financial markets in light of the financial crisis and in order to further protect investors. Extending the transparency regime that was created for equity instruments in the original directive, the revised legislation (MiFID II) will apply from January 2018. It represents a fundamental change for financial markets across a multitude of areas, requiring not only a major implementation effort, but also a reassessment of business models.

This updated directive will change business models and processes for market operators drastically. While it was created by European regulators, it will have a global impact affecting anyone doing business with European customers and firms. Among other things, firms will have to provide exhaustive detail to regulators around their efforts made regarding transparency and how they fulfill execution orders.

The 500-plus pages of technical standards with which firms must become compliant when the directive goes into effect are daunting. However, by partnering with companies that have both the technology and expertise in this area can help make this a much more manageable task. Capabilities such as real-time analytics, sophisticated alerting and increased automation will help firms avoid being buried under a mountain of paperwork.⁵

Fundamental Review of the Trading Book (FRTB)

This provision of the Basel Committee on Banking Supervision pertains to capital requirements for large, internationally active financial firms. It’s seen as something of an update to the Basel III capital requirements; indeed, some are already calling it “Basel IV.” Among the notable changes being introduced by this new provision are higher capital requirements and a stricter separation of the trading book and the banking book. This measure is intended to reduce the possibility of arbitrage between the two books and to ensure a more consistent application across banks. Banks using either standardized or internal models “will need to review their portfolios to determine whether existing classifications of instruments and desks as trading book or banking book are still applicable or whether a revision of desk structure is required.”⁶

Financial institutions will need access to more data and stronger data analytics to meet these new risk management and reporting requirements. According to an analysis from PricewaterhouseCoopers (PwC), the FRTB is pushing banks to calculate their capital requirements with a regulator-approved standardized approach, moving away from the trend of each institution using an internal model. This will impose new reporting requirements, including monitoring market risk on an intraday basis and measuring market risk capital at the end of the previous day. Furthermore, PwC states, “banks that continue to use internal models face even stricter requirements, as they have to report risk capital under both the standardized and internal model-based approach. These banks will also have to report their key modeling assumptions to regulators in order to facilitate a better understanding of the variations between standardized and internal model-based results.”

The Basel Committee is calling for the adoption of the FRTB by January 2019, leaving financial institutions with little time to implement the technology and robust analytics capabilities needed to remain in compliance.

EU General Data Protection Regulation (GDPR)

Another regulation aimed at safeguarding the storage and transfer of client data, the GDPR becomes effective May 2018. The GDPR is designed to harmonize data privacy laws across Europe, protect citizens’ data privacy and reshape the way organizations across the region approach data privacy.

In order to comply with the regulation, companies will have to be able to access a single, universal view of data sources; this means consolidating existing data tools to get an enterprise-wide view of data. Firms will also need to rely on automation to track data and apply the appropriate rules when it comes to client personal data and data sets. Companies that aren’t utilizing technology to do this will surely be at a grave disadvantage in complying with the GDPR.

Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation

The PRIIPs regulation is yet another that has arisen from the ashes of the financial crisis aimed at protecting retail investors. Its goal is to make it easier for retail investors to compare products, thereby increasing customer value and compelling firms to consider how a distilled uniform product description will impact how their products fare.⁷

Among other things, financial firms will need to meet the technical requirements for producing Key Information documents, short and standardized documents that will communicate all relevant information about a PRIIP to retail clients.
Conclusion

What does the future hold?

With the rapid pace of change, firms need to be equipped to handle not just today’s many regulations, but also the ones that will come up in the next five years and beyond.

There are several common themes throughout the regulations discussed here that will have an impact on how financial institutions are able to deal with them. First, it’s obvious that regulators want more data, and faster than ever before. They want to know how firms make investment decisions, how they ensure protection of customer data and what they are communicating to clients.

Financial companies will need robust data analytics tools to process and mine the massive amount of data they store to give regulators what they want, when they want it. And they will need knowledge and insights on their data, which, as we have discussed, can not only improve efficiency, but also lower costs and set firms up much better to deal with future regulatory requirements that are coming down the pike.

It’s also obvious that the manual paper-based processes that constitute much of regulatory compliance must be automated. The sheer amount of data being dealt with means that humans performing these tasks will simply be overwhelmed, increasing an organization’s exposure to risk. Using technology to automate paper-based processes will be essential in not only mitigating risks but improving the use of human capital.

Regtech will be indispensable for firms going forward. Not only will it help cut down the ever-increasing costs of compliance, but it will also provide an edge over competitors who have yet to invest in technology to maximize efforts in this critical area.

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