TREXIN INSIGHT PAPER

December 6, 2018

COMPLIANCE REPORTING EVOLVES THROUGH TECHNOLOGY

Technology's effective impact on streamlining your institution's reporting process.

The regulatory environment enforced upon financial institutions continually struggles to keep up with modern technology and societal economic shifts. While viewed by many as a necessary evil, regulations are often thought by corporate financiers as a largely unpleasant, archaic burden. Banks have entire divisions of people and systems dedicated to compliance reporting, legislation management, public policy knowledge-sharing, and fulfilling (complying) legal obligations to public sector directives. The immense human capital and technology efforts banks employ to deal with the ever-changing regulatory environment makes up a considerable amount of internal and overhead cost. In 2017, it was estimated that 10% of all firm revenue is expended towards compliance issues.[1] **These costs continue to grow but, in many cases, are being divaricated and lessened through the implementation of programs and technology that directly deal with the streamlining and data gathering elements of compliance reporting. This is the power of the new Regulation Tech universe.**

New regulatory policies are often reactionary to economic events, consumer backlash, or weaponized as a political penalty against an institution. Current attitudes and standards towards compliance can evolve, however. We are now seeing banks and other financial services institutions taking a more proactive and prepared attitude towards compliance by finding ways to optimize their reporting and transparency. Banks are currently executing new technologies and platforms that can automate responses to new regulations and are even using data analytics to scope and determine best business practices to keep compliance at bay. In some cases, these radical changes have further embedded compliance standards within their institution's rapidly altering but dynamic financial technology ecosystems and internal operations.

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As of 2018, banks are spending approximately $270 billion a year on compliance-related costs. Settlements, enforcement actions, and fines are reaching $321 billion a year. More strikingly, however, is the fact that 70% of firms in a Thomson Reuters study indicated the focus on managing regulations will increase over the coming year and the costs have the potential to double over the course of the next five years into 2023.[2] On the fixed-income side, many firms have to spend a considerable amount of time away from their clients and more with interacting alongside the in-house compliance team. "Some 94 percent of the 46 sell-side traders participating said they're spending more time speaking with compliance," a recent study Greenwich Associates noted.[3] In Europe, fixed-income traders and servicing banks are dealing with the new MiFID II (Markets in Financial Instruments Directive) rules which require the seller to demonstrate they executed trades for the clients at the best prices and in the right venues. Tracking these requirements

[1] https://www.fnlondon.com/articles/compliance-costs-to-more-than-double-by-2022-survey-finds-20170427

[2] https://risk.thomsonreuters.com/content/dam/openweb/documents/pdf/risk/report/cost-of-compliance-2017.pdf

[3] https://www.bloomberg.com/news/articles/2017-11-29/banks-are-spending-20-billion-on-compliance-tech-as-mifid-looms

in Europe will require the automation and processing power of computers. Compliance has pushed fixed-income toward utilizing new technology and banking's approach to MiFID II will be one of the first back-end business adaptation tests.

Companies, such as BearingPoint, Abide Financial, NEX, Tradecho, and FIS Global, offer entire software suites of technology to deal with banking regulations and compliance. Fair Lending, HMDA (Home Mortgage Disclosure Act), CRA (Community Reinvestment Act), and privacy laws all have the ability to be tracked and quantified for reporting purposes. Financial institutions must take the initiating steps towards implementing new software ecosystems and supplementing technical and project management expertise with the intention of meeting and anticipating any new compliance and regulatory changes. Once these systems are in place, the potential to utilize their data mined information is compounded through external/internal reporting needs, financial forecasting, human capital placement, insight research, lobbying, and even academic research.

In addition to what we are seeing on the fixed-income front, money laundering and financial crimes is another area of compliance that has potential to drastically alter through the influence of technology. The annual cost/loss of money laundering crimes in the U.S. alone ranges from $500 billion to a trillion dollars a year. Nearly half of this amount is expected to touch at least one U.S. bank during the laundering process. The professionals and systems in place to track these crimes require varying degrees of repetitive and monotonous data scanning and research to pinpoint abnormalities. However, improvements and progress within the AI sphere has the potential to cut back labor hours and allow professionals to re-dedicate time towards more valuable initiatives, such as insight building for senior leadership and managing communications infrastructures and rules to better combat financial crimes. With machine learning capabilities, AI and other technologies can conduct rapid due diligence and screening. By discerning between immense amounts of complex data or automating repetitive tasks, AI lets humans redirect their efforts towards decision-making and prioritization of perceived financial crime.

On a final compliance front, technology can be used to analyze complex trading relationships and strategies, as well as patterns and communications between banks, exchanges and wider market participants. It is also capable of monitoring internal conduct and communication to clients using quantitative metrics such as supervisory input—which will be even more critical under new transparency obligations. As AI relies on computer-based modelling, scenario analysis and forecasting, it can also help banks in stress testing and risk management. When dealing with financial regulations, it can simplify the complexity given the multitude of different jurisdictions, products, institutional differences and enforcement mechanisms. **And when algorithms that drive AI are supported by human consultants, the systems can "learn" faster, delivering a wider synergy of capabilities.** More practically, banks can deploy AI to analyze huge volumes of conversations from phone recordings, chats and emails using voice- and text-analysis algorithms to determine unusual employee behavior. Further analysis of these conversations can help identify potential market manipulation and collusion activities. It can help banks prevent not only accidental trading errors (or "fat finger" trades) but also deliberate ones—avoiding damage to that all-important reputational risk.[4]

Financial institutions require trust in these systems and, more importantly, trust in the individuals envisioning and implementing these new technologies. Trexin has both the expertise and passion to meet the growing interest in financial technology supplementing compliance and regulatory reporting. With the strength and speed of technology, financial-services compliance teams can renegotiate their functions in the workplace and assert themselves in more influential capacities at the front office. Reasserting interest in these technologies and meeting with the professional services team that can get the job done is a critical first step towards innovating in the new RegTech universe.

This TIP was written by Joe Oliva, an Associate at Trexin. Joe welcomes comments and discussion on this topic and can be reached at joe.oliva@trexin.com.

[4] https://internationalbanker.com/technology/spotlight-compliance-costs-banks-get-business-ai/