FINASTRA

MARKET COMMENTARY

The Ballooning Cost of Regulatory Compliance — Regtech to the Rescue?

After rising for several years, Opimas expects Regtech spending to plateau through to 2019 at USD7 billion annually. As regulatory deadlines are met, 2020 will see a wave of improvement projects and increased spending.

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The often manual, stop-gap approaches currently required to meet regulation deadlines will be replaced by higher quality, sustainable solutions that require far fewer people to run reliably. The focus for financial institutions will shift from a mad rush to comply with new regulations to a greater emphasis on leveraging technology to reduce the overall, people-intensive cost of compliance.

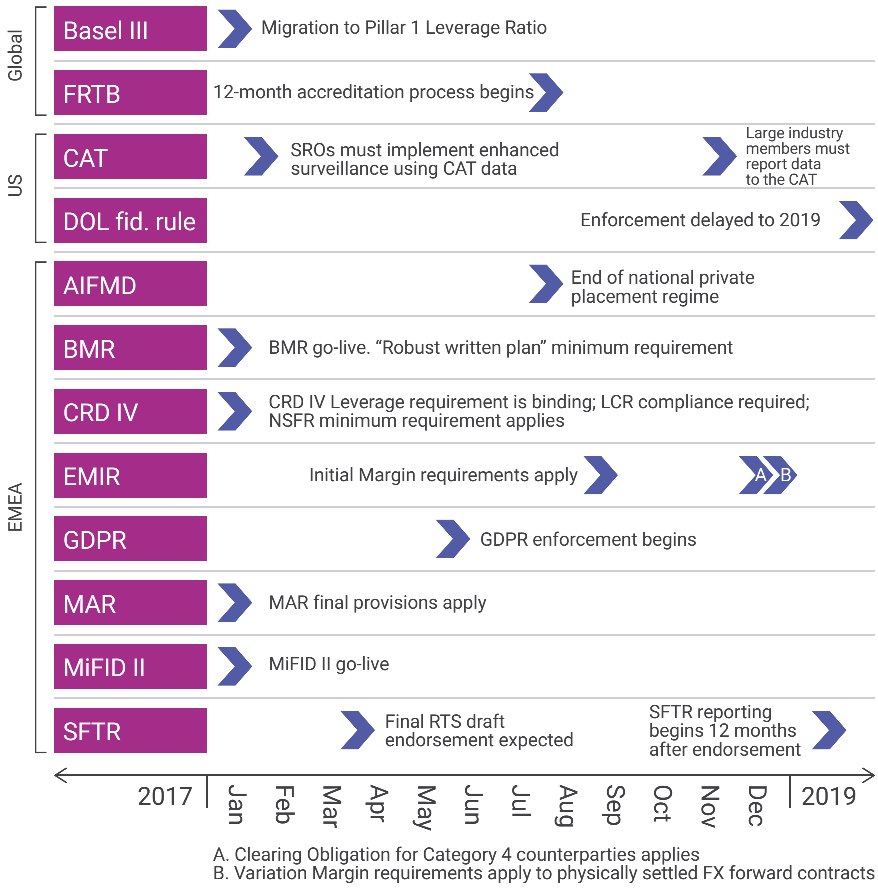
Upcoming Regulations

The pace of new regulations has been particularly intense in Europe, with a plethora of major new regulations going live in 2018. In the US, there are some initiatives, but generally speaking, there is a trend towards lighter regulation and enforcement, a reflection of the policy of the current administration.

In Europe, with the race for the second Markets in Financial Instruments Directive (MiFID II) compliance nearly complete, other regulatory activity still abounds. The General Data Protection Regulation (GDPR) came into effect on May 25, 2018, dramatically changing the privacy considerations organizations must take when handling the European Union's citizens' data. The Securities Financing Transaction Regulation (SFTR) also promises to challenge a broad range of market participants. With the regulatory schedule still snowballing in complexity, there is little room for complacency.

THE FUTURE OF FINANCE IS OPEN

2018 Global Regulatory Timeline*



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Upcoming Fines

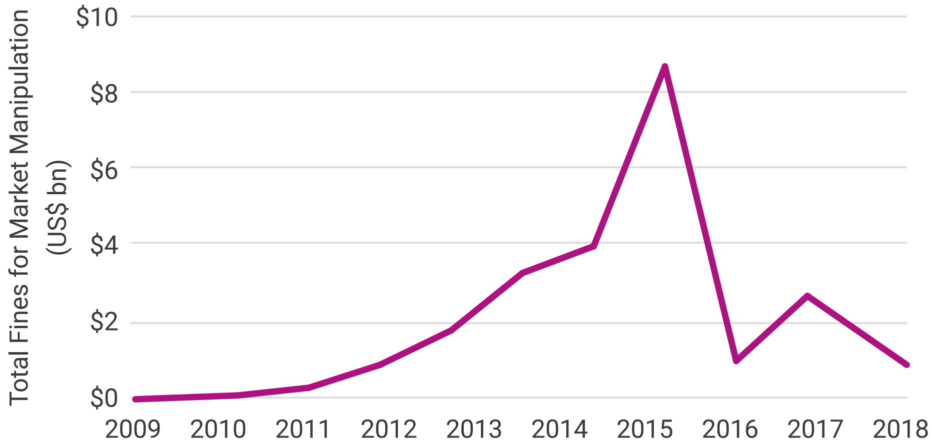
2015 represented a high-water mark in the number of fines for failures to sufficiently monitor for market abuse. While the levels of fines are unlikely to reach these eye-watering sums in the next year, we expect a broader array of smaller fines to be meted to a wider set of market participants.

But where do folks expect fines to come from in the next year? One particular area to pay attention to will be the new requirements made of firms using algorithmic trading strategies. Through MiFID II, these firms are now required to disclose their algorithms to the regulator, test them in an approved environment, and abide by stricter staffing requirements. By increasing the compliance burden on these market participants, this regulatory requirement could jeopardize an already fragile business model and lead to a further decline of volume among these players. In addition, noncompliance may well leave these firms vulnerable to significant regulatory fines.

Another area where we expect to see significant fines delivered in the coming years is for failures to adequately ensure investor protection. MiFID II also expands these investor protection requirements. For product governance, firms will need to undergo strict stress testing of products and share detailed information with clients on each instrument under consideration. They will need to demonstrate a client’s suitability for each potential sale, and document that sufficient efforts have been made to place the investor’s interests first. Special attention should also be paid to the hot and cold tale of the Department of Labor’s fiduciary rule in the United States. If eventually enforced, this will contribute to future fines.

*Source: Opimas Analysis, FCA, ESMA, FINRA, SEC, EBA, European Parliament, ECB

Fines for Market Abuse*



After peaking in 2015, fines for market manipulation dropped steeply in 2016, with the SEC in the US, as well as the FCA in the UK, sharply reducing their enforcement actions.

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MiFID II also extends the ban on inducements, in all forms, from third parties to include portfolio managers, and furthers the unbundling of research, creating further possibilities for fines in the coming years. Indeed, the Financial Services Authority (FSA) in the UK has made the enforcement of MiFID II a major part of its strategy for the coming year.

Regtech Spending and Compliance Headcount

Over the course of the past several years, there has been a bewildering array of new regulations that financial institutions have had to comply with. This has led to a ballooning of compliance staff to deal with reporting requirements, trade and communications surveillance, ensuring investor protection, and addressing general conduct within the firm. While these compliance costs have shot up, the major cost component has been additional staffing. IT investments in this space, regtech, have lagged, as investment firms have found it difficult to automate compliance processes that are often poorly defined by regulators and frequently change. Interpretation of regulations often takes years, leaving firms reluctant to invest in expensive technology. Even the regulators do not "know" the direct meaning of some of these rules.

We expect to see a steady increase in regtech spending as of 2020, as firms move to automate compliance processes that are currently handled manually by compliance staff, as financial institutions aim to use technology to reduce the headcount in their bloated compliance departments.

The human surveillance of voice interactions via random sampling of recordings at a call center is a glaring but all-too-common example of these manual interventions. Over the next few years, firms will begin investing in technologies that can reduce the dependence on such people-intensive approaches. In terms of voice surveillance, improvements may be achieved by enabling automated voice to text transcription and then layering natural language processing that surfaces the voice communications deemed most risky for further human analysis. This would be a vast improvement over the truly random and limited sampling currently happening across capital markets.

*Source: Regulators, Press, Opimas Analysis

ML also holds immense promise for confident closure of suspicious activity alerts that reliably do not require further compliance's attention.

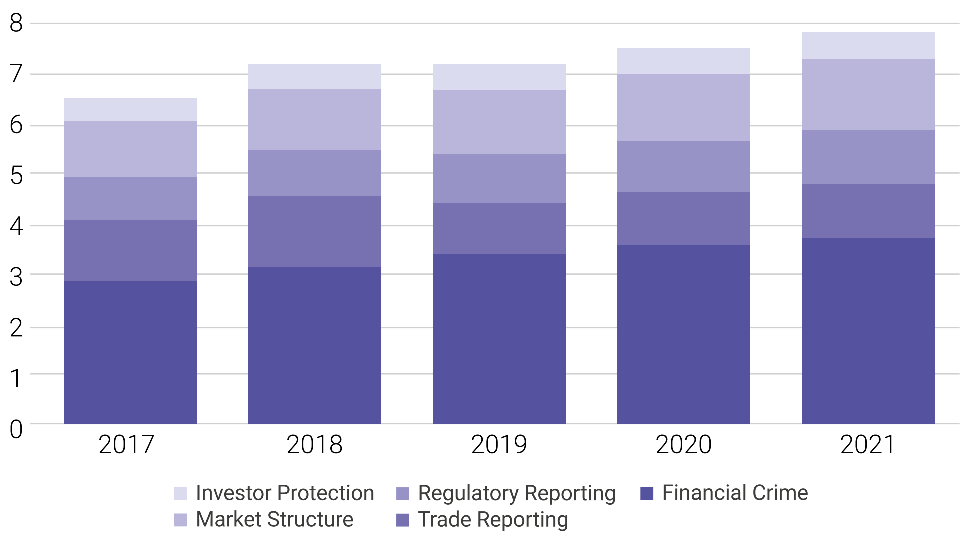
AI in Regtech

Much of this regtech spend from 2019 onwards will aim to make use of Artificial Intelligence (AI) techniques to improve scope and quality of compliance efforts, also enabling reductions in headcount, which should be visible as of 2020. Regtech investments would ideally provide an infrastructure that is flexible enough to deal with new regulations as they appear and would also provide some business advantage above and beyond simple compliance. For example, in trade and communications surveillance, we have seen firms use the voice recordings gathered to perform sentiment analysis, and to use the transactional data required for trade reporting to perform more detailed execution analysis.

Machine Learning (ML) also holds immense promise for confident closure of suspicious activity alerts that reliably do not require further attention from compliance teams. However, a black-box AI solution that closes suspicious alerts without explanation will not hold water at the moment, where clear audit-ability and justifications of alert management decisions are required by regulators.

A key challenge in applying AI and ML techniques to false alert reduction is that these methods require copious historical data points from which to learn and with which to improve algorithms. While regulators have data for previous market misconduct, including, in many cases, related behaviors and communications, this is often insufficient. Building the necessary databases may well take several years before AI techniques can be effectively applied.

Regtech Spending in Capital Markets*



Regtech spending will plateau in 2019 once MiFID II implementations are complete. Subsequently, spending will increase again, as financial institutions turn to regtech to automate manual compliance processes.

*Source: Opimas Analysis

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Looking Forward

Rationalizing otherwise isolated surveillance and reporting systems can also vastly improve the ability of compliance officers to quickly investigate alerts and automate the submission of reports. Where these channels are stored in siloes and coverage is incomplete or inaccessible, delivery of surveillance and timely reporting is still slow and spotty.

Those firms who continue to rely on manual, people-intensive compliance, will struggle and put themselves at risk for fines. As a whole, the market will prioritize meeting regulatory demands in the coming 18 months, and then begin investing in IT to tackle inefficiencies and weaknesses present throughout their compliance infrastructure.

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